PRIME MINISTER 11 June 1985

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The Bank of England's supervision of JMB was clearly inadequate. And after JMB had got into difficulties the Bank was wrong to rescue them. The Chancellor knows this. It was the Governor's responsibility - not his. But it is difficult for him to comment in public as it damages relations with the Governor and exposes the Bank of England to the charge of incompetence. That is why the draft statement just says 'In mounting the rescue I am satisfied that the Governor was acting properly within his discretion'. But can the Chancellor sustain his Pontius Pilate position in the House when David Owen and Dennis Skinner ask:

- Why did it take the Bank six months to grasp a problem which first emerged in March 1984?
- Does the Chancellor believe that it was right to rescue JMB?
- Is the Chancellor satisfied with the Bank's supervision of JMB?

You may want to discuss the handling of these questions.

Politically, the best bit of his statement is the announcement that Arthur Young will be sued for their incompetence in auditing JMB. This is good but there is a risk that Arthur Young might join the Bank of England in the suit. What is the Chancellor's assessment?

At no point do the papers discuss the criteria which the Bank of England apply in deciding whether to rescue a bank. Our impression (and the City's) is that they are committed to sustaining any institution called a bank but not all licensed deposit-takers (LDTs). Yet because "banks" are

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thought to be so reliable and trustworthy they are supervised more loosely than LDTs. So the least work is done where the risk to public funds is greatest. It is right to eliminate the LDT/Bank distinction. But it must be made very clear that financial institutions will only be rescued in the most extreme circumstances and that whether they are called "banks" is irrelevant. It would be wrong to widen the number of institutions the Bank may be forced to take over. And they must be better supervised.

We endorse the detailed proposals for improved supervisory arrangements. In particular, improved communications between auditors and supervisors are sensible. But we have three questions:

i. UK banks are expected to stand behind their foreign subsidiaries. Isn't this an important gap in our supervisory arrangements (eg Midland/Crocker)?

ii. What about requiring more detailed disclosure in banks' accounts. JMB clearly made inadequate provision. Proper reporting of non-performing loans as in the US might be an improvement.

ii. Limiting a bank's exposure to any one borrower to 25% of its capital base could significantly affect its lending activities. A major bank's exposure to a major multinational or indeed HMG could be larger. Do we need to specify a figure?

Whatever the supervisory arrangements, financial institutions will carry on failing just like other commercial firms. We should not take responsibility away from management and take risks away from shareholders. We can't be responsible for failed banks and must not find ourselves morally obliged to bale them all out. There is already a comprehensive Deposit Protection Scheme.

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