

• THE JOHNSON MATTHEY AFFAIR

If you read about Johnson Matthey Bankers last year, when the saga began, the story was straightforward. A small, fast growing bank with inexperienced management incurred large losses and had to be rescued by the Bank of England when no private buyer could be found and the bank's major shareholder, Charter Consolidated, decided to walk away from the mess. In the wake of the collapse of Continental Illinois in the United States, the Bank of England was left with no alternative to nationalisation, firstly, because of the paramount importance of maintaining the integrity of the banking system and secondly, because Johnson Matthey was also a member of the gold market and no-one wanted that to migrate to Switzerland.

Move forward a couple of months and the complacent belief in the innate superiority of Britain's system of banking supervision, and its much vaunted capacity for quick thinking and quick action, had changed; and the story with it. The banks, merchant banks and members of the gold market had put up most of the money for the rescue. They quickly became unhappy with the (in their view) disproportionate burdens they were being asked to shoulder compared to those of the shareholders and the Bank of England. Once they learnt that the Bank had had, or should have had, its suspicions aroused some months previously, they felt rather more strongly about being asked to accept responsibility for other people's incompetence. So they spoke to David Owen and thus transformed the story from a City horror to a Whitehall soap opera which has now gathered a walk-on cast of hit-men, 'businessmen' and libel lawyers.

Johnson Matthey Bankers (JMB) was a small bank. Its loan book was barely 1% of the size of, say, Barclay's. Its status was that of a bank, rather than one of the second class institutions that are merely 'licensed to take deposits'. As a bank it was assumed to be competent and not to need close supervision by the Bank of England.

Yet with the best will in the world it would be difficult to exonerate the Bank. Its 'definitive' version of events is contained in its annual report. There, it said, it found no evidence of fraud, merely a high degree of incompetence: by JMB for concentrating its lending on two risky companies; by the bank's auditors, Arthur Young, for failing to notice that JMB's exposure to these loans was under-estimated by a half; and by the Bank of England's supervision department.



March returns, due in mid-April, were not received until June; and the Bank did not then manage to meet JMB to discuss the worsening situation until August.

Barely six weeks after publishing this account, the Bank called in the fraud squad. Such a performance would do little credit to a bottom rung social services department; and how much less for the reputation of the supple, sensitive, responsive form of supervision for which the Bank of England is famed.

There has been an enquiry by senior Treasury and Bank of England officials. They have recommended the kind of sensible reforms of which the president of Belgium's Commission Bancaire has said, 'Prepare for bank failure, in the sense that at the moment when one does fail, Parliament will demand change. Instead of having to enact somewhat rash legislation, prepare one, have it in your back drawer and present it when opportunity necessitates.'

Without two further factors, however, it is unlikely that the story would have rolled on for nearly a year. For the startling fact is that neither the Conservative Party nor the Government nor the City has done more than offer grudging support to the Bank of England. For an institution which is the Government's outpost in the City and the City's spokesperson with the Government such a situation needs explaining.

The Government's side is simple. It has been embarrassed politically by the discipline of 'market forces' seeming to apply to industry but not to finance; secondly, the Chancellor of the Exchequer feels he has been inadequately consulted and blames the Bank for his having made a misleading statement to the House of Commons on the level of public funds involved in the rescue; and thirdly, there is little love lost between the Chancellor and the Bank's deputy governor whose long held doubts about Mr Lawson's method of measuring monetary aggregates have long been vindicated. Of these three the first is true but unavoidable; the second is true but irrelevant, for having nationalised JMB the Bank of England was bound to be liable for any debts that subsequently emerged. Only the third remains.

The City's withholding of support is more complex. In part, the clearing banks feel the Bank of England has not represented them very well. This Government, they remember, imposed a windfall profits tax on them and last year, much to their dismay, forced them to levy a composite rate tax on bank deposits. In part, it is because JMB's collapse came at the worst moment for an industry gearing up to sell every conceivable financial service

without any unmanageable conflicts of interest; and all to be supervised by the practitioners themselves.

Taken together with malpractice at Lloyds, the insurance market, the JMB debacle has dealt, as the *Financial Times* argues, 'a serious blow to the City's claims to be regulated on its own terms'. Or would have done, if it were not for the alternative: the supine inactivity of the Department of Trade and Industry and the Department of Public Prosecutions when faced with evidence of financial sharp practice.

Furthermore, the financial community is not as robust as it was before the problem of Third World debt was acknowledged. The Bank of England and other banks and central banks throughout the world have been trying to winch the system back to health. This year, for example, the Bank of England allowed British banks to strengthen their capital base by raising more than \$3.5 billion in non-equity perpetual loans, which, unusually, it said could count as primary capital.

Individual banks will thereby be able to expand their lending (and in theory their earnings and profits); but many of the buyers of these perpetual loans have been fellow financial institutions. Should the world economy move into recession or the loans turn bad, the risk will still be concentrated within the financial community and these large capital ratios will turn out not to have been bulwarks and not to have strengthened the banking system at all.

Already the credit rating of many banks has slipped. Solvent countries, such as Sweden, and blue chip companies can actually borrow money in the world's capital markets more cheaply than banks which tend increasingly not to make large loans,

but instead to arrange for companies like ICI to borrow their money directly from depositors. The banks earn a fee for their service, for what they are essentially doing is to enable their clients to make repeated borrowings for short periods over the medium term by guaranteeing that the money will be forthcoming should the markets turn sour, or the company's performance slacken.

When a bank makes a loan, it allocates to it some of its capital in case the debt proves bad. But the beauty (or the danger) of these fashionable new devices like note issuance facilities, currency swaps and interest rate swaps is that banks do not have to allocate scarce capital to these underwriting commitments. They can, instead, expand their earnings as if there were no risk attached; and they have. Last year some \$80 billion of swaps and \$17.4 billion of Euronote issuance facilities (up from \$0.4 billion in 1980) were arranged.

For banks trying to bolster their capital, their reserves and to increase their earnings and profits, the surface attractions of accumulating hitherto unquantified risks are considerable. For the banking system and its supervisors (and the Bank of England has moved more decisively in this area than other central banks) the problem is acute. Trying to limit risk suggests restrictions; but to be restrictive is to ensure that banks' earnings, profits and capital will increase but slowly.

Which brings us back to JMB, the Bank of England and the banking community's silence. For the disquieting thought remains that if the Bank has difficulties supervising a small, uncomplicated bank, its judgement may be questionable in other less clear-cut, but no less important, areas.

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