

RETURN to an Order of the Honourable the  
House of Commons dated 1 December 1977 for

**Report by the Committee of  
Inquiry appointed by the  
Minister of Overseas  
Development into the  
circumstances which led to  
the Crown Agents requesting  
financial assistance from the  
Government in 1974**

*Chairman:* His Honour Judge E. S. Fay, Q.C.,  
Sir Edmund Compton, G.C.B., K.B.E.  
P. Godfrey, F.C.A.

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HER MAJESTY'S STATIONERY OFFICE



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## THE CROWN AGENTS

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## Glossary of Abbreviations

BI	Sterling money market section of the Banking Department
Barclays	Barclays Hotel Group
BEC	Business Expansion Consultants Ltd
Big City Finance	Big City Finance Ltd (formerly Sterling Industrial Securities Ltd to 1969 and then Sterling Industrial Securities (London) Ltd to 1973.)
C & AG	Comptroller and Auditor General
Casserley	Casserley Hotels Ltd
CEO	Chief executive officer
Continental Illinois	Continental Illinois National Bank and Trust Company of Chicago
DGOAS	Director General of Overseas Audit Service
E & AD	Exchequer and Audit Department
E & C	English and Continental group of companies
E & C Property	English and Continental Property Co Ltd
E & C Homes	English and Continental Homes Ltd
E & C Investments	English and Continental Investments Ltd
FCO/ODA	Overseas Development Administration as part of the Foreign and Commonwealth Office
Fenston syndicate	The interests of the late Mr Felix Fenston, Prince Radziwill and Mr M F Rawlence
Finvest	Finance Department Investment Account
FMI	Four Millbank Investments Ltd
FMN	Four Millbank Nominees Ltd
FNFC	First National Finance Corporation Ltd
FS	Financial Services Department of the Finance Directorate
GCA	GCA Capital Corporation
Gramco	Gramco Management Ltd
HEO	Higher executive officer
JCF	Joint Consolidated Fund
JMF	Joint Miscellaneous Fund
Lanray	Lanray Industries Ltd
MIF	Marine Insurance Fund

<b>Ministry</b>	Ministry for Overseas Development which was at one time the Overseas Development Administration, Foreign and Commonwealth Office
<b>MTS</b>	Millbank Technical Services Ltd
<b>ODM</b>	Ministry for Overseas Development
<b>Pennine</b>	Pennine Company Ltd. The corporate embodiment of the Fenston syndicate
<b>POSSFUND</b>	Post Office Staff Superannuation Fund
<b>Sassoons</b>	E D Sassoon Banking Co Ltd—The London company
<b>Sassoon Bahamas</b>	C A Bank and Trust International Ltd (formerly E D Sassoon Bank and Trust International Ltd)
<b>SEO</b>	Senior executive officer
<b>SIS</b>	Sterling Industrial Securities Ltd
<b>Triumph</b>	Triumph Investment Trust Ltd
<b>V &amp; G</b>	Vehicle and General Insurance Co Ltd.

## THE CROWN AGENTS

### I Introduction

1. In December 1974 The Crown Agents for Oversea Governments and Administrations ('the Crown Agents') made a formal request to the Government for financial assistance, and were provided with a recoverable grant of £85m. On 23 April 1975 we were appointed to be a Committee of Inquiry with the following terms of reference:

To inquire into the circumstances which led to the Crown Agents requesting financial assistance from the Government.

2. We have met on 85 occasions and have taken evidence from 46 witnesses. We have made our own investigation of the accounts and records of the Crown Agents and other bodies, and in this respect we have been greatly assisted by the results of detailed investigations made by Coopers & Lybrand, Chartered Accountants, on behalf of the present administration of the Crown Agents, all of which have been made available to us.

3. We have conducted our proceedings upon the analogy of an investigation under sections 164 and 165 of the Companies Act, 1948. But because the Crown Agents are not a company we could not be given the compulsory powers conferred upon inspectors under the Act, and we have had no authority to demand information, whether documentary or oral, from anyone. Nevertheless we have met with complete co-operation from the existing staff of the Crown Agents and from government departments, and a large measure of co-operation from other bodies and persons. There were however three individuals whose evidence would have assisted us but who have not given evidence. The first of these is Mr Bernard Wheatley the Crown Agents' former sterling money market manager. Mr Wheatley died in July 1977; at the time of his death he was awaiting trial upon charges of corruption arising out of certain matters falling within our terms of reference. In those circumstances it was proper for him to decline, as he did, to give evidence to us. The same matters are the foundation of charges of corruption now pending against Mr Sidney Finley, a financier whose companies are mentioned at paras 68-72 and elsewhere. He too has not given evidence. Because these matters are sub judice we do not deal with them in this Report, which we understand is to be published, but have reported on them separately. The third potential witness is a solicitor practising in London, Mr Sidney Davidson. There are, as will be seen, a number of matters upon which he could have helped us, but he has not seen fit either to answer our letters or to respond to our telephoned messages, and we must assume that he declines to give evidence.

4. The Ministry concerned with the Crown Agents has had different names during different parts of the period with which we are concerned. From 1961 to October 1964 it was the Department of Technical Co-operation; thenceforth it was the Ministry of Overseas Development, except from June 1970 to March 1974 when it was the Overseas Development Administration (ODA) within the Foreign and Commonwealth Office. We refer to the department throughout as 'the Ministry' and to its head as 'the Minister'. We have also adopted the practice of referring throughout to individuals by their present designation, although they may not have been so known at the relevant time. Thus, we refer

to the former Crown Agent as Sir Claude Hayes both before and after the date when he was knighted.

5. Our investigations have shown that our Report must deal with three broad topics, viz: (1) how it came about that the Crown Agents grew into a secondary or fringe bank and property developer operating on their own account and frequently in a speculative market; (2) how it came about that those operations led to huge losses; and (3) why there were not any controls, external or internal, sufficient to prevent the catastrophe. Catastrophe is not too strong a word to use; the amount written off or provided for in the last audited accounts was £212m and if the Crown Agents were a commercial concern and had in consequence to cease trading because of insolvency that figure would be the probable measure of the deficiency involved.

6. Having said that, we must emphasise that what went wrong was a part only of the Crown Agents' financial activities, and that those activities themselves form a part only of the Crown Agents' total business. The great bulk of their activity is their traditional function of procurement as agent for their principals. This is valuable and is not criticised. Within the financial field, no criticism has been directed at their management of specific portfolios for principals, an activity handling some £950m at one time. The troubles affected only their 'own account' operations, and only a part of these. Only a few individuals out of the many hundreds employed by the Crown Agents were engaged in this activity. The sad fact is that these few managed to involve the organisation in such inferior investments that the enormous provision mentioned above has had to be made. But as the unfortunate story unfolds it is right to bear in mind that throughout the relevant period, although the Crown Agents incurred comparatively small losses at times on their agency work, the great bulk of their business was proceeding satisfactorily.

## **II Historical Background**

7. The roots of the trouble lie in the past, and in order to understand what happened and why it happened it is necessary to glance at the Crown Agents' history and to examine in a little more detail their process of adaptation to modern conditions.

8. In colonial days the Crown Agents were officially—and correctly—known as the Crown Agents for the Colonies. The principals for whom they acted as agents were colonial governments, to which as time went on were added public authorities in the colonies, such as municipalities and utilities boards. The one, two or more individuals who were the Crown Agents were appointed by the Secretary of State for the Colonies, but because their work was for colonial governments and not for the United Kingdom government their appointments were made under the royal prerogative and not under Parliamentary authority. Their employees were Crown servants but not civil servants. The organisation collectively referred to as 'the Crown Agents' was not a body corporate but was described by the constitutional lawyers as 'an emanation of the Crown'. They were a sizeable organisation occupying their dignified headquarters at 4 Millbank and offices elsewhere in different parts of the world, and employing a substantial staff—1,600 in 1960. Their main work was the procurement of supplies, from

small consignments of goods to major plant and equipment, but as the demand arose they had added many other services, including stamp issue, marine insurance, inspection facilities, and recruitment and other personnel services.

9. Among the other services dating from colonial days were those in the financial field. The Crown Agents floated loans for colonial governments and managed the investment of funds for their principals, either in specific portfolios or by way of accepting moneys upon which they paid interest. The last named activity gave rise to two funds, the 'Joint Consolidated Fund (JCF), which received government money, and the Joint Miscellaneous Fund (JMF) which accepted the funds of the other principals. Prior to 1965 the moneys accepted into these funds were at call, but in that year the practice commenced of accepting term deposits. The Crown Agents also operated a marine insurance business for their principals, and the accounts of this were kept separately, as the Marine Insurance Fund (MIF). The management of these funds was traditionally governed by two guiding principles, one that funds should only be invested in first-class securities, the other that the exercise should be non-profit-making. The JCF, the JMF and the MIF were regarded as principals' money. The Crown Agents had their own funds, the Office Fund, derived from the charges made for their services, but those charges were intended to do no more than pay the costs of running the organisation. A low ceiling was placed on the reserve which the Office Fund might accumulate (towards the end of this epoch it was £250,000) and if the Crown Agents earned more than this amount the surplus was distributed among their principals. In essence they were a co-operative. One feature of the accounts, not irrelevant to our inquiry, was that the Office Fund and the MIF were audited by the Comptroller and Auditor General, but the accounts of the JCF and the JMF were audited by the Director-General of the Overseas Audit Service.

10. In the colonial period the Secretary of State exercised a general supervision over the Crown Agents. This appears to have stemmed in practice largely from his control over and responsibility for their principals, combined with his power to appoint and to dismiss the Crown Agents themselves. This feature of the relationship with Government was later to cause confusion and controversy.

11. With the dissolution of the colonial Empire the Crown Agents' status was inevitably changed, and changed fundamentally. In 1954 the organisation changed its name to 'The Crown Agents for Oversea Governments and Administrations'. With the exception of the few remaining colonies and dependencies it became true to say that they no longer had a captive clientele, and no longer were their principals subject to any control or supervision by the British government. Indeed more than one of the newly emancipated members of the Commonwealth celebrated independence by discontinuing the Crown Agents connection. At one time the opinion was widely held that the Crown Agents would wither away and eventually vanish. Work declined, and the staff was reduced from 1,600 in 1960 to 1,400 in 1963. These were traumatic times. But slowly it came to be seen that the collection of specialised services and expertise offered by this long-lived organisation fulfilled a real and continuing need. The Crown Agents set out to maintain and if possible expand services. There were a number of excellent reasons why they should take this course, such as the needs of the developing world, retaining the British connection, and contributing to the balance of

payments, but the motive power which enabled them to do so successfully was undoubtedly self-interest. It was a large and elaborate organisation composed almost entirely of individuals who had entered it young and made it their life's work. They were unwilling to face the prospect of redundancy, even though they were told that they would if necessary be absorbed in the home civil service. The organisation as a whole exhibited a remarkable will to live and in facing the dramatically changed circumstances it was willing to look at new ideas and willing to shed old constraints.

12. This outlook was undoubtedly sharpened by the belief prevalent throughout the organisation that the government had washed its hands of them. Numerous witnesses assured us that Sir Stephen Luke, the Senior Crown Agent until 1968, had been told by a Minister that 'you are on your own'. This however was not Sir Stephen's recollection. He said:

'I have no recollection of that statement and I very much doubt whether it was ever made'.

The only contemporary documentary evidence supporting it is a note made by Mr Dennis Vosper, then Minister of State at the Department of Technical Co-operation, regarding a meeting on 2 April 1963 with Sir Stephen. Discussing the possibility of crisis, the note says:

'When asked about the action to be taken if a crisis did arise, Sir Stephen said that he would undoubtedly be pressed to ask for a government grant, but that he did not think this stood much chance of success (I think this would be entirely wrong). Thereafter, as things stood at present, he supposed that he would have to come to the Secretary for Technical Co-operation to say they could not carry on any longer.'

13. Sir Stephen accepted that he told his staff that they were on their own: 'By 1961-62 our free reserves were down to about £180,000 and we were in a state of financial anxiety. I kept in close touch with the Department of Technical Co-operation and the Ministry of Overseas Development throughout that period. I neither asked for British Government support, nor did they give any hint that it would be forthcoming. It seemed to me at the time—and I told my staff to that effect—that the Crown Agents could not expect government support at that stage.'

The 'on your own' principle was clearly true as regards agency work for independent governments and no doubt it was also true in the sense that the government would not prevent the decay or death of the organisation; but unfortunately the 'on your own' proposition was carried in the minds of many to the extreme point of meaning that the government would repudiate liability for the Crown Agents' own debts. Sir Stephen himself seems to have subscribed to this view, saying 'I do not think I personally ever thought that the British Government had any residual liability for the Crown Agents'. But this was because he regarded it as an academic question: 'It was never part of my thinking that we could, under any circumstances, allow a situation to arise under which the British Government would have to pick up a residual liability.' The changes which we are about to describe led to the matter ceasing to be academic, and we shall see in due course that its implications were duly appreciated by the relevant government agencies. But not by officials at Millbank: they retained throughout

the impression that they were without any government backing at all, and this was ultimately to enhance the magnitude of the collapse.

14. The main period of transformation in the process of converting the Crown Agents for the Colonies into the Crown Agents of today was the 1960's or, what is much the same, Sir Stephen Luke's tenure of office as Senior Crown Agent. He held that office from 1959 to 1968. 1959 was a time of traumatic shock and sombre outlook, but by 1968 the Crown Agents had emerged as viable, with enhanced turnover, with former principals returning as clients, and with new clients seeking their services. This was an achievement of which Sir Stephen Luke may be rightly proud and one which must be remembered as the background of events which we may have to criticise.

15. A number of the changes made during this period are relevant to our inquiry. On the organisational side a Board was set up in 1964 and a number of limited companies were incorporated: Four Millbank Nominees Ltd (FMN) in 1963, what is now Four Millbank Investments (FMI) in 1963, and Millbank Technical Services (MTS) in 1967. The new Board consisted of senior officers; it could in the nature of things be only advisory and its power depended upon how far the Senior Crown Agent was willing to heed its advice or implement its decisions. Sir Stephen made full use of its services and found it a valuable policy-making body. Of the companies, the nominee company was a vehicle for holding portfolio investments for principals and later for holding assets for the Crown Agents themselves. MTS was set up to improve major procurement functions by itself putting together the items for a large contract and re-selling the whole package to the principal. FMI had originally been called Four Millbank Unit Trust Fund Managers Ltd; it had been formed to operate a projected unit trust scheme which never came to fruition and it remained dormant until it changed its name to FMI and became the company through which the Crown Agents held long-term investments in subsidiary and associated companies. Its Articles of Association were unusual in that they vested final authority in all matters with regard to the company's business in the Governing Director, who at all material times was the Senior Crown Agent. This effectively relegated the Board of Directors of the company to the same advisory status as that of the members of the Crown Agents Board.

16. These companies overcame the difficulties arising from the unincorporated status of the Crown Agents. Throughout this period much discussion went on about adjusting that status to the changed circumstances of the time, and at one time incorporation by royal charter was proposed, but no constitutional change in fact took place. At a lower organisational level a report was commissioned in 1967 from Urwick Orr & Partners, the management consultants; the relevant recommendations of their report, made in 1968, will be referred to later (para 38 below).

17. On the financial side, the first steps were taken to depart from the former guiding principles (Para 9 above). In March 1966 the Finance Directorate put up a paper entitled 'Field of Investment' to the Board. This is reproduced at Appendix I, and it was accepted by the Board. Its major influence on future events lay in its proposal that 'funds under the direct control of the Crown Agents, viz, the Office Funds, the Joint Funds and the MIF should be invested at the discretion of the Crown Agents'. More far-reaching was the abandonment

of the co-operative principle with its accompanying restraint on profits and reserves. In March 1967 the Finance Director produced a paper on 'Office Reserves', reproduced at Appendix II. This, it will be seen, advocated the building up of a reserve of £3m by the end of 1971 and of £7m as the ultimate target. Of the contingencies contemplated as the reason for accumulating a reserve the largest in monetary terms is the shut-down of the office, and it is significant that this was still in 1967 regarded as a possibility to be taken into consideration. The reserve, it was suggested, would be attained partly by taking in existing specific reserves and partly by setting aside additional revenue of £400,000 a year. This paper came before the Board meeting of 21 March 1967 and was approved. It will be seen that in section C of this paper the marine insurance reserve is listed among the existing specific reserves to be taken over. This is significant because these reserves, the accumulated profits of the MIF, had originally been thought to be principals' money. In 1966 the Crown Agents had taken counsel's opinion on the status of this fund and had been advised that the reserves of the fund belonged to the Crown Agents and not to the principals insuring with the fund. In the 1967 accounts this reserve was transferred to the Office Fund.

18. These two changes, the abandonment of a strictly limited field for investment, and the proposed gradual creation of a substantial reserve, were the pre-conditions to the next change in financial operations and the one which led directly to the subject-matter of this inquiry. This was the introduction of financial operations by the Crown Agents no longer as agents but on their own account. Unlike the other two changes this, the most fundamental, was not the subject of a paper. Several different classes of own-account operations started in a small way early in 1967. Of these classes the most significant is that composed of the transactions soon to be known as Finvest, a contraction of 'F Department Investment Account'. This was first mentioned in the Board minutes of 23 May 1967, where, sandwiched between the taking note of the financial report for April and a section about poor publicity, there appears this paragraph, quoted here in its entirety:

'Arising out of the high standing of the Crown Agents in City financial circles we were now being approached by Banks etc, wishing to lodge money with us at short notice. Profit derived from such transactions depends both on the state of the market and on the departmental skill. Although there is a possibility (albeit remote) of loss attaching to these transactions the extent of the profit so far obtained and to be expected justified this new venture.'

### **III Origin of Own Account Activities**

#### **(1) Finvest**

19. From the above minute the surprising fact emerges that the scheme was already being operated, although never approved by the Board. Its first recorded transaction was in fact on 22 March 1967. Its genesis is obscure. We were told by one witness that it originated when the money market manager reported that the money market, in which he was of course continually investing, offered to lend as well as borrow. It was undoubtedly connected with the search, especially from the Finance Department, for additional revenue in order to build up the reserve.



Sir Stephen Luke regarded such a build-up as essential. Referring to the loss of business in the early 60's he said when giving evidence to us:

'Those years were a traumatic experience for us and we determined that as our conditions improved and as our financial resources improved and our prospects improved, we would build up a financial reserve which would be adequate to meet the normal fluctuations in our business.'

Another Crown Agent, Mr E A Morris, who was number 2 in the hierarchy, had minuted Sir Stephen Luke in September 1966 expressing alarm at a deficit of £140,000 forecast by the Accountant for 1967, and proposing that the Finance Directorate's contribution to the income should be increased. Sir Stephen concurred, and a paper on the subject was prepared in December 1966 by the Head of Finance, and endorsed by the Director of Finance. This did not refer to own account operations and dealt with the conventional source of increased income, namely increased charges. But immediately on the heels of this exercise in the matching of the Finance Directorate's revenue to expenditure (December 1966) came the requirement of extra funds for the new reserve (March 1967). Clearly by May 1967, the date of the first report to the Board of own-account operations, the need for an increase in the Finance Directorate's revenue was in the forefront of the minds of those concerned, and thus the suggestion of borrowing in order to re-lend or invest at a profit fell upon receptive ears. And it proved successful. On 11 July 1968, a year after the above-cited minute, the Board were minuting as follows:

'While revenue from traditional functions was falling the new areas of business were making profits which have not so far been included in reports to the Board. Up to the end of May the F D Account had produced a profit of £623,000 part of which after making proper provision for an operating reserve, could and should be transferred to the Office Reserve.'

Events moved fast, and in his next monthly report the Accountant recorded that:

'To meet the expressed wish of the Board that the surplus earned by F Department Investment Account (FINVEST) should be taken into account in assessing the financial progress of the Office through the year, proposals have been agreed with the Head of F Department for a monthly credit to the office on the basis described below.'

That basis was firstly that "the first £250,000 of surplus will be regarded as a reserve against the possibility of loss which, though slight, must be acknowledged to exist," and secondly that each month one twelfth of the excess of the surplus over £250,000 should be credited to the Office account but re-lent to Finvest and not withdrawn unless needed to maintain the liquid position of the Office.

20. All this was likely to commend itself to those searching for a means of turning a forecast deficit into a profit available to build up a reserve fund. We have only found two officials who viewed the development with caution. One was Mr Morris. Upon reading the Accountant's July report summarised above he wrote as follows:

'I must decline to comment on the arrangements proposed for dealing with the Finvest income until I know what Finvest itself is all about. My ignorance

is, I am sure, shared by most other Directors and the time has now come for the Board to be given the following information and any other relevant facts:

- 1 The source(s) of the money invested.
- 2 How and where investment is undertaken.
- 3 Who operates the investments and what higher supervision is applied.
- 4 Whether a clear distinction can be made between surpluses which can be 'creamed off' and 'paper' profits.
- 5 Whether the accounting and reserves arrangements can be put on a similar footing to the new MIF scheme.
- 6 To what extent Office Funds may be at risk.

If we can have basic facts on these lines the Board can begin to consider policy.'

Mr Morris's questions were answered in an important document signed by the Director of Finance on 13 August 1968. This is set out in Appendix III. This is a valuable account, setting out as it does the facts relating to Finvest at a crucial point in its history. While it does not give a precise figure for the size of the Fund—understandably because it would vary from day to day—it does speak of borrowings as 'of the order of up to £50m'. It was still under eighteen months old: a lusty infant. A striking feature of this paper is its imprecision; eg in describing one field of investment as 'various financial institutions'. The operation generally was described to us by Mr Challis as 'building up a banking operation with the object of making money by it'.

21. The other critic was Mr Nowers, the accountant. It is important to note that he was the accountant only of the Office Fund. He was not allowed to deal in detail with the Finance Directorate accounts; he was merely given the figures to incorporate in his accounts, so far as relevant. In the July report mentioned above he said:

'There remains for consideration the revenue from Finvest. Whatever the merits or otherwise of taking this into account as part of the regular revenue of the Office there can be no doubt that the Board would be most ill-advised to consider taking credit for these earnings at any higher rate than their current rate of accumulation. In the quarter under review this represented an annual rate of about £320,000. One must hope that this will continue or perhaps increase but the hazards to which these operations are exposed should not be overlooked. A strongly rising stock market combined with the boom in Australian mineral shares, a boom with few if any precedents, has presented opportunities for gains on a very large scale. Historically every rising market has been followed eventually by a decline. A break in the market, whenever it comes, could cause losses in the market value of investments held and will markedly reduce the opportunities of gains from shares whose performance is much above the average . . . It seems probable that Finvest will contribute enough in the current year to offset a deficit on all other activities and to produce a small overall surplus. The Board should not rely on sufficient to cover what may well be a larger deficit in 1969.'

22. Here it is necessary to pause and see what the Finvest operation originally was and how it was originally regarded by the Crown Agents. It was at first

intended to be, to use Sir Stephen Luke's phrase to us, 'a low-key operation'. Mr E Osgodby, then in the private office of the Senior Crown Agent, told us: 'to my knowledge there was no detailed discussion, certainly not at Crown Agents board level, when the Finvest operation got off the ground'. The original idea was to obtain funds by borrowing on the money market and to lend those funds to first-class institutions requiring them. By using expert knowledge of the money market gained over years of investing principals' funds, the Crown Agents, so they asserted, could gain a fraction of a percent on the deal. Borrowing on the market was said to be necessary because the funds deposited by principals could not be used.

23. In his evidence to us Mr Barley, the Director of Finance at that time, emphasised to us the non-profit-making, or co-operative, view which he said was still taken of principals' deposits:

'Our policy then was that any capital accretion due to our management of the JCF and the JMF was credited to the funds themselves and not to us.'

Because of this, the joint funds, he said, could not be used in Finvest:

A The conclusion, I came to was this: this was an additional source of revenue that we could acquire, but that we could not do it with our principals' funds.

Q When you say you could not do it, do you mean there was some physical reason why you could not do it, or that it was inadvisable?

A There was no physical reason; but the policy had always been that whenever we operated on behalf of our principals, the benefit should go to them.

Q That means you had to find some other funds?

A Yes.

Q What did you do about that?

A There was no difficulty there because all our business had been one way, in the sense that we were receiving moneys from abroad and we were placing it out in the London money markets. When it became known that we were considering taking money from the London money markets we found little difficulty in obtaining deposits from various sources.

24. Thus we were presented with a clear picture of Finvest as operating solely with funds borrowed on the money market and used to re-lend at a small turn. But the records tell another story. In 1968, before Mr Barley left the Directorship of Finance, principals' moneys started being used in Finvest. This was effected by taking principals' term deposits into Finvest instead of into the joint funds. And there was no legal reason why this should not be done. The Crown Agents knew this because when counsel gave his opinion on the status of the MIF in 1966 (para 17 above) he had not limited his views to that fund. He had said:

'No principal would have any interest in or rights against any profits or surplus of the Crown Agents, whether in the Marine Insurance Fund or in any other reserve. The Crown Agents would thus be free to apply any part of the surplus in the Marine Insurance Fund, or other surplus profits from other activities, for any other purpose for the direct or indirect benefit of Overseas Governments and public authorities within the ambit of such general direc-

tions as the Crown Agents have from time to time received from the Colonial Office or from any other relevant British Government Department.’

As to the use made of the funds, they were by no means limited to relending at a small turn: as early as May 1967 they were being used to trade in gilts, and before long the speculation extended to buying commodities such as silver, and to buying Australian mining shares and other equities.

25. The significance of Finvest seems at first to have escaped all but a few minds within the Crown Agents. Whether Sir Stephen Luke appreciated the nature of this development before he retired in September 1968 seems doubtful. In his evidence he mentioned Finvest’s origin as follows:

Q It does not stick in your mind as being some entirely new departure, which caused anxious thought?

A No. Of course in the light of subsequent history one would regard it as very significant. At the time we did not regard it as significant in that sense. We regarded it as an important aspect of our efforts to get financial security and stability; and it was, of course, only an extension of the money market operations that the Crown Agents were performing on behalf of their principals. They then went into the money market on their own.

Q With borrowed money?

A Yes, I mean it was money that they took from one bank and put into another—overnight money and so forth.

26. Looking back on the origin of Finvest the most remarkable fact is the small impact it made within the organisation. It was a novel departure and it does not require hindsight to see that it should have called for both a code of rules and constant monitoring. Yet it seems to have passed into the current operations of the Crown Agents as a necessary part of the changes that were being made to meet changed circumstances. The Finance Directorate is on record as appreciating that there was some risk, but they consistently played it down and gave limited information to the senior Crown Agent. In particular one looks in vain for any appreciation by the Board of the additional risks generated by the movement away from the original operations into less and less secure investment. In evidence to us officers of the Crown Agents have sought to justify the inception of Finvest as (1) needed to supplement the traditional services which could not operate at a profit and could not generate reserves; and (2) designed to utilise the Crown Agents’ first class credit rating, which would enable them to operate at a profit on the inter-bank market. In our view neither proposition is valid. We can understand the contemporary reluctance to raise the charges for the traditional services to the level needed to show a surplus, and we agree that in some cases loss of business might have rendered the operation self-defeating, but the success of the present regime in raising charges without losing business seems to show that the first proposition was invalid. As to the ‘first-class credit rating’, an examination of the Finvest borrowing rates has shown that the Crown Agents were not able to borrow at the inter-bank rate and were only able to make a profit out of borrowed funds by re-lending to secondary borrowers.

## **(2) Other own-account activities**

27. Mention must now be made of three other parallel ‘own-account’

activities outside Finvest but approximately contemporaneous in origin. First the Crown Agents were operating on their own-account in foreign currencies. This operation seems to have originated in dollar payments made by the World Bank to be expended on the purchase of goods and equipment procured through the Crown Agents. The latter credited their principals with the sterling equivalents and treated the dollars as a source of investment on their own behalf. The first of such payments by the World Bank was made in November 1966, and by May 1967 they were accounted for in what was termed the 'Finance Department Overseas Banks Settlement Unit Suspense Account'. Reference to Appendix III will show that by August 1968 these moneys were either banked abroad or invested in European and US bonds and equities. By that time the account was said to show a profit, partly through devaluation, of £378,000. The sterling equivalent of the funds so utilised amounted to £9m at the end of 1968.

28. The other two own-account activities were the acquisition of shares in subsidiary and associated companies, and property investment. The commencement of both these activities is associated with persons introduced to the Crown Agents by one of their officers, namely Mr Bernard Wheatley. Mr Wheatley was then a senior executive officer; in 1966 he had been transferred from the General Department to the Finance Department. When in the General Department he had had charge of such property dealings as the Crown Agents had occasion to transact, and he took this business with him to the Finance Directorate. These transactions were at that time mainly the acquisition for principals of buildings for use as embassies, residencies and the like. Back in 1962 he had met a Mr Ian Abrahams, who was then, with his partner Mr Roe, running a small property developing and managing company called Morley (London) Ltd. It was a modest company: to quote Mr Abrahams, from whom we have taken evidence:

'We started that from scratch. David Roe and I had been in the paint trade together, and we sold our company and went into the property world. We knew very little about it, and we knew a little more about it by the time we finished. We went in in approximately 1960 . . . as developers, agents, general property activities.'

According to Mr Abrahams, his first meeting with Mr Wheatley was fortuitous. They chanced to meet when visiting a property offered for sale; he telephoned Mr Wheatley the next day, and mentioned his company; Mr Wheatley told him that he was interested in leasing premises for High Commissioners' offices. Thereafter Morleys acted in such matters for the Crown Agents.

29. That introduction led to another, and one of considerable significance to the Crown Agents. In about 1964 Mr Abrahams introduced to Mr Wheatley his own solicitor, Mr J J Walker, whom he described as 'a very good young solicitor'. Mr Abrahams and Mr Walker were told at the time that the Crown Agents were in need of a change from their previous solicitors. Mr Walker advised Mr Wheatley successfully on the first problem put to him, and 'having found favour in their eyes as a result of this I was asked to negotiate various small matters connected with overseas governments'. By the time that the own-account activities started Mr Abrahams's firm was established as the Crown Agents' property agents and Mr Walker's firm, Davies Arnold & Cooper, as the Crown Agents' property solicitors. Both firms acted for the Crown Agents on two major purchases of office blocks for their own occupation—St Nicholas

House, at Sutton, Surrey, acquired in 1964 for occupation by various departments, and Luke House, Abbey Orchard Street, Westminster, bought in 1966 for £1,650,000, and later occupied by the Finance Directorate.

30. In 1965 Mr Abrahams and his partner Mr Roe set up Television Recordings Ltd, described as 'a television facility company' or a company for making commercial and other films for television. Early in 1967 Mr Abrahams decided to form a consortium to apply for the Yorkshire television franchise, due to be awarded in April 1967. He secured backing from certain persons in Yorkshire, including Mr Ralph Yablon, Vice Chairman of the Provident Clothing & Supply Co of Bradford, and through Mr Wheatley he approached the Crown Agents. He enlisted their interest; the Crown Agents pledged £1m towards the capital of the proposed programme company, and Sir Stephen Luke undertook to become a director. The consortium was not awarded the franchise, but as a direct result of the meetings of the participants the Crown Agents took an equity interest in two different concerns. The first was a small merchant banking company, the E D Sassoon Banking Company Ltd. During the summer of 1967 Mr Yablon had become aware that a controlling interest in this bank was for sale, and he invited the Crown Agents to join him in the bidding. The upshot was that in November 1967 a 40% shareholding was purchased by Four Millbank Investments for £674,000. The Crown Agents' stated reasons for this new departure were that they wished to offer more sophisticated banking services to their principals, and that it was a means of employing the Office Fund's reserves to advantage. It did not turn out to be a particularly successful enterprise, but its significance lies in two facts. One is that this was the first time in which the Crown Agents had used their own money to buy into a company. To quote Mr Morris's evidence:

'The first occasion on which the Crown Agents took a share in equity in a company was Sassoons. The whole office was agog with this because it was a new thing . . . That was the precedent for taking a share in companies. Thereafter all sorts of companies were participated in.'

Secondly, and unlike Finvest, the transaction was widely discussed not only, as Mr Morris indicated, within the office, but also outside. Sir Stephen reported the proposal to the Ministry of Overseas Development. They consulted the Treasury, who in turn consulted the Bank of England. The Bank disapproved of the original proposal, which was to go into partnership with Mr Yablon alone. They felt that if the Crown Agents wanted to offer banking services to their principals they should set up a specific subsidiary to do it rather than take a small share in a small bank. However, they withdrew their objection when informed that a third partner was to be a leading American bank, Continental Illinois National Bank & Trust Co of Chicago, and when the Crown Agents' stake was increased from the 30% originally proposed to the 40% actually invested.

31. The other investment was in Television Recordings Ltd. Mr Abrahams wanted further capital for this company and approached Sir Stephen Luke, with whom he was by now, he says, on terms of personal friendship. Sir Stephen has told us that he formed the view that a connection with this company would prove beneficial because the Crown Agents were supplying television equipment and systems to principals, and the link would improve their efficiency in this regard. A report was commissioned from Price Waterhouse & Co; this reported

that the company had been making losses and that the prospects were uncertain. Nevertheless in December 1967 the Crown Agents invested £80,000 in shares and also lent the company £90,000. Two Crown Agents officers went on to the board.

32. The Crown Agents' first direct investment in property was made in July 1968 in Australia. They had recently opened an office in Sydney in connection with their general business and had seconded one of their officials, Mr W Walter, to be its manager. They had commenced to take an interest in Australia as a field for investment both for their principals and for themselves: it will be recalled that Finvest had already invested £900,000 in Australian equities by August 1968. At this juncture Sassoons were approached for finance by a property development syndicate headed by the late Mr Felix Fenston and including Prince Radziwill and Mr M F Rawlence. The syndicate had the opportunity of participating with the Anglican Church in Australia in a development of glebe lands at Edgecliff, Sydney. They were seeking financiers with non-sterling funds to lend because this was the period of the Chancellor's request not to lend sterling to fully developed overseas countries. Sassoons did not wish to participate and on 9 February 1968 they passed the proposals put to them by Mr Rawlence on to the Crown Agents, being known to have overseas funds at their disposal.

33. The Crown Agents' officer who dealt with the proposition was Mr J S Shuter, a chief executive officer who was Deputy Head of Finance Department but had no experience of property investment. Indeed no-one in the Crown Agents' finance department was qualified to assess the proposals and the mass of technical detail which accompanied them. Mr Walker, the solicitor mentioned in para 29, was brought in to advise. When we asked Mr Walker about this, he told us:

'I was called in to a meeting which had Mr Rawlence present. I was shown a bundle of files which were very disordered and I was invited to express my views on a transaction in which it was proposed that the Crown Agents could provide finance and Rawlence's syndicate experience, and Crown Agents were to take 20% of profits arising from that and the syndicate 80%. I said, "I really need to read all these papers" and I took all the papers away and I spent the weekend delving into it and produced an initial report which said in fact "You cannot possibly expect anybody to pass judgment on this sort of situation without some local advice".'

On 15 July 1968 Mr Walker submitted a report dealing with the legal aspects of the proposed agreement and with the investment merits of the project. In this report he pointed out that the success of the project depended on whether the rental projections by Mr Rawlence and the property consultant to the Glebe Administration Board (Mr Collier), were achieved and that these were substantially different from figures in a report by Jones, Lang, Wootton, chartered surveyors. Crown Agents were to provide all the finance, estimated at A\$3.3 million and therefore carry all the risks and would receive 10% of any profits (the Glebe Administration Board retained 50%, the other 50% being split 80%: 20% between Mr Fenston's syndicate and the Crown Agents). Mr Fenston's syndicate was to participate through Pennine Company Limited, a Bermudan company and this company was to hold a lease from the Glebe Administration Board.

34. The Crown Agents did not take the local advice that Mr Walker recommended and a Memorandum of Agreement was signed on 23 July 1968, just eight days after the date of his report. It was expressly stated not to bind the parties until formal agreements had been entered into: one provision was that a joint venture agreement should be entered into as soon as possible. Nevertheless the project went ahead in the spring of 1969 although the proposed joint venture agreement between the Crown Agents and Pennine and the lease by the Glebe Administration Board to Pennine were not completed for another two years; an imprudent course of action that could have caused complications had any disagreement arisen between the parties.

35. The Edgecliff development was the Crown Agents first venture into property development, its estimated cost was only some A\$3.3million and at the time the Memorandum of Agreement was signed in July 1968 it appears that just this one development was envisaged, but we were told that it led on quickly to a suggestion, almost certainly by Mr Fenston, that the Crown Agents and Pennine should do more together in Australia. In August 1968 Mr Collier wrote to Mr Rawlence setting out some of the features that were to characterise future joint ventures involving the Crown Agents. He wrote advocating further developments:

‘One or two developments will not change a 99 year lease, run down area into a Hampstead Garden Suburb. One has to stay with the development for quite a time.’

He also stressed that Crown Agents were to provide 100% of the cost of each project. In October Mr Collier wrote again listing a series of proposed developments which were estimated to cost A\$28 million over the period June 1969 to June 1973. As a result of these proposals, a Crown Agents’ team went out to Australia early in 1969 to investigate, and we pick up the story with their visit when we come to the events of that year (para 53 below). What is important to observe at this stage is that within little more than a year after the Crown Agents had taken their first modest steps in ‘own-account’ dealing they were branching out (a) in property, (b) overseas, and (c) in partnership with other entrepreneurs. The person responsible for this expansion was Mr Alan Challis, and we have now reached a point where it becomes necessary to look at the framework within which the staff of the Crown Agents was organised, and to see who were the persons in responsible positions.

#### **IV Organisation of the Finance Directorate in 1968**

36. The Crown Agents’ staff structure was, and still is, organised on civil service lines. The grades and rates of pay are the same. At the top of the pyramid was the Crown Agent, or, when there were more than one, the Senior Crown Agent, with the status, in 1968, of deputy secretary. There have at various times been other Crown Agents, but their title in recent years seems to have been honorific and bestowed on senior officials. In 1968 there were two other Crown Agents—Mr E A Morris, who was in effect the chief administrator, and Mr J H P Hawtrey, the chief engineer. Below the Crown Agents were ranked seven directors, twelve heads of department (including five chief engineers), ten chief executive officers (CEO), 44 senior executive officers (SEO), 114 higher executive



officers (HEO) and on the technical side 25 senior engineers and 152 engineers. The lower grades were executive officer and clerical officer. With the exception of the Senior Crown Agent nearly all administrative posts were held by individuals who had joined the organisation young and worked their way up the ladder of promotion. No one on the administrative side was then recruited with outside experience and this was one feature of the old regime that was not changed with the other changes of the 1960's.

37. Power resided with the Senior Crown Agent. In Sir Stephen Luke's time the advisory board which, as already mentioned (para 15 above) was composed of the seven directors, was a policy-making organ because its decisions were respected. The work of the Crown Agents was divided between the Directorates including the Finance Directorate upon which our attention is centred. The Director of Finance down to 1968 was Mr K W Barley. His no. 2 was known as Head of Finance Department and was Mr A H Challis. The no. 3 was the Deputy Head, Mr J S Shuter, then a CEO. Below him were a number of SEOs, including Mr Norman Hewins, Mr D B Johns and Mr B R Wheatley and a total staff of 76. The Department occupied premises at Luke House, the new office block brought by the Crown Agents in 1967 in Abbey Orchard Street, close to the headquarters at 4 Millbank. All the officials whom we interviewed had joined the Crown Agents young, either as clerical officer or as executive officer. Thus Mr Challis had joined in 1936 at age 17 as a clerical officer. The only outside element in the Finance Directorate was provided by the Equity Investment Advisory Panel, a body formed in 1965 and comprising a stockbroker, an investment fund manager and a merchant banker, who regularly met with officers of the Directorate in order to advise upon principals' equity portfolios.

38. When Urwick, Orr & Partners were briefed in November 1967 their terms of reference were 'to report on management structure with special reference to the working of the board and its committees'. Among the recommendations made in their report dated 7 May 1968 were the strengthening of the board as a policy-making organ, a more independent executive structure, and a liberalising of the attitude to spending and risk-taking. We quote the report: 'the Crown Agents are at a point in their development when a certain amount of adventurous spending will be necessary to secure their future;' and they referred to 'the excesses of caution engendered by a system which is as obsessed as yours is by the importance of avoidance of error'. These consultants were not directly concerned with the work which the departments did, but they did note that 'the services of your Finance Department are also being expanded and strengthened to improve their technical skill'. One of their key recommendations was that the office of Controller should be set up to channel and co-ordinate information for the use of the board. From our point of view this was a most important recommendation. It is contained in a passage set out in full in Appendix IV. The Controller was to head a department including the existing functions of office accounts and office services and to be a member of the strengthened board. Essentially the Controller was to ensure that the board and the Crown Agents knew what was going on. 'We have expanded somewhat on the nature of this function,' say the consultants, 'because it has been a neglected activity in your organisation.' Urwick Orr's report was accepted in its entirety by the Crown Agents.

## V Changes in October 1968

39. Sir Stephen Luke retired on 30 September 1968. He had had a close personal relationship with the Permanent Secretary of the Ministry of Overseas Development, Sir Andrew Cohen, and no problems or difficulties had clouded the relationship between Ministry and Crown Agents during his time. Sir Andrew Cohen died suddenly in June 1968, and was succeeded by Sir Geoffrey Wilson. Before he left office Sir Stephen wrote to Sir Geoffrey a letter dated 5 September 1968 setting out his views of the Crown Agents' position and their relationship with government. This important letter is set out at Appendix V; among its statements is the following:

'As I see it the Senior Crown Agent/Chairman has a dual responsibility: to the Minister, for the efficiency and integrity of his Office, and for the prudent management of its finances; and to his Principals, for the proper fulfilment of their instructions.'

Sir Stephen also referred to now having 'the resources to provide a wider range of sophisticated services' and he concluded with a reference to the Urwick, Orr report:

'These eminent consultants, working within the rigid terms of reference necessarily imposed on them, saw no reason to dissent from the policies that we have been pursuing; what they did say was that our objective of maximum competitive efficiency could be achieved only by a massive decentralisation of responsibility within the Office combined with a far more scientific system of information and control. We must be prepared to take larger risks, and to fuss less about mistakes and errors of judgment. We are all agreed that the consultants' advice must be taken.'

He did not mention Finvest.

40. Sir Stephen Luke was consulted about his successor and recommended that in view of the increasing importance of the Finance Directorate a person should be appointed with banking experience. The Ministry was unable to follow this advice. Sir Stephen said to us:

'Both the Ministry and the Treasury made rather perfunctory efforts to find somebody, but the names they produced, if I remember right, were gentlemen who did not seem to provide the right sort of experience.'

Instead, the official of the Ministry most closely connected with the Crown Agents was appointed. This was Sir Claude Hayes, who since 1964 had been Principal Finance Officer at the Ministry, with the rank of under secretary. His letter of appointment is dated 20 May 1968 and describes the office as 'Senior Crown Agent'. As Principal Finance Officer at the Ministry Sir Claude had acquired some knowledge of the work of the Crown Agents. He told us that he had been 'a type of liaison officer between Sir Andrew Cohen and the Crown Agents'. He knew generally what they were doing, and he knew of the informal talks between Sir Andrew and Sir Stephen.

41. Before he handed over the reins, Sir Stephen took two decisions that were profoundly to affect the subject matter of our inquiry. The first was his decision to replace Mr Barley by Mr Challis in the office of Director of Finance with effect from 1 November 1968. He was clearly impressed, as many people

were, by Mr Challis's personality and apparent skill, and thought he would be more likely than the staid Mr Barley to impress the principals. This was part of the new look of competitive efficiency that he had striven to give to the Crown Agents. Mr Barley was moved sideways to be Director of Personnel.

42. The other decision was to appoint to the office of Controller Mr E J Sayers, who up to then had been head of the Pay Department. Sir Stephen had interpreted the Urwick Orr report as requiring the appointment of an experienced chartered accountant from industry to devise criteria for judging the performance of departments. But he did not wish to bring in an outsider, and he ascertained that Urwick Orr would not regard this as essential. In a letter of 17 May 1968 to Sir Andrew Cohen he said:

'We were a good deal relieved to find out that this was not the consultant's intention; they consider, indeed, that one of our own senior officers could adequately provide the professional expertise if (i) he could have the consultants' help in devising criteria; and (ii) he could be given suitable training in management accounting.'

Why he regarded Mr Sayers as suitable it is difficult to see. Mr Sayers had neither the training nor the experience to be a Controller. His only book-keeping experience was of the elementary kind of cash accounting needed in the Pay Department and, as he pointed out to us, he had served in nearly all departments of the Crown Agents in his time except the Finance Department. His own view was that he was unsuitable. We shall return later to the fate of the Controller; it would probably have failed in any event, but its demise was hastened by this appointment, which we are bound to regard as a serious error of judgment. We must suppose that no one more suitable than Mr Sayers could be found of appropriate rank within the organisation, and we appreciate the point made to us by Sir Stephen that an appointee who already knew the ropes would start with advantages. But the Controller's function—one 'of cardinal importance', to quote Sir Stephen's own phrase—was so fundamental as to demand high qualifications allied to a strong personality, and was so difficult that an appointee from outside unhampered by office history and office friendships would have his own advantages. However Mr Morris has pointed out to us that to bring on to the Board an outsider, perhaps at an exceptional remuneration, would be to cause unrest among the staff. This appointment is one example of the Crown Agents' personnel policy of promoting to a vacancy the next senior person in the organisation without much regard for experience, and of turning their backs on the outside world—a policy partly dictated by the straitjacket of the civil service pay structure. This led to some odd appointments, especially when the Finance Directorate was later expanded. One of the first of these inappropriate appointments was that of Mr Challis's successor as Head of Finance. To this position Mr D W F Clark was appointed by Sir Claude Hayes, he had been acting Head of the Shipping Department. Since joining the Crown Agents in 1937 at 17 he had been in many departments, but never in finance. In evidence to us he said:

'I was completely inadequate for the job and had no previous financial experience or training . . . I was offered the job because there was nobody else in the Crown Agents' organisation with any experience better than I had, and somebody had to fill that hole. It is as simple as that.'

43. Another remarkable appointment of this class was that of the manager of a section set up in 1968 to deal with foreign currency transactions. To this

post there was appointed Mr A J Blundell, a higher executive officer who had spent most of his 20 years with the Crown Agents in the Shipping Department. He had no experience whatsoever of either finance or accounting. He was given no training, and learnt his job from Mr Johns, who had been doing it previously. The following passage from his evidence is illuminating:

Q Had you from your superiors any guidelines upon which to act, or advice, or instructions?

A No. I think it would be fair to say that so far as the Foreign Currency Market was concerned, there was a general lack of knowledge.

Q A general lack of knowledge?

A I would think so, based upon my views arrived at subsequently.

Q You mean within the Finance Department as a whole?

A Yes, it was a new venture for the office.

Having mentioned the oddity of such appointments, we should add at once that Mr Blundell clearly took great pains to learn his way about this strange new world and we shall see later that the losses incurred in his department were largely attributable to transactions which he disliked but where he was overruled by his superiors.

44. By the time of Sir Claude's accession the main lines of the new financial policy had been established. They were (a) to offer a wider range of financial services to principals, (b) to invest principals' money, both specific portfolios and joint funds 'more adventurously', (c) to acquire expertise in hitherto unexplored fields by operating in those fields, and (d) increasingly to finance the organisation and build up reserves by amassing profit on own-account dealing in preference to securing an operating profit on services provided. The framework of the own-account activities, embracing merchant banking operations, equity participations, and property ownership, had been firmly set by the time of Sir Stephen Luke's retirement; the difference between his time and Sir Claude's time was that in the former period the own-account activities, of recent origin, had formed a comparatively small part of the Finance Directorate's operations, whereas soon after the changeover took place they expanded rapidly. We are satisfied that the changes in personnel were a factor in this expansion. No longer was there a Senior Crown Agent who had seen Finvest and the other changes originate and who was in frequent and informal contact with the Permanent Secretary at the Ministry and, no longer was there Mr Barley with the last word on matters financial. Mr Challis was now in the saddle, and above him there was no effective restraint.

45. The growth of Finvest up to the changeover can be briefly summarised. The total amounts borrowed and invested were as follows:

	£m
June 1967	10
December 1967	21
June 1968	47
October 1968	32
December 1968	58

The borrowings were wholly from banks until June 1968, when the Department—taking another fundamental step without any top-level discussion—started injecting principals' money into Finvest: £500,000 by that date, £2m by October, and £10m by December 1968. These were term deposits by principals; hitherto they had been accepted into the joint funds but now they were diverted into Finvest. In the beginning lendings were to banking institutions and local authorities, but as early as July 1967 the fund had started lending to property companies—£65,000 in that month rising to £1,490,000 in April 1968. And, as already mentioned, some of the fund had been invested in equities, starting in December 1967 with £758,000 and rising to £1,744,000 by October and £1,855,000 by December 1968. Fringe banks do not figure among the borrowers until October 1968, when £1,100,000 was lent to First National Finance Corporation.

46. There had been a parallel alteration in the character of the joint funds, the JCF and the JMF. These had shed a large part of the principals' term deposits and were now mostly (so far as sterling was concerned) fed by principals' call money. Hitherto the funds had been put into investments such as deposits with clearing banks, treasury bills and gilt-edged stocks. But by the end of 1968 a trend is discernable towards less secure investments, and the funds' portfolios included trade bills, equities, and deposits with fringe banks. Once Finvest had started taking principals' money, and once the joint funds had started on less secure investment with a view to greater profit there was little to distinguish the two classes of funds save the theory as asserted by Mr Barley (para 23 above) that the joint funds were operated on a non-profit-making principle as trustees for the clients. How this worked was explained by Mr Johns by saying 'the funds were invested to the best advantage and the returns went to the principals . . . in being able to support the interest rates that were being paid'. The confusion of thought over the status of these funds is demonstrated by the fact that during 1968 there were incorporated into the JCF both the "Overseas Banks Settlement Unit Suspense Account" (para 27 above), which was admittedly an own-account activity, and also deposits made by principals in foreign currencies. This last was a new departure starting in 1968 and expanding so rapidly that by September of that year a new Foreign Currency Money Market section was set up to deal with it (para 43 above).

## VI Expansion in 1969

### (1) Finvest

47. In the minutes of the Crown Agents Board meeting of 28 November 1968 it is recorded that 'the Director of Finance was asked to prepare his plans for developing the financing function of the Office and to bring them to the Board for discussion. The Crown Agents would also consider proposals for providing the necessary staff categories or by the recruitment of specialists'. Those plans were formulated in a document dated 16 January 1969 entitled 'Proposed Objectives for 1969' and attached at Appendix VI. This paper is signed by Mr Clark, but that gentleman told us that it was really Mr Challis's paper and not his; indeed Mr Clark could hardly be expected to formulate fundamental policy after only two months' acquaintance with the Finance Directorate.

48. The salient features of this paper are (i) the plan to increase Finvest to £200m within nine months, (ii) the plan to institute a foreign money market

own-account operation, (iii) the proposal in regard to real property 'to intensify investigation into this form of investment on a world-wide basis'. In a covering note to the Board, accompanying this document, Mr Challis, speaking of the £200m target, said:

'This is I believe a realistic target but, even if we were to go flat out to achieve this figure, it would take us several months. Furthermore the mounting of a large financial operation based almost entirely on borrowed money calls for extreme care in management and my intention would be (if the proposal is accepted) that we should proceed with caution towards our ultimate target, having care at all times to maintain very conservative liquidity ratios and demand ratios.'

He thought that within two years it should be possible to produce revenue of the order foreshadowed in the paper, ie just over £1m pa. In an appendix to Mr Clark's paper there were detailed proposals for the staff expansion needed to cope with the increased work, and Mr Challis in his note agreed that more and better paid staff were needed and that a professional accountant should be recruited.

49. The paper was accepted by the Board. No one seems to have appreciated what an extraordinary document it was. In truth it was the prospectus of a sizeable fringe bank operation in divers sections of the financial spectrum and overseas as well as in the UK. It was not reported to the Ministry. The original Finvest had been related to the need to build up a reserve. The quadrupled Finvest was not related to any further need for a greater reserve. On the contrary, in a Board paper of 27 April 1970 Mr Challis argued that the reserve needed could stand at a lesser figure than Mr Barley had suggested in 1967, although he thought that the £7m target should be retained as backing for the Finvest operation.

50. In accordance with the foregoing proposals 1969 saw great expansion in Finvest and the other own-account activities. This was accompanied by the opening of a city office; in July 1969 Mr Wheatley's section moved into Winchester House, adjacent to Sassoon's premises. The increased capital needed came almost entirely from principals. The investment expanded in the categories of property and property companies and commercial concerns and there is clearly discernible the move away from the original concept of safe returns on large sums prudently lent towards longer-term loans and transactions of a more commercial and even speculative character. The shift was made in response to the need to secure a higher return in order to be able to attract deposits and still make a profit. As Mr Challis said in evidence:

'It (sc. the shift) was a response to the need to quote competitive rates in order to obtain deposits, but it was not in fact carried out without recognition of the fact that we were changing the emphasis of the fund, particularly by including property companies.'

Mr Morris put the change in rather different terms:

'We started Finvest with the highest ideals and put money in the best companies but gradually somehow we were more and more in the hands of the secondary banking fraternity perhaps not even as high as that sometimes.'

There was also a shift towards long term ventures:

'In Australia' said Mr Challis, 'we deliberately took a long term view . . . we always had it in mind that Australia was a sort of ten year haul'.

A far cry from the original concept of building reserves by short term gains.

51. As regards direct investment in property, the office of property investment manager was created in May 1969 and Mr P A S Sly was appointed to it. Hitherto Mr Wheatley had dealt with property. So far as we can ascertain, the Crown Agents only direct purchase of property for investment (as opposed to for own occupation or for principals) in the UK prior to Mr Sly's appointment was a transaction negotiated between 1967 and 1969 whereby Mr Abrahams sold them a number of small office blocks for £283,000. Mr Sly was another of the recent recruits to the Finance Directorate. He had joined the Crown Agents in 1949 at the age of 20 and had not served in any financial capacity until August 1968, when he was transferred and began to work under Mr Wheatley as an assistant money market dealer. His experience in property investment was nil. He told us:

'I recall that I was told when I started my section that the Crown Agents had a weakness in the sense they were an investment organisation and had no investment in property apart from their head office and so on, and those two or three blocks we bought around the country. Therefore they said to me "you will be property investment manager and have a sum of money, up to £10m, to invest in property," and it was up to me to decide what was the right sort of line to go into and then seek approval from my immediate superior.'

Mr Sly obtained properties by reading the advertisements in the Estates Gazette or by being approached by vendors' agents. He told us that he was given no guidelines for investment but that he discussed the majority of his deals with the head of his department, Mr Clark, who however had no specialised property knowledge either. The slapdash nature of this exercise is best illustrated in his own words:

Q Were you given instructions about the quality of the property and having reports on it and surveys and the like?

A No, it was left to me. Some of the stuff I bought was top class and some of it, if you like, in terms of an estate agents' language would be poor quality. On the other hand, one paid poor quality prices. One hoped to refurbish it and turn it into select property.

Q It was more or less left to you, was it, is that fair, subject to your superiors' putting the brake on if they thought you were going wrong?

A That is right, that is exactly so.

The Finvest property portfolio had reached £2.8m by the end of 1969.

52. The year 1969 also saw the development of five other major own-account activities. These were (i) expansion in Australian property in conjunction with Mr Fenston; (ii) the formation of Sterling Industrial Securities Ltd; (iii) the purchase of a substantial holding in First National Finance Corporation; (iv) the start of the English and Continental Property Company; and (v) investment in a number of overseas merchant banks.

## **(2) Australia**

53. The initial property venture mentioned in para 35 above, was followed up by the despatch of a Crown Agents' party to Australia in January 1969, briefed to look at the situation and make recommendations. The three members of this delegation were Mr Johns, Mr Hewins and Mr Walker. None of them had visited Australia before. Mr Johns was a senior executive officer with considerable experience in the Finance Department; he was promoted to chief executive officer in April 1969 and in 1970 became Assistant to the Director of Finance. Mr Hewins was another CEO with experience in Finance and was later to become Mr Challis's de facto successor. Between them they were of course familiar with their department's policy, but neither had any experience of the property world. Mr Johns told us that he sought the advice of Mr Wheatley 'who was our only chap involved in property', with the result that Mr Walker, already mentioned as the Crown Agents' property solicitor, was recommended and joined the expedition. We asked Mr Walker what his qualifications were for advising on Australian property and he disarmingly replied 'none', but it is only fair to say that he had by this time acquired considerable experience in property in England; he told us that in Australia he acted as the Crown Agents' spokesman in meetings with bankers and property owners. Mr Rawlence accompanied the party as the Fenston syndicate's representative. Mr Johns and Mr Hewins on their return made a joint written report and Mr Walker made a separate report. Both reports advocated further investments. Messrs Johns and Hewins envisaged a joint programme with the Australian Anglican Church authority under which A\$100m would be invested in property development over a five-year period, with the Crown Agents arranging all the finance and providing up to \$A25m themselves at any one time. Appended to their report was a list of proposed developments which followed very closely the list submitted by the Church's adviser, Mr Collier, in October 1968 (para 35 above). The two Crown Agents' officials also reported orally to the board of Four Millbank Investments Ltd with, they told us, a favourable reaction from Sir Claude and the other members.

54. Mr Walker's report endorsed that of Mr Hewins and Mr Johns and explored two further topics. He dealt with the terms of the Crown Agents joint venture with the Fenston syndicate (see para 60 below) and he recommended that Crown Agents should appoint a suitably qualified person to represent them as projects director for Australia, someone—

'whose integrity is undoubted, whose loyalty to the Crown Agents and awareness of the necessity of protecting their reputation is beyond question. He must also be experienced in the property field in all its aspects in order that he be not swayed by the weight of superior knowledge on the part of Mr Rawlence.'

In the event the Crown Agents asked Mr Walker to undertake the task. He accepted and was rewarded with a 3% profit share. Mr Walker remained resident in the United Kingdom where he was soon to develop other property activities in association with the Crown Agents. Henceforth he appears less on the scene as a solicitor and more as a property expert. Also in 1969 the Crown Agents took on a property executive resident in Australia, this was Mr M B Ottaway, who had been suggested by Mr Rawlence. Mr Ottaway had been involved in commercial property development in Australia and he built up an



office and a staff in Australia which managed the technical side of the development programme over the next three years.

55. There followed not only the projects in collaboration with the Anglican Church listed in the appendix to the Johns-Hewins report but also a series of other ventures so that the programme the Crown Agents were undertaking in collaboration with the Fenston syndicate soon exceeded the figure of A\$100m.

56. Lanray. In early 1969 the Crown Agents decided to go into partnership with Lanray Industries Ltd (Lanray) a small Australian quoted company, to develop a large site owned by Lanray in the middle of Sydney. This development, later named the Capital Centre, comprised 200,000 square feet of shop and office space and a 650 bedroom hotel; it was originally estimated to cost some A\$25m, though with inflation the cost in fact came to A\$45m on completion in 1975. The development was not mentioned in Mr Walker's report on his visit to Australia with Mr Hewins and Mr Johns, but it was discussed at a meeting in Sydney on 23 March 1969 between Mr Walker, Mr Rawlence and Mr L F McInnes, the chairman of Lanray. After further meetings in London also attended by Mr Hewins a joint venture agreement was signed on 30 June 1969. The agreement was between Four Millbank Nominees Ltd for the Crown Agents, Lanray and two of Lanray's subsidiary companies which owned the development sites. It is noteworthy that Pennine (the Fenston company) was not a party though subsequent events indicate that Pennine was intended to participate in the profits. The terms of the agreement were briefly that profits and losses would be shared equally between the Crown Agents and Lanray, that the Crown Agents would provide or arrange for the provision of all the development finance and that Lanray should have no obligation to put up money. Lanray was to manage the development for an annual fee of A\$50,000 plus the reimbursement of certain stated expenses. The venture was conditional on Lanray obtaining a tenant for the hotel part of the development. In the event Lanray seems to have been unable itself to agree terms with Hilton Hotels, the favoured candidates, but Mr Walker's intervention in the negotiations led to a 40 year lease being concluded in April 1970. Mr Fenston and his associates played little part in these negotiations.

57. In 1969 the Crown Agents and their partners began to negotiate another major project. This became known as the Cooks/Prouds/Hooker site from the names of the three owners of adjoining sites in Sydney which were eventually combined in a joint development. Because of this complication it took some time to reach agreement. However agreements were signed in August 1970, committing the Crown Agents to finance a development estimated to cost A\$20million.

58. Also during 1969 negotiations were begun with the Methodist Church in New South Wales. Preliminary meetings took place between the Church's representative, Mr Rawlence, and Mr W Walter, the Crown Agents' representative in Australia (see para 32 above). At a meeting held in London on 10 July 1969 attended by Mr Fenston, Mr Walker, Mr Challis and other Crown Agents' officers, proposals for four developments expected to cost a total of A\$30m were discussed. At another meeting on 9 September which included a discussion of the cash flow requirements of the projects, Mr Johns and Mr Hewins are reported as expressing apprehension that the cash requirement would be too large: this is the first recorded expression of unease at the size of the Crown

Agents' commitments in Australia. In the event one of the four proposed developments did not proceed because of a downturn in the letting market by 1971 when a decision was needed on whether to go ahead.

59. A number of smaller developments were included in the programme during 1969 and early 1970. Within two years of the first negotiations over Edgecliff (para 32 above) Crown Agents were committed to finance a very large property development programme in Australia. A forecast produced in November 1970 estimated the cost of developments under consideration at A\$132m, then equivalent to £61m. By this date the programme was being carried forward by an Australian company, Abbey Orchard Property Investment Pty Ltd, the shareholdings being in the proportion—

	%
Crown Agents	33
One of Crown Agents' principals	15
Pennine	48
Mr Walker	3
Mr Ottaway	1

Thus the Crown Agents together with their principal were in rough equality with the Fenston interests. But the share capital of the company was tiny, (A\$250,000) and was not subscribed in cash but paid up by crediting surpluses arising from subsequent revaluations of the property developments. All the finance for the A\$132m programme was the Crown Agents' responsibility, and this was to cause much anxiety in later years. We now turn to the development of relations with Mr Fenston and his associates from the original Edgecliff Memorandum of Agreement (para 34 above) to a continuing partnership.

60. The report that Mr Hewins and Mr Johns made after their expedition to Australia in early 1969 did not deal with the Crown Agents' relationship with the Fenston interest. Mr Challis told us that they had intended to go into partnership with Mr Fenston before this expedition; we are told by others that the two were on good terms with each other and it seems that negotiations were conducted between them on a personal basis. Mr Walker in his report following the expedition of early 1969, dealt at some length with the Fenston syndicate. He noted that they were not resident in Australia and were not in a position to provide day to day management of the projects. He recalled that on the first Edgecliff development the profits were to be shared 80:20 between the Fenston syndicate and the Crown Agents and were to be shared equally in respect of other transactions. He suggested that this was too generous and that the Crown Agents should seek more favourable terms. Another question was whether the Crown Agents should enter into covenants to tie themselves exclusively to the Fenston syndicate and vice versa. Mr Walker doubted whether the Crown Agents should concede as much as a half share in the profits from developments which might be introduced to them by others.

61. Shortly after Mr Walker had made his report he wrote on the Crown Agents behalf to Mr Rawlence setting out the terms on which the Crown Agents would be willing to enter into a continuing partnership for property development in Australia. Discussions on these proposals proceeded through a series of draft agreements over the next year and a half during which the Crown Agents became committed to finance the developments outlined in the preceding para-

graphs. The course of these negotiations is not well documented: the agreement as finally signed did not incorporate the changes favourable to the Crown Agents which Mr Walker had proposed at the outset. We were told by Mr Challis that this was because Mr Fenston would not accept them, and in particular would not come in for less than a half share in the equity.

62. Mr Fenston died in September 1970. The agreement with the syndicate's company Pennine, was signed in the following January. Notwithstanding that the association with Mr Fenston's name and expertise had been one of the chief attractions of Pennine Company Ltd as a partner, the agreement signed after his death included a non-competition clause binding for ten years which forbade either of the parties to undertake property activities in Australia except through the partnership or with the consent of the other. As Mr Walker had pointed out two years earlier, it is difficult to see what benefit the Crown Agents gained from this clause. Pennine was placed in a very strong position by it because at this time the Crown Agents were already looking for new partners to fill the gap caused by Mr Fenston's death, and to do this they now needed Pennine's consent.

63. In the agreement the Crown Agents were to be responsible for providing all the finance, The relevant clause read—

'Until the 1 January 1979 Millbank shall make available to or procure the advance to the company (if required) of sums by way of revolving credit sufficient for the purpose of carrying out projects involving a capital expenditure of not less than A\$50 million.'

The position was unclear in the situation which by then obtained in which the company's development programme exceeded A\$50 million by a large margin. Subsequent legal advice taken by Crown Agents was that there probably was an obligation to finance projects above the A\$50 million limit. In fact the Crown Agents found themselves shouldering the whole burden, the only alternative being liquidation of the venture, when they would only have recovered whatever could be obtained from a forced sale of the partially developed properties.

64. The Fenston syndicate were entitled to 50% of any profits: what responsibility did they have for losses, if these be incurred? They had put no money into the company (para 59 above). The agreement in fact provided for the company to have a capital of A\$1,000,000, of which the Fenston interests were to provide A\$480,000 and this sum would have been at risk, but this did not happen. After Mr Fenston died Prince Radziwill entered into a non-liquidation agreement with the Crown Agents. Under this agreement, in the event of the company being insolvent, either party could call for both parties to advance in equal shares whatever sum was required to make it solvent, but with an overriding provision that Prince Radziwill's obligation would be limited to £1m. Crown Agents have since been advised that this part of the agreement might be unenforceable in the courts, on the grounds that it was designed, perhaps artificially, to extend the life of an insolvent company to the possible ultimate detriment of creditors. It was certainly no substitute for an adequate capital base for the venture.

65. At no stage were these proposals debated by either the board of FMI or by the full Crown Agents board. After Mr Fenston's death Mr Challis had written

to Sir Claude Hayes (then on tour overseas) in terms that implied some knowledge of the matter. But Sir Claude does not appear to have taken a close interest in it.

66. It has been seen that Mr Fenston and his associates were admitted to partnership with the Crown Agents in Australia on very favourable terms. Mr Fenston also received favourable treatment as a borrower in connection with his property development activities in England, and we must briefly notice this transaction because it illustrates the willingness of the Crown Agents to enter into unorthodox deals.

67. The transaction was a loan made to Mr Fenston personally in January 1969 to enable him to finance a development in London known as Ethelburga House. The amount was £5m and the duration was one year. The rate of interest was  $2\frac{1}{2}\%$  above Bank Rate, minimum  $9\frac{1}{2}\%$ pa, which was low in the circumstances. The security was by way of mortgage of the property in question, and the advance exceeded the Crown Agents' ordinary limit of two-thirds of the value of the security. However the taking of the security seems to have been something of a formality because at the borrower's request the mortgage was not stamped nor was the transfer registered at the land registry. In return for these concessions the Crown Agents were granted a 5% share in any profits yielded by the development. At the end of the year the loan was extended, but before another year had elapsed Mr Fenston had died. His executors received considerable indulgence from the Crown Agents: it took them a long time to settle the estate, and for a time interest was in arrear. Had the estate been insolvent the Crown Agents would have ranked as unsecured creditors by reason of the non-registration of the mortgage. However the estate was solvent and in September 1972 the loan was repaid with accrued interest. And at the end of the day, in October 1976, they received £600,000 as their 5% share of the profits. The gamble had come off. But it was a gamble nevertheless.

### **(3) Sterling Industrial Securities Ltd**

68. This small secondary bank was set up in 1969 and financed partly with Crown Agents' money. To trace its origins it is necessary to go back and look at the history of the Crown Agents' relationship with the two men who became their partners in the enterprise, Mr Sidney Finley and Mr Sidney Davidson. As neither of these gentlemen have given evidence, nor has Mr Wheatley who largely dealt with matters from the Crown Agents' side, the following account has to be pieced together largely from documentary evidence.

69. Mr Finley is a financier who since 1956 had controlled a finance company called firstly Sterling Industrial Securities Ltd, and later (1969) called Sterling Industrial Securities (London) Ltd, and still later (1973) called Big City Finance Ltd. To avoid confusion we shall call it by its present name of Big City Finance.

70. It seems that Mr Wheatley and Mr Finley were in touch as early as April 1968. In that month Mr Wheatley bought certain trade bills endorsed by Mr Finley, and between then and August 1969 he bought further such bills. They seem to have been accommodation bills; many were renewed on maturity and when they finally fell due they were converted into loans to Big City. These loans together with one further advance totalled the £850,000 recorded as advanced by the Crown Agents to Big City during 1969.

71. Meanwhile Mr Wheatley had interested Mr Finley in the setting up of a company named Interservice Mediterranean Ltd, projected by a Mr Stanton and promoted by the energetic Mr Abrahams to provide film facilities in Malta. A minute of 28 November 1968 by Mr Wheatley records a meeting with Big City to seek finance for this venture, and on 2 December 1968 in another minute to Mr Clark he records Mr Finley's view that:

'Upon the basis of the prospectus which he has seen he is unable to see any profit in the endeavour but is nevertheless prepared to take the major portion of the risk in order to facilitate his relationship with the Crown Agents. I have intimated to him that somewhere along the line there will be an unspecified quid pro quo for Mr Finley. I have arranged that on . . . 5 December Mr Finley will meet Mr Challis, yourself and myself . . . '.

The Crown Agents and Big City both took up shares in the company.

72. After Mr Finley had thus become well known to the Finance Directorate he, in early 1969 introduced Mr Sidney Davidson, a London solicitor, to Mr Wheatley with a view to a joint takeover by the three parties (Finley, Davidson and the Crown Agents) of a finance house which was on the market. This sale fell though but the parties did not abandon the idea and by 14 April 1969 Mr Wheatley was minuting Mr Clark asking for approval to subscribe at par for 33,000 £1 shares in a new finance company. This minute is Appendix VII and it will be seen that it was a proposal to set up a fringe bank. In a later minute Mr Wheatley expressed the view that the venture would not be 'unduly competitive' with the Crown Agents' existing bank, Sassoons, a view not shared by the Sassoon management, although according to Sir Claude Hayes the Crown Agents were by this time becoming dissatisfied with the Sassoons' management. The minute also speaks as though £33,000 was the limit of the Crown Agents' involvement; it makes no mention of any prospective loan. On 29 May Mr Challis accepted the proposal to participate; he did this without reference to the Crown Agents board. The company was duly incorporated as Sterling Industrial Securities Ltd (SIS), Mr Finley's company (now Big City) having obligingly changed its name to enable this title to be adopted. Mr Wheatley was appointed a director to represent the Crown Agents. The Crown Agents duly took up their shares on 30 July 1969 and thereafter the new company was almost immediately financed by loans from Finvest and the JCF, which by the end of 1969 totalled £7,150,000. We asked Mr Hewins why the Crown Agents went into SIS when they already had a banking arm for their principals' service, and he replied 'It was another facet of the principle of making money by entrepreneurial efforts.'

#### **(4) First National Finance Corporation Ltd**

73. By 1969 the Crown Agents already had contacts with this company; money market dealings had brought the two organisations together. In October 1968 Finvest had added it to its list of borrowers with a loan of £1,100,000. In early 1968 there had been a small purchase and subsequent re-sale of shares. But in June 1969 there began the Crown Agents' massive involvement in the equity of this company. Of a new issue, the company offered the Crown Agents 700,000 5/- ordinary shares at £1.80 each. This was taken up on Mr Challis's authority; it represented 4.9% of the total issued capital. Of the 700,000 shares, 250,000 were held by the Crown Agents on own account, and the rest assigned

to the portfolios of two of their principals. As part of this transaction the Crown Agents were asked to nominate a director, and Mr Wheatley was appointed to the board on 26 June 1969. It is to be observed that the Crown Agents rapidly increased their stake in First National Finance Corporation (FNFC) by further purchases, their holding rising to 816,000 shares by the end of 1969 and to 1,843,000 by the end of 1970. The association between the two organisations quickly became close and confidential; just how quickly is demonstrated by the fact that within three months of the Crown Agents' nominee joining the board, on the occasion of the underwriting of a new issue of FNFC by Hambros Bank, the Crown Agents were offered and accepted a secret commission from FNFC which reduced the price to them of 555,000 shares which they took up from the £1.80 at which they were offered, to £1.72½. Because this transaction seemed to us to contravene certain sections of the Companies Act 1948, we made a full interim report on this matter to the Minister on 28 June 1976.

74. The commencement of the close association of the Crown Agents with FNFC, is also noteworthy in that it provoked the first exchange to take place since Sir Claude's appointment between the Crown Agents and the Ministry of Overseas Development. The Ministry had not been advised of the substantial purchases of June 1969 or of the appointment of an official to the Board, and when these facts were noted in the press, Mr Maurice Smith, Sir Claude's successor as Principal Finance Officer at the Ministry, wrote asking for information and mentioning that they would expect to be notified in advance of all the main extensions of the Crown Agents' activities. We attach Sir Claude's reply at Appendix VIII. It contained two misstatements of fact and one further misleading implication. It was incorrect to say 'our investment is about £700,000': the investment was 700,000 shares, cost £1,260,000. It was incorrect to say 'this investment is in fact a straightforward investment on behalf of our principals': 250,000 shares, costing £450,000, were held on own-account. It was incorrect to imply that the deal had been advised upon by the Equity Investment Advisory Panel; its functions were limited to principals' portfolios and it did not advise on specific purchases. Sir Claude told us that the errors could well have been slips by him: 'Challis and two or three others came to my room and I jotted points down on a piece of paper and dictated a letter.' We acquit Sir Claude of any attempt to mislead but he did misinform the Ministry and the misinformation went uncorrected.

#### **(5) English and Continental Property Company Ltd**

75. This company, whose operations in the years ahead were to bulk large in the Crown Agents' affairs commenced as a relatively small business promoted by Mr Walker. He had been introduced towards the end of 1968 to two brothers, Mr Ramon Greene and Mr Lionel Greene who, together with their father, Mr W Greenbaum, ran a collection of companies known as the Greene group and engaged in estate development and house building. Mr Ramon Greene was principal of a firm of estate agents at Reading. The companies controlled a number of development sites in the west of England and in Ireland. Mr Walker, together with his senior partner in Davies Arnold & Cooper, Mr Henry Kaye, had been operating Keepsake Developments Ltd, a company engaged in building flats in London. In a memorandum submitted to the Crown Agents in May 1969 Mr Walker suggested the formation of a new company under the name of Keepsake Homes Ltd, to be jointly owned by the Greene brothers, the owners of

Keepsake Developments and the Crown Agents. Keepsake Developments would be wound up, and its directors and staff would devote their expertise to the new company's affairs. The Crown Agents would under this proposal subscribe for one third of £100,000 share capital, and the company would also use short term loan capital, also to be obtained from the Crown Agents. Mr Walker envisaged working up the company and going public after about five years. This proposal was passed to Mr Sly, as the Crown Agents' property official, and the Finance Directorate gave him the go-ahead to negotiate. The story is succinctly put in Mr Sly's own words to us:

'What happened was, a very short while after I took over the property mantle myself, Walker came to me with a proposal—he had found two people called the Greene brothers, and I think you know this story but I shall repeat it so you can cross-check if you want to—he came to me and said he had found these housing developers called the Greene brothers, and he thought they had some very good situations; the housing market was relatively speaking not going terribly well but there was good potential for improvement in the next eighteen months or so. I discussed this with Clark and Challis and they told me to negotiate the best deal I could, for a company in which the Crown Agents would have a shareholding. I insisted in taking a 51% shareholding, and the rest was shared between the others.'

76. Mr Sly got the terms altered to give the Crown Agents their majority shareholding and the company was incorporated in June 1969 as Keepsake Homes Ltd. (The change of name to English and Continental Property Company was made in the following December.) It had an issued share capital of £90,000 in £1 shares made up as follows:

Four Millbank Investments Ltd	51,000
Ramon Greene	12,250
Lionel Greene	12,250
J J Walker	2,250
H Kaye	2,250
Trail & Co Ltd	10,000

The last-named shareholder was a Bahamian company controlled by Mr Walker and Mr Kaye. Mr Walker was given an option to purchase a further 10,000 shares at par, which he exercised in 1971, bringing the issued capital to £100,000. He also in 1970 took over the shares of Mr Kaye and Trail & Co, so that after 1971 his shareholding was 24½%. In the same year Mr Ramon Greene took over his brother's shareholding, bringing his stake in the company also to 24½%. The new company bought the Greene group's development sites for £358,000. The Crown Agents undertook to provide up to £3m loan capital, secured by a debenture. Mr Walker agreed to covenant not to compete and to wind up Keepsake Developments. The new company's board consisted of Mr Sly, chairman, Mr R. Greene, managing director, Mr L. Greene and Mr H Webb (who had been managing Keepsake Developments) executive directors, and Mr Walker and Mr Greenbaum, part-time executive directors. The company was vigorous from the start. During its first six months it not only continued and expanded the housebuilding operations but also sent Mr Sly to Cyprus to investigate a proposed development at Kyrenia, and entered into an arrangement with another developer, a Mr David Lewis, for participation in a scheme to build offices in Charing Cross Road, London: this included a one-year advance

of £200,000 to Mr Lewis's company—the Crown Agents' money being advanced at second hand, as it were.

77. We shall return later to English and Continental's (E & C) subsequent history. Here it may be noted that the manner of its inception sheds light on the informal and unsupervised way in which the Finance Directorate was conducting its expansion. As to informality, Mr Sly apparently discussed the project and his negotiations with Mr Challis, Mr Hewins and Mr Clark, but no minutes or any written authority exist beyond a manuscript note by Mr Sly recording that his superiors thought the terms fair and that he should be the Crown Agents' director. As to supervision, it stopped with Mr Challis. The setting up of this new company and the making of a junior official its chairman were not thought by Mr Challis worthy of being submitted for decision to the Crown Agents board. The board seems to have been surprised when told about it afterwards; Mr Morris then minuted Mr Clarke, saying:

'I would like more information about the investment in Keepsake Homes Ltd. You will have noticed that there was a good deal of bewilderment when you made this announcement at the recent Board meeting, both as to the nature of the investment and also the choice of Chairman.'

We shall mention later Mr Morris's efforts at this time to have some control applied to the Finance Directorate, but in truth the Board was helpless. It was only an advisory body and it carried less weight with Sir Claude than with his predecessor, and Sir Claude could hardly have been expected to enforce reference of this sort of proposal to the Board when, as to our surprise he told us, he himself did not expect to be informed. He said:

'I cannot remember whether Challis consulted me before we went into it or not. It was a small investment—£50,000 I think. It was not on the list which he would normally come to me about.'

#### (6) Overseas merchant banks

78. We have already recorded (para 30 above) how the Crown Agents came to take a 40% shareholding in E D Sassoon Banking Co Ltd. This small bank traded both in London and Nassau, Bahamas. As we have seen, another shareholder was a leading American bank, the Continental Illinois National Bank & Trust Co of Chicago, with 25% of the shares. Between 1968 and 1970 there followed a number of investments in overseas merchant banks set up in association with Continental Illinois and often with other local institutions:

		<i>FMI holding</i>		Continental
		Cost		Illinois
		£	%	holding
				%
1968	Caribbean Bank Ltd	109,000	40	40
1969	Westralian International Ltd	467,000	17	17
1970	Malaysian International Merchant Bankers Berhad	200,000	24	24
1970	Singapore International Merchant Bankers Ltd	184,000	24	24
1970	Commercial Continental Ltd (Sydney, Australia)	467,000	20	20



79. Unlike the shareholding in Sassoons these investments were not considered by the Crown Agents' board. The FMI board minutes record that proposals for the banks in Malaysia and Singapore were explained to the board in an oral report, although not, apparently, as a matter requiring their approval. The others only became known to the FMI board after the investment had been made, when they became the subject of routine quarterly reports. The Ministry were not always informed at the time the investments were made. It appears they learned of the investment in Westralian International when it was reported in the Evening Standard on 23 October 1969, but they knew nothing of the Caribbean Bank until July 1969, when they received the Crown Agents' annual report for 1968. The banks in Singapore and Malaysia were reported by Sir Claude when they were set up.

80. We find no documentary record of Sir Stephen Luke, or, later, Sir Claude Hayes, approving the investments. However we have no doubt that they knew of them. Both Sir Stephen and Sir Claude became directors of the Caribbean Bank. As noted above, Sir Claude wrote to the Ministry on the investments in Singapore and Malaysia.

81. The purposes for which the investments were made were not defined at their inception. A paper written by Mr Johns in 1971 gave them as:

- 1 To provide additional services to principals.
- 2 To derive business for Crown Agents' traditional fields through or in conjunction with the merchant banks.
- 3 To obtain new principals.
- 4 To assist in the economic development of their principals' countries provided it could be done on a viable basis.

While we note that the enhancement of services to principals was stated to be an objective, we also note that when Mr Challis wrote to Continental Illinois inviting them to join in the Caribbean Bank, he held it out to be a potentially very profitable investment. We are disposed to think that profit for the Crown Agents' own account was probably the principal aim of Mr Challis and Mr Johns, who as Managing Director and Executive Director of FMI, were the Crown Agents' staff most closely concerned.

82. In the event none of the merchant banks proved very profitable. Mr Johns thought the rigid seniority rule (see paras 42, 43 above) partly responsible: 'the Crown Agents said they would not bring in people from outside . . . you go by a seniority list and you see who is next on the list, therefore the (companies) started reasonably well and they were started for the right reasons but other people took over and lost direction.' In 1972 there were problems with the two Australian banks. The Crown Agents seconded Mr Johns to Westralian International, where he remained until 1974. Continental Illinois grappled with the problems of Commercial Continental. In 1974 substantial losses were incurred by Caribbean Bank Ltd. It had made most of its advances to property developers, many of whom got into difficulties.

### (7) Position at end of 1969

83. By the end of 1969 the Finvest balance sheet had reached £127m. The funds were obtained in approximately equal proportions from principals and from the money market and were invested as follows:

	£m	£m
Banking assets		
Cash and loans to major banks	44	
Loans to finance houses and secondary banks	23	
Property lending	18	
Commercial and other lending	28	
	—	113
Investments		
Quoted	3	
Unquoted	4	
	—	7
Property investment by Mr Sly's section		3
Miscellaneous assets		4
		—
		127
		—

Other own-account activities were the overseas investments of the JCF at £12.5m, and the investments of FMI which, though only £1.9m included the key shareholdings in E & C, FNFC and SIS mentioned in paragraphs 68-77. A substantial commitment to finance property development in Australia was building up; the sums actually advanced up to the end of 1969 were small (£200,000) but plans were in being for developments costing perhaps £50m, for which Crown Agents were to obtain all the finance, either from their own resources or by borrowing locally.

84. These figures have been extracted by us from such records as are available. They are not to be found collected or summarised in any accounts kept by the Crown Agents and it is doubtful whether the Chairman or the board ever had an overall picture of this side of their business. This is an appropriate place therefore to look at the system, or lack of system, of accounting which prevailed up to that time at the Crown Agents. A look at the accounting arrangements is also a necessary preliminary to dealing with one important event which we have not hitherto mentioned. This was the discovery by the Comptroller and Auditor General of the existence of Finvest and his report thereon in 1969 to the Treasury.

## VII Accounting, Control and Audit

### (1) The accounting system in 1969

85. The Crown Agents' system had to account for, firstly, the large number of specific investment portfolios managed for principals, and secondly, the four funds under the Crown Agents' own control. These were the Joint Consolidated Fund (JCF), the Joint Miscellaneous Fund (JMF), the Marine Insurance Fund (MIF) and the Office Fund. The JCF and the JMF contained the cash balances of principals held to pay for supplies purchased through the Crown Agents or awaiting investment; and in addition to these call balances the Crown Agents had since 1965 taken into the JCF and the JMF fixed term deposits and deposits

at three months notice from principals. These funds were thus in the nature of banking funds. They were audited by the Director General of the Overseas Audit Service (later wound up: see para 117 below). The Office Fund, into which came the revenue from services and from which were paid the expenses of running the office, was audited by the Comptroller and Auditor General. The Marine Insurance Fund's function is explained by its title; it too was audited by the Comptroller and Auditor General. The distinction between these funds was historical but there was no legal distinction between them such as would, for example, have stemmed from separate incorporation. Nevertheless separate accounts were prepared and were reported on by different auditors, apparently without any form of liaison.

86. The Crown Agents' equity investments in Sassoons and the other companies already mentioned were made through Four Millbank Investments Ltd, whose accounts were audited by Price Waterhouse & Co. These investments thus fell clearly outside all the pre-existing funds; but the position in respect of the other new own-account activities was less clear. Finvest, which had begun early in 1967, was not accounted for within any of the funds at the end of that year. In the accounts for the next year the profit on Finvest was taken into the Office Fund and its assets and liabilities (by then £58m compared with a balance sheet total of £10m for the rest of the Office Fund) were shown in a note to the Office Fund accounts notwithstanding that Finvest contained principals' deposits formerly shown in the JCF. The overseas investments described in para 27 above were similarly not included in any fund at 31 December 1967. In 1968 they found their way into the balance sheet of the JCF and it is to be noted that (a) without them and the profit they were showing at that time the JCF would have been in deficit, and (b) some of these investments were financed by borrowing from non-principals.

87. The bookkeeping at clerical level for the traditional activities seems to have been competently done but the same cannot be said of Finvest and the foreign currency transactions. The Director General of the Overseas Audit Service found that no proper books of account had been maintained for the foreign currency transactions, and his officers had to prepare the accounts themselves. He refused to certify the 1968 JCF accounts until proper books were written up. In September 1969 the Crown Agents called in Price Waterhouse & Co to perform this task and also to advise on the Finvest bookkeeping and help write up those books. They found so many errors in the foreign exchange records that they had to make a detailed check of all entries. In their report dated 6 May 1970, on the completion of their assignment, they had this to say:

'We consider that the form of the accounts and the basis on which they were prepared did not provide management with a true indication of the results of the Finvest operations as a whole, nor did they provide any meaningful analysis of the results for each individual investment manager's area of operations.'

They also commented 'there is a general lack of accounting knowledge and training among the staff of the finance department'. They recommended the appointment of a qualified and experienced accountant to be responsible for all the accounting functions of the Finance Directorate. This recommendation was accepted and on 9 November 1970 Mr G R Towse, a chartered accountant, was

appointed 'financial controller' within the Finance Directorate. We shall revert later to his functions.

88. The compartmentalised system of accounting separately for each fund had the following effects:—

- (i) in the absence of consolidated accounts only a series of partial views of affairs were presented;
- (ii) related transactions were not brought together in any accounting statement, eg where FMI made equity investments in companies to which Finvest or the JCF lent money;
- (iii) no one auditor had the overall responsibility such as is borne by the auditor of a holding company under the Companies Acts;
- (iv) new ventures which did not fall into an established pattern might not be accounted for in any fund and could escape audit.

89. This haphazard system of public reporting mirrored the internal arrangements for financial reporting to the Crown Agents and the board. The Finance Directorate, like other directorates, produced a monthly board report describing its activities in general terms but the only figures given regularly were for the total of funds under management and in the JCF and the JMF, and the total profit or loss arising on Finvest. Individual results from particular adventures were reported from time to time: eg a profit of £55,000 on dealing in silver in August 1969. A loss on silver of £323,000 in July had not however been reported. Monthly accounts showing the disposition of the individual funds and an itemised profit and loss account had a restricted circulation within the Finance Directorate. It is clear that the Crown Agents and the board were never given adequate information in the first place, although it is doubtful whether they possessed the expertise to interpret and act upon it, had it been presented.

90. There seem to have been two main reasons for the unsatisfactory state of the accounting. Firstly there was a dearth of capable accountants within the organisation due in part to the Crown Agents' promotion policy (para 42 above). Prior to Mr Towse's appointment the only officer in the whole organisation with any accounting qualification was Mr Nowers, the accountant of the Office Fund. Secondly there seems to have been no appreciation either within the Finance Directorate or at any higher level of the importance of full accounting and close financial control. The hazards of this lax system would have been mitigated had Urwick Orr's recommendation about the Controller been put into effect.

## **(2) Control**

91. As we mentioned in para 38 above, the Controllership was one of the key recommendations of the Urwick Orr report; see Appendix IV. But Mr Sayers, the official appointed to the post, had no qualifications for the task (para 42 above) and moreover was given no authority or backing from the top. Mr Challis said:

'In my opinion the way the Controller's job was set up was to make a kind of obeisance in the direction of going along with what Urwick Orr said, without in practice introducing a Controller.'

We asked Sir Claude Hayes why someone of real stature was not appointed to the job, and his answer was 'I think for the simple reason that there was not anyone'. He added that the concept of a controller was not liked by several departments, including finance. In practice Mr Sayers found his function on the board was to represent Mr Nower's office accounts division and little else. He was not allowed to do more with the Finance Directorate than pass on their estimates of their earnings. He told us:

'I asked direct questions quite often to the Finance Department about certain things. I did not get replies.'

Having been appointed on 1 November 1968, he had by July 1969 become so frustrated that he applied for early retirement, which was granted as from 1 January 1970. At the time of his application Mr Morris and Mr Barley put up a minute suggesting that the post of Controller be made redundant, and Sir Claude appended this note:

'I agree reluctantly that we should abolish the Controller's post as we now have it on the grounds that we have not got the full-time commercial/financial work which Urwick Orr envisaged.'

The surviving functions of the controllership were taken over by Mr Morris, and after him by Mr Newman, but this involved no more than the representation on the board of office management and the Office Fund. The person who did the work in this regard—and did it well—was Mr Nowers. From November 1970 the Finance Directorate had its own accountant, Mr Towse, and both before and after this date there was no one, short of the Chairman, whose business it was to look at the Crown Agents' finances as a whole, and no one, including the Chairman, who was given the material for taking such an overall view. The Chairman on taking office had reserved oversight of finance to himself, thus rendering difficult any representation by others, such as Mr Morris or Mr Nowers. With the failure to implement Urwick Orr's recommendation about the Controller there was lost any real chance of control within the organisation of whatever the Finance Directorate might choose to do. External restraint there yet might be however, and the first step in this direction was taken when in October 1969 the Comptroller and Auditor General alerted the Treasury to the inception of Finvest.

### **(3) The Comptroller and Auditor General**

92. Section 3 of the Exchequer and Audit Department Act, 1921, requires the Comptroller and Auditor General to audit all accounts which the Treasury may, by Minute to be laid before Parliament, direct. A Treasury Minute of 1 January 1923 so directed in respect of inter alia 'the Crown Agents Office Fund'. We shall look later at the scope and manner of the audit (para 280 below), but here it is sufficient to note that the audit of the Office Fund had this statutory origin, and to add that the Comptroller and Auditor General informed us that when he audited and certified the account it was also the practice of his office to report separately to the Treasury any matter which in his opinion he should draw to their attention. Now Finvest was first mentioned by the Crown Agents staff to the audit officers of the Exchequer and Audit Department at a meeting on 20 May 1968 called to discuss the change in the form of the Office Fund accounts for 1968 from the cash basis used heretofore to an income and

expenditure basis. The Exchequer and Audit Department officers have a clear recollection that Mr Challis told them that an operation of borrowing and re-lending (not then referred to as 'Finvest') had started with a view to making profits to enable the Crown Agents to hold down the charges for their traditional services. The auditors were asked to agree that in 1968 only one figure, the net assets, should be in the accounts because the Crown Agents did not wish to publicise this activity. They agreed with this suggestion; unwisely perhaps when they knew so little about it and there the matter rested until the following year, when the officers were at work on the 1968 accounts. They then ascertained, although, they tell us, not without difficulty ('Mr Challis seemed anxious to exclude us from information' reads a contemporary minute), the size of Finvest—£59m by the 1968 year-end and £150m by June 1969. This discovery alarmed the officers. They consulted their superiors; the upshot was a letter dated 6 October 1969 from Mr H A Long, the Deputy Secretary at the Department, to the Treasury Officer of Accounts, Mr A J Phelps (with copies to Mr Challis, and to Mr Smith at the Ministry), saying inter alia:

'Crown Agents have embarked upon a new venture of large scale borrowing for on-lending or investment purposes (Finvest). I understand that the object is to earn surpluses in order to build up the Crown Agents' reserves or keep down the fees charged in their normal business for their overseas clients, and also to extend their experience so that they may provide a better investment service for their clients. . . . Finvest is regarded as an extension of the Office Fund activities (which indeed it is) but Crown Agents are reluctant to include the gross figures in their Office Fund balance sheet since they would "swamp" the other entries there and, they say, might lead to misinterpretation of Crown Agents' financial position by their principals. After discussion with us they propose to incorporate the net Finvest surplus in their Balance Sheet figure for investments matched by an equivalent increase in the Unallocated Reserve and to give the gross Finvest assets and liabilities figures in a note to the accounts. . . . The Finvest organisation and accounting system are at present under review by Price Waterhouse, who have been called in as management consultants, and we are inclined to accept this style of presentation on an interim basis until any recommendations resulting from the review have been considered. But, in view of your responsibility for the form of Section 3 accounts and the size and unusual nature of the Finvest activities, the C and A G thought you should be given an opportunity to comment.'

93. Mr Long accompanied the above formal letter with a personal one to Mr Phelps from which we quote two passages. The first cannot be bettered as a description of the constitutional difficulties encountered by all who dealt with the Crown Agents. It runs:

'The Crown Agents are "sui generis". Their functions have changed over the years as the Colonies have become independent and the Colonial Office has faded away. They have been aptly described as the smile left by the Cheshire cat. Their precise status is doubtful and while the Minister of Overseas Development appoints them and their funds appear to be public moneys, there seems to be little or no Government control over their activities. Among the many uncertainties however two facts stand out clearly: under the Exchequer and Audit Department Acts and the Treasury minutes thereunder,

the Treasury is responsible for the Crown Agents' accounts and the Comptroller and Auditor General for their Audit.'

The other passage underlines the reasons for making the separate report:

'We are concerned not only with the technical accounting point, which although important is not a great problem, but also with the liability of the Consolidated Fund in the event of Crown Agents running into trouble. . . . The C and A G thought that in the circumstances it would be right to consult you about the accounting question and that this would give you the opportunity, if you wish, to consider, and if necessary inquire into, the question of Government responsibility for the Crown Agents' present (tax-free) activities.'

## VIII Government Reaction

### (1) Initial reaction

94. The Treasury accepted the accounting presentation proposed, but for the 1968 accounts only, and commenced to look at the broader issues involved in the news, with especial reference to any ultimate liability upon public funds. Their researches led them to pronounce the Crown Agents' status to be 'obscure', and they at first formed the view that there could be no liability upon the Consolidated Fund for any deficits incurred by the Crown Agents. But it was accepted that the relationship of Crown Agents and Government was the concern of the Ministry of Overseas Development and it was at that Ministry that Mr Long's news caused immediate action to be taken. The persons concerned within the Ministry were Mr Maurice Smith, an under secretary and the Principal Finance Officer; Mr E C Burr, an assistant secretary and Head of Finance Department; Mr (now Sir Richard) King, then a deputy secretary; and Sir Geoffrey Wilson, Permanent Secretary. It is worth quoting Mr Burr's immediate reaction to the C and A G's letter: in a minute of 9 October he said:

'I have had a good deal of doubt for some time of the ways in which the Crown Agents were ramifying, but the knowledge that they are borrowing and investing to the tune of nearly £60m seems to me quite beyond the nature of any functions which they were originally set up to perform. Nor do I see that they have any obligation to try to earn money by extraneous activities in order to reduce the charges to their principals. I suppose they would argue that this is one means of retaining their principals but since the Minister is publicly regarded as having some responsibility for the Crown Agents' financial activities I would not feel at all happy about advising her to support their borrowing and lending these amounts of money if any responsibility of hers is employed in it. They may be riding a bull market at the moment but a time will surely come when things go the other way and one wonders how they will then find the money to finance their losses.'

Five days later Mr Burr read in a newspaper about the Crown Agents' investment in Sterling Industrial Securities (para 68 above), and wrote another inquiry to the Crown Agents, similar to that about FNFC, asking what was going on.

95. On 16 October 1969 Mr Smith obtained fuller details about Finvest from an E&AD official, and on 20 October he wrote a long minute to Sir Geoffrey Wilson setting out the position and the problems posed and ending by saying

'on present information I am doubtful whether the operation should continue, given the present functions and constitutional position of the CA and their freedom from taxation'. Sir Geoffrey agreed with a suggestion that the matter be discussed with Sir Claude Hayes, and on 12 November Sir Claude and Mr Challis were seen by Mr Smith. They gave him some further information about Finvest, including a statement that the 'vast bulk' of the fund was in non-speculative investments; his record of the meeting contains the following passage:

'The somewhat surprising impression I gained was that Finvest under Mr Challis, who seemed a competent executive, were exercising a freedom and developing at a speed which came as a slight surprise to Mr Hayes, who leaned heavily on Mr Challis for his account of the present position. However, I was also confirmed in my impression that in a number of ways the Crown Agents have found that their recent diversification of activities and development of their business as principals has been both satisfying as an experience and financially rewarding; and that having got the bit between their teeth they would be most reluctant to accept any restraint from us. For some little time now they have ceased even to advise us in advance of new ventures that they were sponsoring or supporting. The most recent illustration of this is the merchant banking business in Western Australia for which they are putting up a good bit of the capital. Indeed I feel that we have reached a stage at which it is almost embarrassing to both sides for us to have to write to them several times a year saying plaintively that we have first learned of this new venture through the press and asking what it is about. We must either insist on prior consultation or accept that they make the running.'

96. By this time Mr Smith felt that the relationship between the Crown Agents and the Ministry had become unsatisfactory. Anything so important as Finvest should have been discussed before being embarked upon, and, as he put it to us:

'To have a mine like this sprung under one's feet was sufficient indication that our relationships could not be relied upon.'

He wanted immediate action with a view to establishing that the Crown Agents should consult, and should submit to some limits on their actions. His minute on the situation included this:

'The Crown Agents have become principals in respect of a significant proportion of Finvest funds—and the proportion may well increase if they continue to find it profitable—because they want as principals to build up both profits and capital. It is not impossible, but it is not easy to endorse activities such as these as coming in any way within the present concept of the Crown Agents, a body without a constitution existing as the creature of HMG on the basis of appointments by the Minister.'

97. Mr Burr for his part went so far as to deny the Crown Agents' need for any substantial reserve: he thought their reasons for embarking on Finvest wholly invalid, and he thought all the own-account operations should be stopped. Sir Richard King is on record at that time as feeling 'uneasy' and needing further information, perhaps from the Bank of England. He foresaw 'an overwhelming moral and political obligation to bail them out if they got into financial difficulties'.



98. These views were put up to Sir Geoffrey Wilson, together with other relevant considerations and problems, including the political implications of a body exempt from taxation engaging in profit making, and the uncertainties of the constitutional position. Sir Geoffrey told us that he did not think it imperative to stop Finvest at once: he felt the force of the argument that a reserve was needed, and he was not alarmed at the Crown Agents operating on their own-account because he assumed, wrongly, that they were dealing in the same way as with their principals' funds and were advised by the Equity Investment Advisory Panel; he thought that it was a limited operation and that it would stop when their reserves reached £5m. He had no reason to suppose that the operation was being conducted rashly or ill-advisedly; moreover he saw the difficulties of the Ministry trying to run the Crown Agents' business:

'We were dealing with people whose competence and good faith and integrity we had not the slightest reason to question, and in circumstances where we had no sanctions of any sort. Apart from dismissing the Crown Agents, we had no sanctions. There was no Government money in it. I was not the accounting officer. All that we could do was look at their accounts a year after the event.'

And he appreciated the beneficial effect upon the country's economy of the Crown Agents traditional services. The result was that he authorised an investigation of the tax position and the constitutional position, but no expression of disapproval of Finvest, or any request to be kept informed, or for prior consultation was transmitted to the Crown Agents.

## **(2) Investigation**

99. The investigations went ahead. We need not concern ourselves with the discussions with the Board of Inland Revenue, but we must note the significant advice given in February 1970, by Sir Arthur Grattan-Bellew, a legal advisor at the Foreign and Commonwealth Office, to Mr Smith. This was to the effect that the Crown Agents were an emanation of the Crown and from this it followed that 'the liabilities incurred by the Crown Agents, save in so far as they were liabilities solely as agents for other principals, must ultimately be regarded as liabilities of the Crown. If therefore the Crown Agents were at any stage in default or difficulty ultimate responsibility would lie on the Crown'. This view was communicated to the Treasury, who were thus aware of the possible liabilities of the public purse when, as we shall see, the Bank of England informed them, later in 1970, of its anxiety over the Crown Agents' operations.

100. But at the Ministry of Overseas Development the prevailing feeling was one of unease at the Crown Agents' status rather than of anxiety over possible monetary loss. On 7 January 1970 the Minister, the Rt Hon Judith Hart, MP, lunched with the Crown Agents, and by way of background information she was provided with a note by Mr Smith stating:

'that the general position of the Crown Agents was now under study because in the course of enlarging their business in the past few years they had partly emerged from the role of agents and become in some respects principals. . . . We have not yet put the Crown Agents on notice that we are looking critically into their structure and functions. I should add that while this study of the

Crown Agents appears critical, there is general and warm approval for their activities. . . . Whatever conclusion is finally reached about the constitutional position and continuing functions of the Crown Agents, I feel sure that HMG will wish to preserve in effective form a body which, however anomalous its position, is providing such useful service to the British economy and to the remaining dependencies.'

101. We have had evidence from Mrs Hart: she found the Crown Agents, whose acquaintance she first made at this lunch, to be proud of their achievements, financial and otherwise. She was not told by her officials of any anxiety aroused by the own-account activities, but she herself soon had cause to appreciate the anomalous constitutional position. This arose a month or two later when, desiring to have some urgent action taken to get supplies to Nigeria after the end of the Biafran war, she asked that the Crown Agents be told to try a certain procedure. She was promptly told that she could not give orders to the Crown Agents, and this puzzled her.

'I had been a minister in a number of different Whitehall departments,' she said to us,

'I had had a number of responsibilities relating to appointments to Government and quasi-Government organisations of various kinds. I had not, until now, come across a situation in which I had the duty to make appointments but had no powers. This seemed to me anomalous indeed in Whitehall terms. Hence I asked for a look to be taken at the constitutional relationship. I wanted a clear explanation of what that constitutional relationship actually was and . . . officials went away and said yes, they would look into this.'

102. This directive, and three further events, led to renewed action at the Ministry. The first was the receipt by Mr Burr of a letter from the Director General of Overseas Audit Services (DGOAS) dated 20 February 1970 which mentioned problems arising during the audit of the JCF accounts for 1968 which he felt he should bring to the Ministry's attention. These were (a) the state of the bookkeeping, which had led him to suspend his audit pending Price Waterhouse & Co's construction of proper accounts (para 87 above); (b) the incorporation of about £14m in foreign currencies in the total assets (£105m) of the fund:

'I should add,' he said 'that I have the Crown Agents' assurance that the dealings in question were in accordance with the provisions of the British exchange control regulations';

(c) 'It seems to me that as public moneys are involved, there should be a code of rules approved by the Ministry which regulates the administration of the Fund and which, incidentally, provides the auditor with more precise terms of reference than exist at present';

(d) the quality of the management in the light of the fact that but for the foreign exchange balances there would have been a capital deficiency; (e) the question whether he should qualify his certificate, which he proposed to deal with by insisting upon the Crown Agents giving a full explanation in their accompanying annual report. Thus, within the space of four months, the Ministry had been made aware that both the E&AD and the DGOAS thought that the Crown Agents financial activities merited official consideration. Moreover the DGOAS

had stressed ((c) above) the need for a code of rules to govern the Crown Agents' investment activities.

103. The second of the events occurred when on 10 April 1970 Sir Geoffrey Wilson read in his newspaper of yet another Crown Agents' investment, namely their taking of a 45% interest in Tradewinds Airways Ltd, a charter airline operator. He was moved to inquire what action had resulted from the prior discussions, and while minutes setting out the state of the taxation and legal inquiries were passing through the office, the third event took place. This was the publication in the Sunday Times for 19 April 1970 of an article by Mr Charles Raw and other financial journalists. The article was headed 'Crown Agents: Who Carries the Final Buck?' It noted the large sums the Crown Agents had at their disposal, lent by principals or borrowed on the money market, for use on their own account. This fund was put at £50 or £60 million—an understatement, as we now know (para 83 above). It went on to say:

'This makes the Crown Agents a big force in London's money markets. And it makes them a particularly big force in the rapidly expanding secondary banking market. For a couple of years ago, when the Crown Agents woke up to their potential, they pursued a policy of taking stakes in smaller banks: they put money into E D Sassoon & Co; they own a bank in the Cayman Islands; they bought a lump of First National Finance Corporation. And last summer they took up a third stake in a new banking venture called Sterling Industrial Securities.'

The authors then examined the current operations of SIS and criticised the investment of £6m out of total deposits of £9m in one property. The deposits were largely provided by the Crown Agents. The article, after mentioning that Mr Sidney Davidson had promoted the company, concluded:

'If the Agents are going in for property dealing—and they do some already—this does not seem the best way to finance it, especially as Davidson and his partner own two-thirds of the profit made while the Crown Agents get only one third and yet effectively carried most of the risk. . . . If the Crown Agents are going to get more embroiled in the riskier ends of the financial spectrum it might be as well to sort out their financial responsibilities.'

This was a well researched article; its facts were accurate and we think its comments were fair.

104. On 20 April Mr Smith minuted, advocating a general inquiry into the Crown Agents' status and responsibilities, and mentioning that this was also the Treasury's wish. On 21 April Sir Richard King agreed and proposed informing Sir Claude Hayes that such an inquiry was proposed. Sir Geoffrey Wilson assented, and on 24 April a meeting took place at the Ministry between Sir Claude Hayes and Mr Challis on the one side and Sir Geoffrey Wilson, Sir Richard King, Mr Smith and Mr Burr on the other. This meeting forms an important landmark in the relationship between the two bodies, and we attach at Appendix IX the two records of the discussion, as made by Sir Claude and Mr Burr respectively. Sir Claude's note illustrates his growing distrust of his former Ministry: he thought, wrongly, that the meeting was caused by the Sunday Times article and by resentment at not being consulted over the Tradewinds investment. The Ministry's note illustrates how the constitutional problem had come to dominate their thinking: financial risks were touched on but

as a reason for re-examining the Crown Agents' status and not as a problem in themselves. The Ministry's attitude comes through as conciliatory and trusting, the Crown Agents' attitude as antagonistic. Clearly the question of the propriety of own-account activity was receding: the Crown Agents were playing it down, minimising its degree and importance and asserting that it was all done for the principals' benefit; the Ministry were agreeing that it was prudent to build up a reserve and accepting that little could go wrong with the accounts in view of the C and A G's audit. Two remarkable differences between the two records must be noticed. Sir Claude notes:

'Sir G Wilson said that in the light of recent press reports there had been consideration by the Treasury of our position and the Treasury had come to the conclusion that HMG had a residual responsibility for the Crown Agents, for instance in the sense that if the Crown Agents incurred deficits which they could not meet or went out of business leaving debts, HMG would in practice have to assume responsibility. I said that this was not what we had been told seven years ago and that if this is now the Treasury's view it transforms the situation since it reduces the pressing need to have an adequate reserve against remote calamities (though it does not remove the need for an adequate working capital and sensible liquid reserve).'

Although the preamble to this statement is garbled, the gist must be accurate since it records the opinion which we know the Ministry had obtained, an opinion which would clearly come as a surprise to the Crown Agents' representatives in view of the 'you are on your own' doctrine so firmly held at Millbank (para 12 above). The surprise and the comment does not seem to have struck Mr Burr as important; in his note there are only passing references to this liability, eg para 10:

'If the Minister was responsible for the appointment of the Crown Agents it was impossible to avoid the conclusion of the residual responsibility falling on her.'

Sir Claude at once saw, as his note shows, the fundamental importance of the opinion, cutting away as it did the reason for a large part of Finvest. The Ministry does not seem to have grasped this point, and we shall see later how Sir Claude went on arguing against HMG's residual liability because he appreciated that with it must go some right to control. By the time he gave evidence to us Sir Claude had convinced himself that his note was wrong. He said:

'I do not think that this report is an authentic statement.'

He also said:

'I do not find it surprising that when the Crown Agents looked like sinking they were told that they were on their own, but when they had amassed £7 million of reserves and owned their two buildings, there was an ultimate Exchequer responsibility'.

Mr Challis also said:

'I did not carry away from that meeting any suggestion that HMG accepted a residual responsibility for the Crown Agents.'

105. The other divergence appears in the final paragraph of each note. That of the Ministry reads:

‘The Crown Agents undertook to provide a statement of the bodies in which they had an interest such as would involve them in the management.’

Sir Claude’s version is similar but with this significant qualification, that the list was to be of ‘the investments which we have made directly for the benefit of our activities for principals’. Those words would exclude from the list such investments as E&C Property. We asked Sir Claude why they should be excluded. He at first said that he meant to include them. But in the list which was sent they were excluded: why? He answered that he could not say:

Q You had £6.5million in English & Continental at that time in loans, as well as 50% of the equity. These items (sc. those listed) were small beer in comparison?

A I can only assume that I sent them what they wanted. They knew that we had English and Continental, so I was not concealing anything from them. Why I defined it in this way I do not remember.

However, at a subsequent meeting we were able to show Sir Claude a draft list prepared in the Crown Agents’ office, in which SIS and E&C were both included, but against them in this draft, in Sir Claude’s handwriting, appeared the words ‘not for principals’ benefit’. And they were omitted from the list as sent. We asked Sir Claude about this:

Q So you were deliberately excluding them from the information given to the Ministry?

A Yes, I was categorising—

Q Thinking that is what they wanted, as I understand your answer. But it is not quite consistent with Mr Burr’s note, because he does not limit what he asks for to investments on behalf of principals; and if the Ministry were interested in your investments on behalf of principals, I would have thought that *a fortiori* they would be interested in your investments on your own-account—but you seem to have taken a different view?

A Obviously I took a different view then. But I think we are making too much of an apparent discrepancy. The Ministry knew about the own-account interests—E&C and SIS.

It was of course true that the Ministry knew about SIS: they had read it in the newspapers (para 103 above). But they did not know about E&C. Sir Richard King told us that when they got the list they thought it covered all investments:

‘I think we may have been a bit too innocent, but we assumed that this was the lot.’

It is our view that this incident is one of a number demonstrating how the Crown Agents wished to avoid, so far as they could, disclosing details of their own-account activities to the Ministry.

106. Interchanges between the Crown Agents and the Ministry continued during the rest of 1970. In May Mr Hayes notified the Ministry that the Crown Agents proposed to acquire a 40% interest in Stanley Gibbons Ltd, the well-

known postage stamp dealers. This linked in with the Crown Agents' stamp issuing and promoting activities on behalf of its principals, and after some discussion it was put up to Mrs Hart with a recommendation to approve. She did approve, but at the same time noted that she proposed to consult her colleagues on the general questions of the Crown Agents. However in June 1970 there was a change of government, and Mr Richard Wood succeeded her as Minister. In July Sir Claude notified a further purchase, that of a 20% interest in the new merchant bank in Sydney (para 78 above). In acknowledging this, Sir Richard King mentioned that:

'We are considering whether and in what form we should make a submission to the Minister in relation to the Crown Agents and we will of course be consulting you in due course about this.'

In September the first draft was sent to the Crown Agents of a lengthy brief or background paper which was to form the proposed submission to the new Minister. A little earlier, on 19 August 1970 Mr Smith had sent Sir Geoffrey Wilson a summary of the present situation as he saw it. This contained the following important paragraphs:

'I continue to believe that the main real issue is the distinction between the Crown Agents' actions as agents and their actions as principals. If the Crown Agents were prepared to restrict their business to acting as agents and to accept some stricter arrangements with us for prior consultation in respect of new fields of business or investment, then I think that we might probably be able to advise the Minister to retain the present arrangements untidy as they are. With all their untidiness they attract a considerable volume of valuable business to the UK and I doubt if we could necessarily assume that all this would continue undisturbed if the Crown Agents were floated off as a body separate from the Government. If however the Crown Agents, using the ingenious financial services of Mr Challis, are unwilling to abandon their so far profitable and expanding business as principals, it seems to me much more in question whether the present constitutional set up can continue. There are inevitable risks in handling £100m of other people's money and for the Minister to underwrite this sort of risk while having virtually no say in how the money is handled and what business is taken on, seems to me a situation not merely indefensible but potentially ludicrous—he would look plain silly if in these circumstances he had to answer in Parliament for a Crown Agents boob.'

Mr Smith might have written even more strongly had he known that the Bank of England had already approached the Treasury about the Crown Agents' activities.

### **(3) Bank of England's concern**

107. For some time the Bank of England had felt uneasy at the items of news about the Crown Agents which reached them in one capacity or another. For example, the Crown Agents had since the 1950's enjoyed a special arrangement whereby they were allowed to buy Treasury bills from, or sell them to, the Bank later in the day than was allowed to other customers of the Bank. The object of this was to serve the overseas principals by ensuring that their balances could be invested promptly without loss of interest. But in 1969 the Bank discovered that the Crown Agents were using this concession for dealing

on their own account; this they considered to be an abuse of the facility, and they withdrew it. Also, 'We felt', said the Deputy Governor in his evidence to us, 'that they were dealing in paper of less good quality than we thought they ought to.' When the Bank's officials read the Sunday Times article of 19 April 1970 (para 103 above) their unease increased to active concern. They approached Sir Claude with a request for information, and in consequence one of their senior officials had an interview with Mr Challis. And on 13 May 1970, the Deputy Governor orally informed the Treasury of the Bank's concern at the risks the Crown Agents were running if the facts given in the Sunday Times article were accurate. The Bank's officials got a certain amount of information from Mr Challis, but, as it now appears, they were not given a full picture of the own-account dealings and were told little of the property investment expansion. They were left with a high opinion of Mr Challis's ability, but with insufficient information to allay their doubts, and with an impression that the staff were insufficiently experienced to conduct the widespread new banking and investment activities. The Governor, on the 9 December 1970, voiced his concern to Sir Frank Figgures (then Second Permanent Secretary at the Treasury) over the Crown Agents' activities.

108. The Treasury was the proper channel for communication between the Bank of England and the Government. As Sir Jasper Hollom said to us:

'You must remember that throughout we felt that this was a body which was more within the field of HMG than ourselves and so that our tendency, if we felt concerned, was to say to the Treasury, "Here is an area which makes us concerned; ought not something to be done about it?" To a considerable extent with the implication that they should be doing something rather than us.'

Sir Jasper summed up the Bank's view at that time by saying:

'We thought that they were associated with some rather doubtful people and were therefore making some unwise investments which involved risks which we did not feel that a body of their standing should be taking with their principals' money. We also felt that they were not really subject to any appreciable control in what they were doing, and we thought that there ought to be control.'

The Bank's duty, as he saw it, was to warn, and this it did:

'The discussions were primarily between the Treasury and the ODM as to how its problems should be tackled. I think we probably felt that, having sounded some alarm bells and got the thing moving it was not an area in which we had any standing.'

109. The Treasury did not construe the messages received from the Bank as representing warnings about the Crown Agents' Fininvest operations, although they did share a common concern over the need to secure greater accountability and supervision. They do not seem to have regarded the situation as alarming, or as needing urgent attention. They were aware that the Ministry's thinking was tending towards an inquiry of some sort, and this they approved. On 4 December 1970 there was a meeting at the Treasury between Treasury officials and Mr Smith and Mr Burr of the Ministry. The minutes of this meeting start by saying:

'The meeting noted that the present lack of a clearly defined relationship

between HMG and the Crown Agents was potentially embarrassing both financially and politically and that FCO(ODA) was considering what future action should be taken. The Minister for Overseas Development wished to see a submission on this question and for this purpose a paper had been prepared.'

The minute emphasises that HMG's ultimate financial liability had not been lost sight of:

'Should, eg Finvest, turn out to be a financial failure the financial burden which might be laid on HMG—assuming that some degree of responsibility was accepted—might be considerable.'

But the upshot was that the Treasury, like the Ministry, felt that an inquiry was the answer to the problem. One thing missing from the minute was any reference to the Bank of England. Neither Mr Smith nor Mr Burr nor anyone else at the Ministry had heard of the Bank's action.

110. We asked the witnesses from the Treasury why more urgent action was not taken, having regard to the potential liability upon the Consolidated Fund, and in the light of the Bank of England's 'alarm bells' and the other disquieting information. These were the answers given by two of those witnesses:

(1) 'I am sure that the Treasury were definitely thinking that something should be done. However at that point the Minister for Overseas Development said that he thought, on the basis of a submission paper prepared by ODM, that there should be an inquiry. From that point onwards there was not much that the Treasury could do. They certainly could not refuse to have an inquiry, but they could not do a lot while it was sitting;'

(2) 'although there was disquiet about the development of the Finvest activities, there was not, certainly in the winter of 1970–71 any expectation or assumption that the kind of investments that were being made were of a particularly risky kind. As regards the doubts expressed by the Bank about the managerial ability of the Crown Agents, we in the Treasury were, of course, in no position to judge this, because we had no direct contact with the Crown Agents. Nor, for that matter, was there hard evidence to use with the ODM to suggest in this particular respect that action ought to be taken.'

111. Meanwhile the paper or brief for submission to the Minister was finalised on 30 December 1970. This was the day before Sir Geoffrey Wilson left the Ministry. On 21 December Sir Geoffrey had addressed to the Minister a note referring to the forthcoming paper and setting out the advice he would tender upon it. This important document is reprinted at Appendix X. Three points should here be made upon it. Firstly, the 'obligation to bail them out' is regarded as a moral rather than a legal duty: Sir Arthur Grattan Bellew's advice seems to have been ignored. Secondly, in respect of risks, we note the statement that:

'Some people think that you might minimise the risk by exercising more control than at present over the activities of the Crown Agents. I do not myself believe that this is either possible or desirable.'

That was a reference to the divergence of opinion apparant between Sir Geoffrey and the officials who had reacted with alarm to the C and A G's views about Finvest. It is important both as explaining the Ministry's weak response to the



problem, and the feelings of hostility which, as we shall see, Sir Claude developed towards the Ministry officials with whom he should have been working in harmony. Thirdly: 'I think the extent to which you are at risk is quite minimal.' Sir Geoffrey infers this from his view that:

'The Crown Agents have conducted their affairs sensibly and efficiently in the new circumstances of the last ten years, and in my view there is no reason for any change.'

This contrasts markedly with Mr Smith's strong opinion given in para 106 above. Time was to show that Mr Smith was right, and Sir Geoffrey was wrong. We appreciate Sir Geoffrey's point that 'we do not have the competence or commercial expertise to supervise their activities in any meaningful sense;' but while the Ministry could not be expected to have the ability to monitor banking operations there was a public institution concerning itself with the Crown Agents which had just that expertise and that was the Bank of England. Had the Bank's concern reached Sir Geoffrey, he might not have written as he did.

#### **(4) Summary**

112. Fourteen months had now elapsed since the C and A G had alerted the Treasury and the Ministry. The legal position had been explored (but not exploited); the tax position had been explored; the process of grappling with the larger problems of structure and accountability had been started. It had taken a long time. We appreciate Sir Geoffrey's standpoint, put to us in these terms:

'The question that was in my mind then and now is, given that you have appointed competent people in a successful organisation to what extent do you then recognise that things could go wrong, and therefore put yourself in a position to interfere at all moments with their activities?'

We appreciate too that the Ministry was entitled to trust to the integrity of the Crown Agents; and had been led to believe that the financial operations were profitable. Nevertheless too much time was slipping by. Sir Geoffrey recognises this now. He said to us:

'One of the regrets I have on this is that we did not get some kind of an inquiry going earlier. I think the lack of urgency on this was a pity.'

113. Our account of the Government's handling of the Crown Agents problem has taken us up to the end of 1970 and we must now go back and see what the Crown Agents were in fact doing at this time.

## **IX The Finance Directorate 1970–1971**

### **(1) Reorganisation**

114. The rapid growth of own-account activities led to an enlargement of the staff of the Finance Directorate, and, in April 1970, to its reorganisation into four separate departments. These were Investment, Banking, Financial Services and Control. Above these stood the Director of Finance, Mr Challis. The head of Investment was Mr Shuter: his function related to quoted securities and largely to principals' portfolios. Financial services provided the book-keeping function for the other departments: its head was Mr Knight. Control meant accounting;

this office was not filled until later in the year (para 118 below). The important department for our purposes is Banking. Its head was Mr Clark, its deputy head was Mr Hewins, and under them were ranged three investment Managers—Mr Wheatley, the sterling money market manager, Mr Blundell, the foreign money market manager, and Mr Sly, the property manager. These three officers were directly concerned, together with their superiors, in the investments into which the Crown Agents' funds were deployed. A suggestion was made in 1970 that the Equity Investment Advisory Panel be abolished as yielding no better advice than the staff could tender. But it was retained, partly for window-dressing or propaganda reasons. (See paras 74, 98 above).

115. In addition, an increasingly important branch of Finance was Four Millbank Investments, through which the Crown Agents held their key equity shareholdings. The board of FMI was chaired by Sir Claude and had a permanent majority of directors drawn from the Finance Directorate. But its efficiency as a policy making body was limited by its peculiar constitution (para 15 above). The Executive Director of FMI was Mr Johns who was also Assistant to the Director of Finance.

116. The funds at the Finance Directorate's disposal were the Joint Consolidated Fund, the Joint Miscellaneous Fund and Finvest. By now the distinction between Finvest and the other funds had become quite blurred. Finvest had started as an own-account fund fed by money market borrowings, but was now increasingly fed by principals' term deposits. The joint funds had started as principals' call money in sterling but by now they embraced principals' deposits in both sterling and foreign currencies and some foreign currencies borrowed by the Crown Agents themselves. The joint funds had traditionally been invested in Treasury bills, government securities and bank deposits, but were now increasingly put into commercial loans and equities. If a manager wished to lend £1m to some organisation it seems to have been a matter of indifference which fund was drawn on. By the end of 1970 the funds which the Crown Agents deployed had passed £400m, including £180m assigned to Finvest, of which £125m was principals' deposits. The original idea of Finvest had gone, and the Crown Agents were conducting a banking operation with funds the greater part of which came from their principals.

## **(2) The Accounts consolidated**

117. This merging of Finvest and the joint funds is linked with the consolidation effected in the 1970 accounts. The office of Director General of Overseas Audit Service was wound up in 1970, and another auditor had to be found for the joint funds. After some discussion of alternatives this task was given to the Exchequer and Audit Department, who thus brought within one audit all the Crown Agents' activities except those of their subsidiary companies, notably Four Millbank Investments. In agreeing the new form of accounts in October 1971 the Treasury inserted this significant provision: 'provided that their content is amplified by notes, forming part of the audited accounts, such as to conform to the standards of disclosure required by the Companies Acts where these are appropriate'. We have had conflicting accounts as to whether it was the Auditor General or the Crown Agents who initiated the idea of consolidation. This process was undoubtedly facilitated both by the combining of the two audits, and also by the fact that when the time came for the accounts to be prepared the Finance Directorate had its own accountant.

118. This was Mr G R Towse, appointed as from 1 November 1970 in consequence of Price Waterhouse's recommendation (para 87 above). Mr Towse is a Chartered Accountant; he was then 31 years old. His previous work had been as a management accountant with Jessel Securities Ltd. He had been ill, and he had answered the Crown Agents' advertisement in the hope that he would have a quieter and less exciting life than in the City. He found the life to be somewhat different from that which he had expected. At the outset he did not find his new position an easy one. He was a young man among seniors, he was a newcomer among those whose whole working life had been spent in the office, and he was an accountant in an office unaccustomed to accountancy disciplines. He told us that:

'They saw me as a convenient person who could keep the accounts groups functioning, and my role, from their angle, was simply to pacify the Exchequer and Audit Department and give them what they wanted. I think any attempt to produce more than they wanted would have led to my being put pretty firmly in my place. You must remember that this place has survived, as I was frequently told, for 130 years odd with no chartered accountants, and therefore they regarded me as somebody who had perhaps in the nicest possible way been inflicted upon them by Price Waterhouse.'

119. Mr Towse in his evidence to us linked the consolidation with the fact that the JCF was found to be insolvent at the end of 1970. This was due to falls in value of the foreign currency investments which it held. Mr Towse said that Mr Challis suggested consolidation as a means of disguising this state of affairs.

'I think Mr Challis gave me the job (sc. of consolidation) because he was very concerned about the state of affairs in the JCF because of a substantial unwise investment in the American market. The JCF was clearly insolvent at the end of the year—that is, if the previous accounting conventions had been applied. To have published an account showing that the JCF was insolvent would have been terminal to Mr Challis's position, so he had a very strong interest in seeing what accounting techniques he could extract from me.'

120. What was ultimately done was that the sum of £1,649,000 was transferred from the Office Fund to the JCF. It was described in the JCF balance sheet as 'Due from Office Fund' and in the Office Fund balance sheet (together with £2,000 transferred to the JMF) as 'Amounts due to funds managed by the Crown Agents.' To enable the Office Fund to find this money, the property assets were written up by the requisite amount.

121. Since the Office Fund was concerned, Mr Nowers had to be brought into the picture. He was appalled at the situation. He did not so much mind writing up the property, which he conceded had been previously carried at an undervaluation, but he objected strenuously to concealing the insolvency of the JCF. He regarded the process so he told us, as 'rigging the books'. He felt that the Board and the Chairman should be informed before the process was carried out; and on 17 December 1970 he went to see Mr Challis to tell him so. He was told, he said, in no uncertain terms to keep out of the affair, and he was so shaken by what Mr Challis said that he did not take the matter higher himself. Instead, he took the precaution of making a full note of the interview, putting this in a

sealed envelope, and handing it to a colleague to keep. He did this, he said, because:

‘Challis could be a very dangerous man. He was very influential. I crossed swords with him on more than one occasion. As you will see, on this occasion he had said quite specifically “Keep out. This is nothing to do with you”. I felt my position to be very vulnerable and yet had I made any representations at that time I think it could well have looked like personal vindictiveness and, as I say, Challis’s voice usually stood against mine.’

122. Mr Towse did not feel so strongly about ‘rigging the accounts’. He regarded it as the lesser evil, the alternative being to ‘bring disaster on the office’ since it was assumed that principals would withdraw their funds if they saw that the JCF was insolvent. He did not think it would have been useful to go to a higher level: ‘I think Challis would have stabbed me in the back if I had gone higher.’ In Mr Towse’s favour it must be remembered that this dilemma was presented to him within a few weeks of his joining the office. So much for his hopes of a quiet life!

123. The audit of these accounts took a long time. This was in part due to the extension of the Exchequer and Audit Department’s jurisdiction to the new field of the joint funds, and to securing Treasury and Ministry approval both to this audit procedure and to the new form of consolidated accounts. The auditors’ certificate was not given until 12 January 1972, more than a year after the close of the period dealt with. We shall later be considering this delay and even longer delays in later years, and examining their causes (see paras 280 et seq below).

124. As ultimately published the accounts comprised balance sheets for the Office Fund, the JCF, and the JMF and a consolidated balance sheet for all three funds, together with a separate revenue account for each fund. This time the assets and liabilities of Finvest appeared, although not described as such, in the Office fund balance sheet; the device of showing only one figure for the net assets had been abandoned. Among the notes to the accounts were (i) a statement that the greater part of the freehold and leasehold properties occupied by the Crown Agents’ offices (£8,046,000 out of £8,134,000) were ‘at directors’ valuation 1970’, and that ‘the valuations adopted by the directors in 1970 are substantially below recent professional valuations’; (ii) a note that ‘The revaluation of certain properties occupied by the Crown Agents’ offices has produced a surplus of £4,358,000. This has been utilised in making full provision for loans which may prove irrecoverable (note 5) and in making provision for the loss which would have occurred if the quoted investments of the Office and joint funds had been realised at the year end’. Note 5 indicated that £1m had been provided for loans which might prove irrecoverable. The accounts showed that £3,358,000 had been provided for loss on the value of investments, but careful examination was needed in order to discover what share of this sum related to each of the three funds. Nor was it made clear that the ‘valuations adopted by the directors’ had been arrived at in order to produce the exact sum needed for provisions. Nor was there anything to indicate that the £1,649,000 described as ‘due from the Office Fund’ in the JCF balance sheet was a subvention and not a debt. We note that the Comptroller & Auditor General gave an unqualified certificate and made no report to the Treasury. The present Comptroller & Auditor General in his evidence to us made the points that it was after a good deal of discussion that

the Crown Agents agreed to the notes, and that the revaluation and its application were disclosed in these notes, although

‘whether it was as explicit as might have been the case is perhaps arguable . . . I would not want to argue it was the ideal way. We did have a lot of discussion about it at the time. I certainly do not think it could be said there is no disclosure. There is a clear disclosure of what happened.’

He also pointed out that the revaluation itself was reasonable, and that the loss on the JCF was an unrealised loss in the sense that the securities which had fallen in value were still held and the loss could have and partially did disappear in the following year. But although accepting the procedure for 1970 ‘we did make it clear that for the future we would not think it appropriate to secure a provision from a revaluation of assets of this kind’.

### **(3) The Status of Principals’ Money**

125. The consolidation of the accounts in 1970 made it difficult if not impossible to continue to maintain the co-operative theory of the JCF. Mr Hewins said:

‘Whatever may have been the situation with regard to surpluses before consolidation I think it was quite clear after consolidation any surplus merely had the effect of swelling the residual assets of the organisation as a whole.’

Mr Challis agreed, and mentioned counsel’s opinion about the Marine Insurance Fund (para 17 above) which he thought applied by analogy to the joint funds. That opinion was given, of course, in 1966, but Mr Challis put it at 1971, the year when the accounts for 1970 were being consolidated. However his conversion from the co-operative theory to the own-account theory can be dated earlier than that. In August and September 1970 there had been correspondence between Mr Burr at the Ministry and Mr Challis about the need for the JCF to have a reserve. Mr Burr had written:

‘Surely as managers of the JCF you are rather like my bank manager who if I instruct him to buy me some shares or if I give him some general direction as to what shares he can buy with my money does not expect to have a reserve to pay me any losses which he may have incurred. The only reserve he would need would be against his own negligence.’

To this Mr Challis replied on 25 September 1970 saying:

‘The equation with the Bank Manager is not in the sense of your instructing him to buy shares but in putting money on deposit with him which you expect back in full whenever you like to call it. What he does with the money in the meantime is his business and he will similarly like a reserve against any mishap of his own.’

There could hardly be a clearer rejection of the co-operative theory in favour of the own-account view. The JCF was like any other bank deposit account; the fund could be used in any way the banker chose, and the profits or losses were for account of the banker and not of the clients. But, as we shall see, the co-operative or non profit making view of the joint funds was retained as an argument to be used by the Crown Agents when it suited them, for example in dealing with the Exchange Control Department of the Bank of England.

#### (4) Exchange Control

126. The Crown Agents never at any material time had exchange control permission to operate in foreign currencies on their own account. As the Bank's representative said in evidence:

'We made it quite clear that we would not give consent for them to invest their principals' money as principals themselves.'

The Crown Agents did however receive certain permissions in respect of the JCF upon their representing that this was principals' money. We note that on 29 January 1970 a letter was sent to the Bank of England signed for Mr Challis by Mr Shuter, stating:

'As the Bank are doubtless aware, the JCF is a pool of liquid funds belonging to the Governments who are our principals, and is managed exclusively for the benefit of those principals; the joint ownership nature of the fund is accepted by the Board of Inland Revenue who accord the fund "Crown exemption" from UK taxes. The profits from the fund's operations accrue to the fund after payment of the Crown Agents' management fee.'

In reply the Bank wrote:

'I am pleased to say that the Bank of England are agreeable that the Crown Agents should continue their practice of lending foreign currencies in their own name, notwithstanding that the capacity in which they provide their services to overseas governments, institutions, etc, is that of an agent.'

Later, in September 1971, Mr Blundell suggested an application for permission to deal in foreign securities on behalf of the JCF. A draft application was prepared but not sent. Mr Challis is reported in a note on the file to have said that the application should not be sent but that 'we should wait to be reminded by the Bank'. The draft letter included the statement that:

'As you are doubtless aware that JCF consists entirely of funds (including sterling) in the beneficial ownership of sovereign governments.'

In August 1972 Mr Blundell expressed doubts about the exchange control situation. Mr Osgodby noted on the file that 'for very good political reasons it has been agreed to let this matter lie for the time being. Please bring it up in three months' time'. It does not seem to have been brought up again. Mr Challis agreed that he thought it better to let sleeping dogs lie. He was asked:

Q Once you had got your opinion about the Marine Insurance Fund and had come to the conclusion that the Joint Consolidated Fund was your money and not principals' money technically, why did you not get the Bank of England to deal with it, across the currencies?

A I do not think it ever presented itself to me as a particularly important point. I must admit, looking at it in retrospect, it would have been more sensible to do it, but the Bank of England itself did not seem to be particularly concerned about it.

127. We have evidence that the Crown Agents' policy towards exchange control was to avoid seeking permission whenever possible and, if forced to seek permission, to conceal their own-account activities. Thus Mr Shuter in

November 1969, when he was Deputy Head of Finance Department, had sent a note to Mr Clark, saying, inter alia:

‘As you know, we do not wish to broadcast news of our foreign currency dealing until we are more sure of our status and at least can point to a significant balance of invisibles earned by repatriated profits taken in sterling (and lodged with the B of E) in the event of awkward questions.’

Mr Clark told us that the ‘awkward questions’ would presumably be those asked by the Bank of England. This was at a time when exchange control permission had been given to conduct certain dealings in foreign currencies in the Crown Agents’ own name on the faith of the representation that this was in fact done as agent for principals. Mr Shuter said to us:

‘I think the whole question of foreign exchange control here in my somewhat lay opinion, even now, hangs upon the status of the JCF and certainly in my own admittedly somewhat inexperienced view at that time—and even to this day—I found it reasonably logical to think that a fund which was, if you like, a bath filled by taps all of which were essentially sovereign state funds and recognised as such by the Inland Revenue as being tax exempt was not of itself collectively an external fund and not subject, as I would have understood it, to this kind of domestic regulation.’

Mr Johns took the same line. He said:

‘The JCF was regarded by us very strongly at that time as being a foreign sovereign fund . . .’

Q You mentioned a foreign sovereign fund. Was somebody within the Crown Agents saying the JCF is outwith exchange control because it is foreign government money?

A That is the way we took the JCF to be. The situation of the JCF was that it was foreign government money.

Q When you say “we”, who are “we” in that context?

A The total senior management of F Department at that particular time.

Q Did you take any advice about it from solicitors?

A Not that I have seen at all.

Now that sort of thinking might perhaps have been honestly held by those who took no advice and had not learnt that there was no Crown exemption from exchange control; and it might have been honestly held at a period when the co-operative theory of the JCF prevailed, but it is difficult to see how such a view could have survived the consolidation of the accounts for 1970 and how it could ever have applied to moneys borrowed abroad by the Crown Agents. No application was ever made for permission for own-account dealings, although the DGOAS was assured, when he asked (para 102 above), that the foreign exchange dealings were in accordance with exchange control.

128. However we say no more about this subject because we understand that the exchange control authorities are pursuing their own investigation into the matter, and into the allied question of non-payment of dollar premium. Its relevance to our inquiry is the light it casts upon the ethical standards prevailing within the Finance Directorate.

### (5) Banking Expansion

129. The magnitude of the Crown Agents' financial operations by this time is indicated by the following summary of the consolidated balance sheet at the end of 1971.

	£m	£m
SOURCE OF FINANCE		
Deposits by principals		300
Borrowed on the money market		111
Other liabilities		9
		—
		420
Reserves		9
		—
		429
		==
INVESTED IN		
Banking assets and advances		362
Investments—		
Quoted	22	
Associates and other unquoted	8	
	—	30
Property development		31
Property for own occupation		6
		—
		429
		==

130. A feature of the Crown Agents' operations that manifests itself in these figures is the use of banking funds borrowed on varying terms to finance own-account activities of a speculative or long term nature. These comprised FMI's investments in associates, the overseas portfolio investments of the JCF, equities held by Finvest and investment in property development, both direct by Mr Sly's section and through E&C and in Australia. They totalled £42m in 1970 and £61m in 1971. The diversion of banking funds to these activities became increasingly necessary over the years because Crown Agents' reserves did not rise fast enough to provide an adequate financial base for these activities. Indeed the bulk of the disclosed reserves was provided by revaluation of the Millbank premises and as such did not provide funds for reinvestment. The position at the end of 1971 may be summarised as follows:

	£m	£m
Reserves		9
Deduct property for own occupation		6
		—
Available for investment		3
Investments	30	
Property development	31	61
	—	—
Shortfall at 31.12.1971		58
		==

As no steps were taken to arrange long term finance, this shortfall of £58m had



to be funded by the banking side. The growth in this diversion of banking funds over the years is set out in Table 4 at appendix XVII.

131. This state of affairs is not readily ascertainable from the liquidity statements produced within the Crown Agents for their management purposes; these showed, for example, call advances to E&C Property (£5m at the end of 1970, £7m in 1971) with other call advances, notwithstanding that E&C Property was a subsidiary and that it had sunk these sums into property development: they could only be recovered insofar as E&C Property might be able to re-finance them elsewhere. Indeed Mr Walker told us in evidence that he from time to time told Mr Sly that he was unhappy about the short nominal term of these advances. It is clear that they were always intended to be rolled over and were only nominally short-term in order to balance Crown Agents' book.

132. Some of the lending was of an imprudent character and among the list of borrowers there begin to appear the names of companies which ultimately were to default. One feature of the lending is that a number of the borrowers were introduced by the Finance Directorate's solicitors, Davies Arnold and Cooper. In some cases this firm introduced clients of their own as borrowers; in other cases the firm took commissions from the borrowers, apparently as sub-agents to money brokers (para 172 below). Lending to financial institutions was normally unsecured, but security was generally taken on loans to commercial businesses and on property. The Finance Directorate did not concern itself with the quality of the security, but did lay down a general rule that lending should not exceed about two-thirds of the value. They left the assessment and processing of the security to Davies, Arnold & Cooper, who apparently assisted in many ways outside the ordinary functions of solicitors. Mr B R Levy, a former partner of this firm, told us that in his opinion the Directorate was insufficiently staffed for its task:

'One was dealing, I believed, with an organisation which, while engaging in the commercial world, in many ways was not really set up to do so from the point of view of normal administrative aids—enough secretaries etc, enough staff really, to cope with the situation . . . My firm collected interest for the Crown Agents on these various loans, including loans with which we had absolutely nothing to do. I suspect we sometimes acted on the making of the loan, sometimes not; but we got a list of accounts due each quarter, or whatever, and it was our function to collect them and chase up borrowers when they did not pay, simply because the Crown Agents did not I think have the administrative secretarial staff necessary to run that sort of operation.'

Mr Johns agreed:

'The amount of work was enormous . . . we were spread too thinly.'

Mr Levy used his discretion on occasion whether to take security, and what valuations to accept. Where he acted for both sides he did not feel embarrassment: if there was a conflict he only acted for one side:

'This was a situation where Bernard Wheatley had a fair amount of money at his disposal for investment. Some of the transactions which I dealt with for the Crown Agents . . . could have been improved by propositions from my own clients in the sense that I felt that the security, the status, the rate, etc, would be better for the Crown Agents than some of the transactions which

came to me as solicitor for the Crown Agents . . . This was a time when the Crown Agents had a vast input of finance and required to put it out again to earn money. Now, they wanted to put it out, and it seemed to me silly, if I had clients who would like to borrow it and who could provide satisfactory security, that I should not put the two together. Obviously one must take the point that there could be a conflict, but in dealing with these transactions I believe . . . I put the Crown Agents' interests first. I am hopefully a commercial lawyer, and in that sense it seemed to me far more beneficial that I should preserve my relationship with the Crown Agents than with any other single one of my clients.'

It is only fair to Mr Levy to note that the Law Society's ruling which now prohibits a solicitor from acting for both sides (with exceptions which are irrelevant in the present context) had not then been promulgated.

133. Among the borrowers introduced by Davies Arnold and Cooper we must mention three hotel groups, the Casserley Hotel group, the Barclays Hotel group, and GS Gill Hotels. They have these features in common: they were all introduced to the Crown Agents by Mr Walker, they were all lent substantial sums against the security of their properties, and they have all defaulted. Mr Walker introduced these groups in July 1967, September 1968 and April 1969 respectively, and each case was followed by the granting of loans.

134. Barclays was the largest of these groups; on its first introduction one of its constituent companies, Highgrange Investments Ltd, was the applicant. This company was jointly owned by the Barclay brothers and Mr Kaye, the senior partner in Davies Arnold and Cooper. Mr Walker was sure that this personal involvement of his partner was known to the Crown Agents:

Q I think Barclays Hotels was one of the borrowers whom you introduced?

A Yes.

Q They had a subsidiary called Highgrange Investments?

A Yes.

Q In which your partner Mr Kaye was a shareholder?

A Yes.

Q Was that fact disclosed to the Crown Agents?

A I am sure it was. Bernard Wheatley had a very close knowledge of the business activities in which I was engaged. There is little doubt that Henry Kaye's name came up. I think we were both directors at one stage of Highgrange.

Q You say 'both of you'?

A Both Henry Kaye and myself. I cannot be sure.

135. Later, in 1970, the Barclay brothers put up a scheme for the purchase of a large hotel in the West End of London. A memorandum in support, signed by Mr Walker, was sent to the Crown Agents. The memorandum forecast high profits, and as regards the price of the hotel said:

'Based purely on the value of the property, it would be difficult to justify the price being paid but based on the operating profit of the hotel . . . this fully justifies the purchase price and as an addition to a hotel group anxious to invite public participation, it becomes a good buy.'

The Crown Agents lent the whole of the first instalment of the purchase price, and took an option to purchase at par between 17% and 29% of the issued share capital of the company. The idea was that the company would later go public, and the hope was that in that event the Crown Agents' equity would yield a handsome profit. J and A Scrimgeour, the stockbrokers, who were at this stage advising Barclays, recommended the proposal in these words 'the whole situation is a high risk one but it could well prove extremely profitable to all parties', and they suggested that the Crown Agents should have accountants check the figures. This the latter decided to do, and they asked Cooper Brothers to examine the books and report. Mr Towse wished this to be a full report, but Barclays wished to exclude from the accountants' purview the calculations and figures contained in the profit forecast and the assumptions underlying it. Mr Johns, to whom Mr Towse reported, decided that only a limited report was needed from the accountants. We asked Mr Towse:

Q Do you know why the Crown Agents went on despite that?

A They had a characteristic contempt for accountants. If Coopers merely checked the numbers, that was all Coopers or any other accountant was competent to do.

However the profit forecast was not met, Barclays did not go public and the option was not taken up. The Crown Agents continued to support the group with loans, which reached a total of £9.5m by February 1974.

136. Casserley Hotels reached a total borrowing of £5m and GS Gill Hotels a total of £2m. The easy relationship of the Crown Agents and these clients of Davies Arnold & Cooper is illustrated by the fact that when in June 1972 Casserley Hotels wanted to find building finance from another source, the Crown Agents at Davies Arnold & Cooper's request released one of the properties charged to them so that it could be used as security for the new loan. This left the Crown Agents with sufficient security, as it seemed on the then current valuations. Mr Levy, of Davies Arnold & Cooper, explained his role as follows:

'What happened in this case was that Casserley came to me and said "I should like to buy this; where do I find the money?" I said "let us go into the whole situation, and tell me what you think your hotels are worth now". It was a time of rapidly moving values. I organised something for him which I thought would be acceptable to Crown Agents, and I put the proposition.'

Later on, however, the Crown Agents had second thoughts about the same solicitor acting for both parties, and in October 1974 a member of the Finance Directorate wrote with reference to one of the hotel groups that:

'We are still unhappy with the situation in which you are acting for both parties in this matter with the consequent conflict of interests.'

We think it significant that this letter, referring to a practice of seven years' standing, was written in the month following the end of the old regime, and at a time when the new Crown Agent, Mr Cuckney, was initiating an investigation of the Finance Directorate. It should be mentioned here that in the case of each of the three hotel groups referred to above, some of the property valuations proffered in support of security were made by the firm of Caplan & Hay, chartered surveyors. This firm were Davies Arnold & Cooper's regular valuers; they will be referred to more fully at para 230 below.

137. On the direct investment side, the expansion during this period was largely into companies carrying on activities useful to the principals and we do not find it necessary to concern ourselves with most of these. Whether this vast and successful buying organisation should secure its infrastructure by buying a share in a cargo airline or whether this printer and issuer of postage stamps for customers throughout the world should also take an interest in the cognate services conferred by part ownership of Stanley Gibbons & Co. these are matters for commercial judgement. They may be wise or they may be the reverse but they are within the organisation's normal purview. We must however watch the merchant banking associates, both because it is questionable how far they ever did or ever were intended to serve the interests of the principals and because of the losses ultimately incurred. And the purely own-account investments, such as E&C are in the main stream of our inquiry, as is FNFC.

138. FNFC. During 1970 and 1971 the Crown Agents retained nearly two million shares in FNFC worth at the end of 1971 approximately £6.4m. Mr Challis replaced Mr Wheatley as a director in October 1970. This change of directorship came about at the instance of Mr Matthews, the managing director of FNFC, who thought that Mr Wheatley suffered from a conflict of interest with his directorship of SIS, and who also thought that Mr Challis would be a greater asset to FNFC. When the proposed change was reported to Sir Claude Hayes he took the point that Mr Wheatley ought not to have both an interest as director of SIS to seek loans and also authority as money market manager to grant them. Mr Challis dealt with this by instructing Mr Wheatley to report to the head of banking any loans he made to SIS. But no attempt was made to see that this instruction was observed and in any event it hardly met Sir Claude's point.

139. There were frequent purchases and sales of FNFC shares by the Crown Agents. We have investigated one incident recorded in a minute of 17 May 1971 from Mr Johns to Mr Challis. This said:

'Pat Matthews of FNFC telephoned to say that the FNFC price had fallen from 306 to 285 mainly on the market's reaction to the Green Paper. In his opinion the effect of the recommendations contained in the paper would be to FNFC's advantage and he asked if we would be prepared to enter the market as a purchaser to push the price back up to 300. Matthews stated that he would make sure that we did not stand any loss that might possibly be incurred (ie if during the next month we could not sell at a profit, Pat Matthews would pay for any loss which arose from the sale).'

(In fact the price moved up without this support being needed.) We asked Mr Challis whether he thought share support was a proper field of activity for the Crown Agents:

A I do not think it was an improper field of activity. It is not the sort of thing I would think it reasonable to do frequently. I did not know about this transaction until afterwards, actually.

We also asked him about the report that Mr Matthews would pay for any loss:

A I assumed that he was going to buy the shares from us.

Q Personally?

A Obviously, yes, He had a very substantial shareholding in the company himself.

140. Sterling Industrial Securities. During 1970/71 SIS expanded its banking business rapidly and also made other investments including property, Hawkes & Co Ltd the tailors, substantial investments in a variety of quoted companies and in insurance, including a 30% shareholding in Nation Life Insurance Co Ltd, subsequently sold to one of Mr W G Stern's companies. In late 1969 Mr Morris had joined Mr Wheatley as Crown Agents' representative on the board. Mr Morris used his influence to reduce the company's dependence on the Crown Agents, so that their lending declined from £7.5m reached in April 1970, when it constituted virtually the whole of the funds in the business, to £3m at the end of 1971, out of total deposits of £12m. One of the facts which he elicited when he protested to Mr Davidson at the high volume of lending by the Crown Agents in 1971 was that the deposit of a sum of £7.25m on 31 March 1971 was part of an arrangement made by Mr Wheatley to help 'window-dress' the balance sheet of a finance house, N H Woolley & Co Ltd. 31 March was that company's year-end: it had lent the sum to the Crown Agents, who had lent it on to SIS, which had lent it back to Woolley. After the balance sheet date had passed the transactions were reversed. The effect of course was to inflate both sides of the balance sheet by that amount. We asked Mr Challis about this transaction; he could not recall whether he had been consulted about it, but said:

'If I had, I would probably have said yes anyway, because he was a good friend of the Crown Agents over many years; he had been very helpful to us.'

This is not the only short-term window-dressing loan by the Crown Agents that we have come across. The only object of the device is to present a false picture to readers of the balance sheet and we regard it as a deplorable practice. Mr Challis's comment on the practice was:

'It was, and for all I know still is, a major City practice and it would be nice if this were not done, but one has to live in the world as it is.'

141. In October 1970 SIS issued 200,000 ordinary £1 shares at par, of these Lord Mais (the chairman) and Mr Morris each took 5,000 and 85,000 went to three major institutional shareholders, Crown Agents' holding being reduced from 33% to 25%. In May 1971 Mr Morris wrote to Mr Davidson thus:

'With the injection of support from three additional institutions SIS is now in a much better position to stand on its own feet . . . Crown Agents primed the pump in the early stages. The policy must be to reduce lending progressively to, say ten per cent of total borrowings.'

We come later (para 161 et seq) to Mr Morris's attempts to control the activities of Finance Directorate and only pause to note here that he had a steadying influence on policy towards SIS.

#### **(6) English and Continental**

142. For this company the period was one of continued expansion. In November 1970 it moved its office to London, to premises in Upper Brook Street, W1. It continued its house-building operations, using contractors for this purpose, chief among them being Pridestoke (Construction) Ltd, a company solely owned by the Greene brothers until early 1970, when a Mr R Day participated in the shareholding and became managing director. Through Mr Sly's contacts E&C secured a large contract to build approximately 1,000 houses for

letting to US military personnel. In December 1970 Mr Day joined the board of E&C, and so did Mr Challis, who became Chairman in succession to Mr Sly. At the 1970 year end the company's capital employed reached £14,229,000 of which £14,088,000 was loan capital, and of that £9,185,000 was advanced by the Crown Agents, £8m being secured by debenture. During the year Mr Walker had given up his partnership in Davies Arnold and Cooper in order to become a full-time director of E&C: he told us that this was Mr Challis's idea:

'As the company moved further into the commercial field, it was then Challis said that I should really give up practice and take on this full time. It was quite obvious that it was going places and needed, I suppose, my hand on the tiller.'

143. A feature of 1970 was that a large part of the Fininvest property portfolio was transferred to E&C. It will be recalled that Mr Sly had been authorised to invest £10m in real property and had gone about this task in a manner which we described as 'slapdash' (para 51 above). It was apparently realised before long that the routine tasks of monitoring such an investment and collecting its yield were beyond the Finance Directorate's abilities, and most of the smaller properties were passed to E&C as the subsidiary better able to cope. Mr Walker said:

'It was decided as fact—I was given it as a fact—that there was insufficient in-house expertise to run a property department. The portfolio which had been acquired was of a very poor quality in nature and was not of the type that Crown Agents ought to be associated with.'

Mr Sly said that the proposal to transfer did not come from him but from either Mr Challis or Mr Clark.

144. We call attention to the fact that the properties were not valued for the purpose of the transfer, but were taken over at book value, ie cost plus relevant interest charge. The amount credited to the Crown Agents was £4.3m. This was a time of rising values in the property market, and ordinary prudence would have required a valuation to have been made where, as here, the Crown Agents owned only half the equity in the company. If the properties showed a capital profit, as they ought to have done, the Crown Agents were making a free gift of half of the profit to their partners in E&C. Mr Walker however thought that the properties had been so haphazardly collected that they would be found to have shown a loss when sold by E&C. In that case it is surprising that the acquiring company did not demand a valuation. Since receiving Mr Walker's evidence we have ascertained the sale prices of those properties which have since been sold by the company. Some have been sold at a profit and some at a loss. Taking these figures, and taking the current values of the few properties remaining unsold, the overall net profit after deducting proper holding charges was about £700,000, a figure amply accounted for by the rise in property values in the period between transfer and sale. Therefore although we regard the failure to have the portfolio valued as reprehensible, we can record that the Crown Agents did not suffer from the omission.

145. Under Mr Challis as Chairman and Mr Walker as full-time director the company's property investment expanded in a remarkable fashion. Within weeks it had purchased two large London Office blocks, Cunard House and Burmah House. Its capital employed rose from £14 to £31½m by June 1971 and to £45m by the year end. The Crown Agents' lending increased to a peak of £23m by

August 1971, but had declined to £15m by December. This decline was due to E&C's ability to borrow on reasonable terms elsewhere, and that ability depended on a device utilised by the Finance Directorate and known within that office as the 'comfort letter'.

#### **(7) Comfort letters**

146. A comfort letter as used by the Crown Agents looked remarkably like a guarantee. We quote its wording from an actual letter dated 3 December 1971:

'In the event of your granting English and Continental Property Company Limited loan facilities of £1,000,000 on 3 January 1972, we confirm that on or after the maturity of the loan you shall be at liberty to call upon us to procure repayment of that company's indebtedness to you and you have our undertaking that on receipt of such request we shall arrange for your advance to be repaid together with accrued interest.'

This letter was addressed to a finance house and was signed on behalf of the Crown Agents by the Head of Banking and the Assistant Property Investment Manager. The earliest of such letters which we have found was dated 27 April 1971 and the approximate total sums 'guaranteed' by these letters reached a peak of £38m in April 1973. We cannot be more precise because no register of the letters was kept.

147. We have had varying and inconsistent accounts of the origin of comfort letters. Their purpose however is clear enough. They were a piece of double talk. To the recipient they were intended to convey the assurance that the Crown Agents would see them repaid; but they were internally regarded as binding morally but not legally, so that although they would be honoured as though they were guarantees, they need not be disclosed as contingent liabilities either in the accounts or to the board. Sir Claude was not aware of their existence.

148. If these contingent liabilities were to be omitted from the accounts one would expect that legal advice would have been obtained. Mr Towse thought that it had: he was 'under the impression that it had been cleared with Davies Arnold and Cooper'. Mr Hewins thought so too. He gave the following reason for the inception of the practice:

'The practice started when the English and Continental Companies with a continuing requirement for money to fund their activities could have looked to the Crown Agents to lend directly but the Crown Agents very much preferred not to, and wrote these comfort letters in order to elicit loans from the market for English and Continental.'

Mr Walker agreed that English and Continental looked to the Crown Agents to raise their loan capital. He said:

'It may come as a surprise to you to know that we, the executives of the company, did not know in the first instance such letters were being issued. The role of raising finance for the company was with Peter Sly who had (a) a Crown Agents basis and (b) was a director of English and Continental. I cannot particularise when we became aware of these matters. Certainly I was only asked to advise on their issue afterwards. I said . . . that they were peculiarly worded. I certainly believed the recipients of the letters were taking it as the Crown Agents' rather quaint way of saying "we are guaranteeing your loan".'

Mr Hewins had this to say:

'The text of the standard comfort letter . . . was to my certain knowledge either drafted by or finally approved by, Challis. If he was not the drafter but the final approver, the drafter would very likely have been Mr Jack Walker, but I think the truth of the matter is, it was Challis's drafting . . . He told us in specific terms that the wording was never to be varied. Under no circumstances. He said that he had satisfied himself and I sincerely believe that he added that he had taken legal advice, but I must say that I have never since been able to identify the source from which the legal advice had come. In fact the text of the letter was such that it would be unnecessary for the Crown Agents to footnote the amounts covered by these comfort letters on their balance sheet as contingent liabilities.'

149. Mr Challis differed. His evidence was as follows:

Q We have been told that you were responsible for the drafting and the wording of those letters. Is that right?

A Not to my recollection.

Q Who was?

A I have no idea. Was that not drawn up by a lawyer? I would have thought most likely it was the money market who produced the format.

Q Did you give instructions that the wording was in no instance to be departed from, otherwise their utility might be vitiated?

A Certainly not.

Q You did not?

A You mean that I gave some instructions that they were to be worded in such a way that they would be more of a guarantee or less of a guarantee?

Q No, that the wording must not be departed from. This was the wording laid down, so we have been told.

A That, to the best of my knowledge and belief, is completely untrue. I have no recollection of that at all.

Q What do you know about these comfort letters?

A The practice of giving comfort letters was one suggested by the money market, and to the best of my recollection the actual form that they took was suggested by the money market.

Q When you say 'money market' do you mean your money market people here?

A No, I beg your pardon; I mean the brokers.

Q The external money market?

A Yes.

Q Who were covering the loan from outside sources?

A That is right; they said this had become a common practice and this particular form had been accepted by various people. This was what I understood.

Q You accepted that advice?

A Yes.

Q What did you regard these letters as doing?

A I regarded them as a moral rather than as a legal commitment.



Q Did you take legal advice as to whether that was accurate?

A No.

Q Mr Hewins said that you conveyed that the letter was specifically drafted so that it need not be shown in the Crown Agents' accounts.

A This, if I may say so, is putting to me what I believe to be the advice which the Banking Department had received from the money market brokers.

Q Who are those brokers?

A May I make one point here? I must make it clear that it was not at my initiative that letters of comfort were given. As I said before I believe that the money market suggested that we should consider embarking on this business of giving comfort letters in the case of companies which were close to us, because they said it was an increasing practice. Other people were doing it.

Q Who were these brokers who suggested that?

A I simply do not know who the brokers were, but they were a number of leading brokers which we used; I think certainly one of them—

Q One of them was who?

A I have no idea who the broker was.

Q So some broker you do not know the name of suggested this; and on what basis did you decide that it was a moral and not a legal obligation?

A I was told that was the whole object of the operation.

Q By whom?

A Well, the broker told the money market who reported this to me.

Q Which individual reported it to you?

A I presume it was Hewins who reported it to me because he was the person with whom I normally dealt.

Mr Challis added that he regarded the letters as creating a morally binding obligation on the Crown Agents to procure their subsidiary to repay. He was then asked:

Q It could occur to anybody reading this that if you could not make them repay because they had not got the money with which to repay, then this undertaking that the advance would be repaid, would fall back on the Crown Agents. I am only saying that this is at least one view that could be taken of this document?

A Yes.

Q I want to make sure that this alternative did not cross your mind to the extent of your thinking it right to obtain some professional advice, either legal or accounting professional advice, about the status of an undertaking of this kind in relation to the affairs of the company and their recording in the accounts?

A Yes, it did not occur to me to do so, sir.

150. The devious story of the comfort letters illustrates the secrecy with which the Finance Directorate conducted its affairs. If it was right to go into the speculative property business, there could be no reason why the Crown Agents should not finance it either directly by loans or indirectly by guarantees. But by doing so in this way they prevented top management from appreciating the size of the involvement and the magnitude of the risks being run and also concealed the

existence of substantial contingent liabilities from the auditors and thus from the Ministry. The policy of concealment received striking illustration in 1972 when a sceptical lender sought confirmation that the signatories to such a letter were empowered to bind the Crown Agents. Mr Hewins minuted Mr Sly 'If the lender wants to see some resolution of the Board or document of authority from the Chairman or something of that kind, we should decline the business on that basis.' To us Mr Hewins explained that minute by saying:

'my then Director would have been seriously upset with me, if, by some action of this kind, I had exposed his comfort letters to the Chairman.'

We have little doubt that legal advice was not taken about these documents because it was feared that it would not support the Finance Directorate's interpretation.

#### **(8) Singapore and Australia**

151. Property expansion overseas was also taking place during this period; Mr Walker heard of a development site in Singapore and a local company, the Orchard Square Development Corporation, was set up to deal with it. This company took an option on the site in January 1971. We shall return later to the lamentable history of this company (para 258 below). It was owned as to 75% by the Crown Agents through FMI, 20% of the equity was held by Town & Commercial Properties Ltd, and the balance of 5% by Mr Walker. Mr Walker had visited the site prior to the company's formation and had approved it. It was he who recommended that Town & Commercial Properties be brought in, as a company familiar with the problems of overseas development. He carried out the investigatory work for the Crown Agents without fee, on an expenses only basis, reaping his reward, as he hoped, by being allowed to subscribe for 5% of the shares.

152. The Australian venture took a new turn in 1971. The Crown Agents' partner, Mr Felix Fenston, (para 59 above), had died suddenly in September 1970. This was shortly after the formation of the Australian company, Abbey Orchard Property Investment Pty Ltd, to carry out the partners' plans. The death of Mr Fenston threw the new venture into disarray, and the Crown Agents felt that another partner should be found, having experience of Australian property development. Eventually Capital and Counties Property Co Ltd was proposed for this role. It was already engaged in Australian development through its subsidiary, Capital & Counties (Australia) Pty Ltd. A complicated series of transactions was set up, involving the Crown Agents and Capital and Counties taking interests in each others' companies, in conjunction with Pennine, Mr Fenston's company (see para 33), and the setting up of a new jointly owned company, Abbey Capital Properties Pty Ltd. Under the former regime the Crown Agents, with their principal and Mr Walker, had a controlling interest, but in the new scheme the shareholdings they controlled dropped to 49% in Abbey Capital Properties, 30½% in Abbey Orchard Properties, and 30% in Capital and Counties (Australia). Mr Hewins explained the tripartite setup as follows:

'The original company carried the bulk of the interests of the original Pennine group. For that reason alone it had to carry on. Of the two new companies that came in, Capital & Counties (Australia) had, of course, a previous existence as the company that Capital & Counties had used for their own developments

which were in a much more advanced stage of completion at that time than our own. The new company was a jointly-owned company to do new developments together on top of what was already in the portfolios of the other two companies.'

The reduction in the Crown Agents' share of the equities was due to the presence of the third major partner, namely Pennine. Mr Hewins was surprised at their having as much as 23% of the new Abbey Capital company; he thought they must have been extraordinarily good negotiators. But Mr Walker explained the strength of their bargaining position:

'Under the terms of the original agreement there were mutual covenants not to compete for a period of 10 years. Crown Agents were not able to carry out this agreement except with the agreement of Pennine. Pennine's consent was procured on the basis they would continue; also they had in fact introduced Capital & Counties.'

153. Provisional Heads of Agreement upon these matters between the three parties were signed on 25 August 1971. They contained a provision requiring the Crown Agents to make loans to Capital & Counties (Australia) sufficient for it to wholly repay its borrowings from Capital & Counties in London and to complete its existing programme of property development. Figures supplied by Capital & Counties in January 1971 showed a requirement for A\$65m under these headings. On 29 September the Crown Agents instructed Price Waterhouse & Co (Sydney) to report on Capital & Counties (Australia)'s future cash requirements, but this was after the heads of Agreement were signed and indeed the binding agreement in its final form was signed on 19 November 1971 before Price Waterhouse reported in December. Their report did not upset Capital & Counties' figures, but the Crown Agents' slapdash approach to this matter would have left them very exposed had it been otherwise.

154. A further provision required the Crown Agents to provide a further A\$50m for the new company, Abbey Capital Properties. At this time the Australian economic scene was less rosy than at Crown Agents' entry into it in 1968 and in the event the new company's programme never reached this figure, but it was this commitment which seems to have made the greater impression on the minds of those concerned. Mr Hewins, who as the effective Head of Banking had to find the needed money, thought this commitment unwise. He said:

'I personally regard the deal that was done with Capital & Counties as very disadvantageous to the Crown Agents . . . My own feeling was that we were taking on far too much in the way of obligation . . . I was very worried indeed about the extent of our obligations before Capital and Counties came on the scene, but the deal with them meant that we had to finance the finishing off of their own programme as well as ours and also in the last resort at least be responsible for up to A\$50m worth of new development in the new joint company . . . I think myself that the price we paid was too heavy and that it would have been better not to do the deal and either try and find someone else who would not have extorted so high a price, or even soldier on with what we had started by ourselves rather than put ourselves in the appalling, to me quite appalling, position of obligation that obtained in the Capital & Counties context.'

155. Now the decision to enter upon this deal was taken by Mr Challis. There is a disagreement between him and Sir Claude over whether the latter agreed to the terms, Mr Challis said:

'The Fenston estate . . . surfaced with Capital & Counties and said were we prepared to accept them as substitutes for Fenston and I said we were. They approached Capital & Counties who agreed to do it, but asked us if we were prepared to do a joint venture with them on a bigger scale, they contributing their developments, we contributing ours to a joint pot effectively. We entered into some very protracted negotiations . . . I had kept the Chairman in touch with the course of negotiations, and there came a point in time at which we had finally arrived at what looked like a deal. I took to him a sort of draft agreement or something and said "This is the point of no return". This is as far as we can go in the deal.'

Sir Claude said in evidence that he understood the A\$50m commitment not to be binding but to be an expression of intent:

Q What do you regard as the nature of the commitment?

A As far as I was concerned it was 'best endeavours'. In other words I gave instructions that there should not be a legally binding commitment, a contractual commitment to raise this money willy-nilly.

Q Who did you give that instruction to?

A I either had Challis in my room or I said it at a Four Millbank Investments board meeting.

Q If the commitment were legally binding that means that your orders were disregarded, does it not?

A I do not think there can be a misunderstanding. Could I say on that, that I am not trying to take the benefit of hindsight on this. I have spent several years in the Treasury and one of the few things I learnt there was that you do not undertake open-ended commitments.

Mr Challis would not have this. He said to us that it would not have been possible to conclude the deal with Capital & Counties on such a basis, and, had it been insisted on, the deal would have been off.

156. However a last-minute hitch there clearly was, caused by Sir Claude's doubts. Mr Challis's account of this is as follows:

'We went through it (sc. the draft agreement) and when we came to the clauses about the A\$50m and so on we had some debate about it . . . After a little while he confessed himself unhappy about it, and more or less invited me to persuade him that it would be appropriate to go ahead. I remember saying to him that this was the most crucial point of the document, and . . . if he had some reservations on this score I was not going to try to persuade him against it . . . He said "I feel that it is perhaps too large a commitment; do you think you could decently get out of it at this stage?" I said "This is the stage at which that decision should be made." I went away from the meeting and I got on to Andrews, Joint Managing Director of Capital & Counties, and told him . . . He said "Oh well, I shall have to talk to my Chairman about it" and left it at that. A little later he rang up and said "My Chairman has gone off to have a word in the Ministry" or some such phrase.'

The Chairman of Capital & Counties was Sir Richard Thompson, MP. He did see the Minister, Mr Wood. Sir Claude's recollection of the incident was vague:

'I have a dim recollection that there was some reason why we wanted to delay it, and I cannot remember what that was, and that the Chairman of Capital & Counties went to see Mr Wood . . . There was some reason, I do remember, why I wanted to hold it up, and Thompson was very anxious it should not be held up, and he said he would go and see Mr Wood and get his agreement to it going through. I do remember this, but I do not remember that I was anxious to stop it altogether.'

157. These events led to a belief in the Crown Agents' office—as we were told by Mr Challis and Mr Walker—that the deal would have been off had not Sir Richard seen the Minister. In these circumstances we thought it right to take evidence both from Mr Wood and Sir Richard Thompson. From them a rather different picture emerges. Mr Wood had little independent recollection of the matter but he accepted a record made a few days later by his private secretary, who had been present at the interview which took place on 25 August. This note records Sir Richard as explaining the nature of the transaction, saying that the heads of agreement were due to be signed that day, and continues:

'Mr C J Hayes had advised Sir Richard that, in view of recent publicity surrounding the Crown Agents and an impending private inquiry into their structure, the Minister should be consulted before the agreement was concluded. Sir Richard emphasised that this was a normal—though large—transaction which would raise no doubts in other circumstances. His company was a large and respectable concern and both the company and the Crown Agents regarded the arrangement as highly satisfactory; there was certainly nothing to hide; but it seemed fair that the Minister should be forewarned. Some publicity was unavoidable at one stage or other. Sir Richard proposed to include a reference to the agreement in his Chairman's Statement, the final text of which had to be cleared that morning. He would be prepared to delete the reference but even so an announcement of the agreement would have to be made by the middle of the following week under Stock Exchange rules . . . Sir Richard asked if the Minister wished to intervene over the agreement or if he wished him to withhold mention of it from his Chairman's Statement.'

The note goes on to record that the Minister said that he would not wish to intervene but that he would consult his officials; that he held a discussion with Sir Michael Walker and Mr Burr, after which he confirmed that he had no desire to intervene.

158. Sir Richard Thompson had a clear recollection of the matter, and was aided by a note which he had dictated after the interview. His account is that on the day before the Heads of Agreement were due to be signed he was told that the Crown Agents were unwilling for the deal to be announced publicly. This was embarrassing because his company had a board meeting the next day at which he wished to finalise his statement to the shareholders at the forthcoming Annual General Meeting, and in it he wished to announce this new enterprise:

'My people said "the Crown Agents are rather reluctant that you should make this announcement without further authority because they have come under some public or political criticism recently, and they think that the announcement of a commercial operation could be inopportune or objectionable to

them at this time.” I said “Well, we have got this time-table that I hope to meet. The best way of settling that would be to go and talk with the Minister.” That is what I did.’

But first he saw Sir Claude. His contemporary note reads:

‘I interviewed Mr Claude Hayes of the Crown Agents this morning to see how serious these reservations were and if they could be overcome. Mr Hayes made it abundantly clear that he wished nothing better than a satisfactory outcome as soon as possible. Nevertheless he felt his position was an awkward one in that if an announcement of agreement were published at this time it could have the effect of embarrassing the Minister who, it was understood, was about to conduct an internal reappraisal of the functions, powers and general activities of the Crown Agents. I told Hayes that independently of my approach to him I had arranged the previous day for a personal interview with the Minister later on that morning. He very much welcomed this and stated he would hold himself in immediate readiness to join our meeting if it was thought desirable.’

Sir Richard’s evidence, and his note, proceed to record the interview with Mr Wood and its result. There is a difference in emphasis between the Ministry’s note and Sir Richard’s, in that the latter speaks of seeking consent to the publicity whereas the former talks also of consent to the agreement itself. We do not think there is any real conflict here: if the Minister was to be asked to approve of, or not to dissent from, the announcement, the deal had to be explained to him, and it is not difficult to see the private secretary, when drafting his note, thinking that the agreement as well as the publicity was the subject of the inquiry. Moreover if no announcement were to be made the future of the deal might be jeopardised, and to that extent the two questions were inseparable. We find it established that Sir Claude did have reservations about the matter, but that these were put to Capital & Counties only as regards the public announcement. It may also be that Sir Claude, if worried over the implications of the deal, wished to be able to say that the Minister had heard of it. This is Mr Burr’s view: he was consulted by the Minister immediately after the interview with Sir Richard, and he tells us:

‘My recollection is quite clear that the meeting was to discuss the announcement of what had already been agreed. Of course a discussion of the announcement would imply a discussion of the substance but I am quite clear that the point at issue at the meeting was that the Report of Capital & Counties was to be published the next day. . . and would announce that the Crown Agents were arranging finance for the Australian operation. Very late in the day Mr Hayes had said that the Minister ought to have an opportunity of hearing about this . . . I think he wanted to obtain Ministerial acquiescence in what he had already fixed up.’

159. A final point in this somewhat confused story upon which we are quite clear is that Sir Claude is mistaken in saying that he only approved the deal on a ‘best endeavours’ basis. In the Crown Agents’ files we have found Capital & Counties’ draft press notice, amended in Sir Claude’s writing. As drafted the relevant section reads ‘the Crown Agents will provide or procure short term funds sufficient to carry out further developments of at least A\$50m

and will undertake to find the long term funds'. As amended by Sir Claude, it reads:

'The Crown Agents will provide or procure short term and long term funds sufficient to sustain further developments which will amount to A\$50m over several years.'

This is the version which, with the addition of the words 'at least' before 'A\$50m', was released to the press.

#### **(9) 1970—71: Summary**

160. We can summarise the events of 1970 and 1971 by saying that the Finvest conception of dealing with a view to making profits for the Crown Agents reserves was being exploited to the full. In property the policy was to expand, at home and overseas, in conjunction with developers who would link their know-how to the Crown Agents' money: in investments the policy was to support by loans the companies in which the Crown Agents had a stake; in money market dealings the object was to show a profit margin by obtaining high interest rates either from the less secure borrowers or from longer term loans. It was now over four years from the start of own-account dealings. What had been achieved? The reserves had risen by £6.5m, from £2.9m in 1967 to £9.4m in 1971. But little of this increase can be ascribed to profits from Finvest and other own-account activities, the main elements being £6.4m from revaluations of the Millbank offices in 1968 and 1970 (for the latter see para 120 above) and £3.5m from revaluing FMI's shareholding in FNFC. Against these unrealised surpluses had to be set small losses on the traditional services of the office (£0.5m) and about £3m for losses on investments, of which £0.9m related to the fall in value of the JCF's foreign investments. In addition the Crown Agents had £1m on loan to the Vehicle & General Insurance Co Ltd when that company went into liquidation in 1971. Full provision was made against this debt in the 1970 accounts (see para 124 above). In the same year losses were incurred in the Mersey Docks & Harbour Board to which Crown Agents had lent £1.75m, plus a further £450,000 of principals' money. £525,000 was written off in the 1970 accounts and a further £543,000 in the 1973 accounts when the full extent of the write down occasioned by the reconstruction of the Harbour Board, consequent on the Mersey Docks & Harbour Act of 1971, became known. There were also two other defaults, both in the foreign sphere, \$899,000 had been lent to the Great South West Corporation and \$500,000 to the Republic Corporation. Those two United States borrowers had defaulted in 1970 and 1971 respectively. However no provision was made in the accounts in these cases and these loans were included at face value among the Crown Agents' assets in the 1970 and 1971 (and also 1972) accounts. Losses such as these were bound to attract criticism inside the Crown Agents organisation, and we now return to the other strand of our narrative, that of the efforts, within and without, to check the activities of the Finance Directorate. We start with the former.

## **X Criticism: Internal**

### **(1) Mr Morris**

161. Mr Morris was a not infrequent critic of the own-account activities and their manner of operation. We have seen his comments on Finvest in 1968

(para 20 above) and on the investment in English and Continental in 1969 (para 77 above). In the autumn of 1969 he initiated discussion of the current problems of organisation and communication, a discussion noteworthy for a forthright minute from Mr Challis in defence of his directorate. Mr Challis conceded that investments undertaken by the Finance Directorate with a view to improving services to principals, such as that in Stanley Gibbons might be discussed outside the directorate, but went on:

‘Those which are undertaken purely as an attractive investment . . . for example our participation in Keepsake Homes or First National Finance Corporation, is no whit different from any other investment decision which is undertaken by the Finance Department or at the highest, by the Director of Finance, and I should not be willing to accept the suggestion that these should be the subject of Board approval; in my view the suggestion that the Board should give their approval to our participation in these companies is on a par with the suggestion that the Board should approve the design of a locomotive by L Department.

It has also been suggested that the appointment of staff as Directors of these outside companies should also be subject to approval by the Board and here again I must demur in those cases where the participation has been undertaken purely for investment purposes.’

162. Upon that minute Mr Morris aptly commented:

‘What comes out of these minutes is the firm avowal by the Director of Finance that he alone will decide on:

- 1 Any participation in an outside company purely for investment purposes, whether or not it involves sharing in the management of the company.
- 2 The selection and appointment of a Director to represent the Crown Agents on the Board of such a company.
- 3 The investment of all money, whether it belongs to the office or to a principal or to others . . .

This whole subject is so important that it should be the subject of a paper for the Board, approved first by the Chairman.’

We asked the Chairman what had come of this, but he could not remember. The facts demonstrate that nothing did.

163. Further minutes by Mr Morris in 1970 and 1971 show him as aware of the risks to the Crown Agents’ funds and of the inability of the Board either of the Crown Agents or of FMI to secure prior consultation or any effective control. Unfortunately Mr Morris, although his status was that of Crown Agent, second only to the Chairman, now carried little weight in the Office. He has been described to us as a good general manager. Sir Stephen Luke thought highly of him:

‘I had a high opinion of him. When I first arrived at the Office, he had just become Head of General Purchasing Department. He then became Head of the first Management Organisation Department, and I increasingly thought he was a man of very considerable substance. He spent all his career in the Office; he knew it inside out. He had taken an external degree of the University of London in the evenings. I thought he was a very nice colleague and a loyal colleague, and a man who got on well. I thought too that it was a good



thing that having got an outstanding member of the indigenous staff, for the first time in the history of the Crown Agents it would be nice if they could produce their own Crown Agent. I was happy with him as my deputy . . . I have never served in any organisation where the esprit de corps was so great as it is here, and loyalty to the Office, and I think Mr Morris epitomised that.'

164. But under Sir Claude Hayes he had little influence, and with Sir Claude his relationship was very different. Partly this was due to the fact that Mr Morris, as deputy to Sir Stephen, had conceived the idea that he might be appointed to succeed him. One can appreciate the train of thought, although he was never in fact in the running for the office. Sir Claude was not tactful with subordinates and while he valued Mr Morris as an administrator he paid little attention to his judgement. To us Mr Morris summarised his attempts at reform by saying:

'The Board functioned well while Sir Stephen was in office, but it deteriorated after he left, so much so that I felt bound to minute Mr Hayes. There was no reply and no improvement up to the time I left . . . I would write these minutes and never heard anything more.'

This was an exaggerated view, in that in some cases Sir Claude added to the minutes that were circulating by attaching pertinent questions, although nothing came of them. Mr Morris was due to retire in 1970, but he continued in office on a disestablished basis until he left in 1971 in circumstances which we shall have to mention (para 196 below). It was his retirement gratuity which he had invested in SIS shares in October 1970 (para 141 above).

165. Sir Claude also neglected the views of the Crown Agents' board as a whole. On 14 September 1970 Mr Smith wrote to Sir Claude:

'Geoffrey Wilson has reached the conclusion that there should be a further look at the constitution and functions of the Crown Agents.'

Sir Claude was abroad at the time this letter arrived and because of its importance Mr Morris called a special Crown Agent's board meeting to consider it. Mr Morris was chairman at this meeting. Mr Challis and Mr Barley attended together with three other directors. The meeting adopted unanimously a paper prepared for the meeting by Mr Challis which suggested:

'That both the link with the Crown and the freedom of action could best be preserved if direct ministerial sponsorship were abandoned and the office were placed under the overall direction of a Court of Governors appointed by HM the Queen . . . Executive responsibility would rest with the chief executive and a board drawn mainly as at present from the career structure of the office.'

Such a solution would have put an end to Sir Claude's autocratic position as Senior Crown Agent. Sir Claude, when he got back to Millbank, signed the minutes adopting Mr Challis's paper but the minutes of the next meeting record:

'The Chairman said that he was taking no further action in connection with the letter dated 14 September 1970 received from Mr Smith until after the meeting with officials from the ODM.'

Mr Morris felt that Sir Claude was passing over the wishes of the board and told Sir Claude so without result. He then wrote directly to Mr Smith as follows:

'Hayes is, as you know, seeing the Minister on Wednesday next about Crown

Agents' affairs and he has not invited me to go with him. The reason no doubt, is that I do not support his intentions. Those intentions are to persuade the Minister that there is no need for an inquiry into the [Crown Agents'] office and also to try to "put to sleep" your letter to Hayes dated 14 September. My own view is that your letter must be answered and that no-one in this office should put to the Minister a point of view which is not representative. While Hayes was abroad I fell in with the wishes of my fellow Board Members that a Special Meeting should be called to consider the terms of a reply to your letter and to determine how best to convey to the Minister the desire of the Board that it should be associated with any decisions touching the future of the office . . . The meeting also had before it a paper [Challis's paper referred to above] and this was unanimously agreed by those present.'

After receiving this, Mr Smith telephoned Mr Morris to say that for obvious reasons he could not write an acknowledgement. He thought it was improper for Mr Morris to go to the Ministry behind Sir Claude's back.

166. This attempt by the board to participate failed because Sir Claude had little regard even for the unanimous opinion of his colleagues and the Ministry felt able to deal only with Sir Claude on these matters. Both of these attitudes were unfortunate as the proposals put forward by Mr Challis deserved serious consideration. These events also illustrate how Sir Claude discouraged contact between Crown Agents' staff and officials at the Ministry. Sir Claude was so successful in this that Mr Cuckney told us that when he became Senior Crown Agent in the autumn of 1974 he discovered that Crown Agents' staff went in real fear of being discovered by Sir Claude when they had had dealings with the Ministry (see para 367 below). But by the time Mr Morris submitted the board's proposals to Mr Smith the Ministry was already intending to recommend some sort of inquiry to their Minister and the time for independent action by officials along the lines proposed by the Crown Agents' board had passed.

## **(2) Mr Nowers**

167. Another critic was Mr Nowers. We have noted his appraisal of the risks of Finvest at its outset (para 21 above) and his dismay at the 'rigging of the books' of the JCF (para 121 above). In March 1971 he put up to Mr Morris a Board paper on 'Financial Control of the Office' which advocated the establishment of a real and independent controllership under whom he and Mr Towse could work. The paper referred to:

'The risk involved in the Finance Directorate in some of its traditional operations as well as in the more recent non-traditional developments . . . Concern at the financial involvement of the Office has grown in recent months as some disquieting items of news have become known. The variety of avenues through which matters have come to light itself illustrates the need of a direct flow of up to date information to central management and the events themselves demonstrate the need of closer control from outside the Directorate.'

This was not long after Mr Nowers' brush with Mr Challis over the 1970 accounts (para 121 above) and—perhaps not surprisingly—nothing was done. As time went by Mr Nowers became increasingly perturbed by what he heard on the office grape-vine, and in August 1971 he decided upon an unorthodox action. He wrote to the former Crown Agent, Sir Stephen Luke. He had had a conversation with him that summer about the 1970 accounts, and he felt that

his former chief was still in touch by virtue of his directorship of Sassoons, and that he would share his disquiet.

168. We print his letter at Appendix XI. It will be seen to be a comprehensive appraisal of the financial situation, its actual losses, its potential losses, and its outlook. In a striking passage Mr Nowers says:

‘All that has happened seems to me to be evidence that the Office has lost its sense of direction in, for want of better description, a spiritual sense. From money being needed as reserves against the hazards of our traditional activities we are becoming geared to money making as an end in itself.’

The letter was written, it states, because:

‘There are many of us in the Crown Agents who share your concern and it occurred to me that you, as an elder statesman whose views still command respect, might be able to exert some influence towards a return to sanity.’

169. Alas, this letter had no effect. Sir Stephen Luke now has little recollection of the matter, and in any event he would have been loath to interfere. He said:

‘My position by that time was a delicate one. I was no longer concerned with the Crown Agents in any way. I knew very little of what was happening here. I was rather disturbed at some of the publicity that they were managing to accumulate . . . I was not then on very good terms with my successor, and he was not likely to listen to me patiently. I may have talked to Morris about this, but I have to admit that in however much time I do not think it is likely I shall remember what I did about this. It was an embarrassment to me to receive it.’

170. We asked Mr Nowers the obvious question, why he had not carried these comments to the Chairman.

Q Supposing you had gone to the Crown Agent?

A It was Sir Claude Hayes at this time.

Q If you had gone to Sir Claude, do you feel that would have done any good?

A I find it very difficult to answer that. Definitely I feel it would have done no good.

Q Would you like to explain why?

A It was very difficult to make any comment to Sir Claude. In fact when, anybody was going to see him, my advice to them was ‘If you want to say anything, say it in the first sentence because you probably will not get any further’.

So Mr Nowers, having done what he felt impelled to do, dropped the matter. For his subsequent attempt at reform see para 331 below.

### **(3) Sir Claude Hayes**

171. Sir Claude Hayes has told us that he knew little or nothing about City finance, and was unable to form judgements upon what the Finance Directorate was doing.

‘All I could do was to make my views known and throw my weight around if necessary on matters which had impacts I could deal with.’

He did not find Mr Challis forthcoming; asked how he got on with him, he said: 'At this time I got on with him very well in the sense that I never detected any personal difficulty or any reluctance to talk or co-operate. I detected a reluctance to reveal the details of Finance Directorate business. I detected a feeling that I was not an expert and that he was and that it was a waste of time trying to tell me. It is a feeling that I have had myself on occasions and I can understand it. It was true. I was not an expert. Nevertheless personal relations were good and if I asked him to explain to me all about options or some obscure subject, he would gladly come and do it. There was not, so to speak, a voluntary flow of consultation.'

172. On at least two occasions during this period Sir Claude 'threw his weight around' in sharp minutes to Mr Challis. The first arose out of a claim by certain money brokers against Davies Arnold & Cooper, alleging breach of a warranty that they had the Crown Agents' authority to lend £11m to a client of the brokers, whereby the latter lost commission at  $\frac{3}{8}\%$ , or £41,250. The papers in the case showed that Davies Arnold & Cooper were getting  $\frac{1}{4}\%$  for introducing the borrowers to the Crown Agents.

173. Sir Claude found various matters in this affair disquieting, and he asked for a discussion with Mr Challis and others. In a minute dated 11 February 1971 he said:

'The questions which seem to me to rise are the following:

- (i) Discussion on the telephone amounting or leading to a commitment to lend without knowledge of the other party's standing or reputation. . . .
- (ii) Discussion as above without knowledge of the effective borrower or his business or standing (. . . our solicitors admitted that they had never heard of the borrowers but offered no advice on concluding a deal with them).
- (iii) Conclusion of a deal as above without knowledge of the use to which the money was to be put.
- (iv) Lending in full knowledge that the loan was going through a string of commission men . . .
- (v) Knowingly being parties to the receipt of introduction fees in respect of Crown Agents placing of money. Our own solicitors' share of this was £7,500.
- (vi) The characters of the people we were dealing with. They did not apparently even know who their own principals were, which suggested that they might have been percentage men getting the loan first and farming it out afterwards.'

174. The other occasion was the Vehicle & General Insurance Company's (V&G) default on the £1m loan. Sir Claude's minute to Mr Challis of 7 May 1971 reads in part as follows:

'I am bound to say that I am very perturbed, and not only with hindsight, at what the banking department have done in the way of unsecured loans to V&G . . . We made a £ $\frac{1}{2}$ m loan for three months on 13 October 1970. On 13 January 1971 we continued the same loan on an eight-day basis. By that time however the financial and investment press criticism had been going on for several months and was increasing daily. It seems to me irresponsible to have extended this loan beyond 13 January and not to have called it at any eight-

day period thereafter . . . Mr Hewins sent me a whole bundle of cuttings from the financial and investment press from June 1970 to March 1971, and every single one of them expresses warnings about the viability of V&G's operations. The simple fact is that during that time the value of the shares fell from 72/- to 12/-. This criticism is on a steadily increasing note. It is no answer to say that the comment relates only to the share values, because share values reflect the deep uncertainty in the City about all of V&G's operations. It is especially important that the Crown Agents, because of their status, should be "gilt-edged" in their financial activities and I do not see how any responsible officer taking note of these press comments could make loans unsecured, especially when the balance sheet was a long way back and (as it appears) we were virtually the only lender . . . We mentioned this morning that this case raises the question how far we need to be involved in unsecured lending of this kind.'

175. When he came to give evidence to us Sir Claude seemed to think this matter less serious than the wording of his minute would indicate. He said the minute had been written after discussion with Mr Challis in order that it be circulated as a reprimand to whoever had slipped up, and as a warning to others generally.

'So far as I know, this was one careless deal, which I was using as an example. I was not aware of other careless deals. But what I was trying to do was to bring home to Challis, and his staff, that constant care is needed.'

176. These minutes show, it seems to us, that Sir Claude was well able to discern what was wrong in an individual case when the facts were presented to him, but was unable or unwilling to draw the inference that the organisation and control of the Finance Directorate needed radical overhaul. In part this inhibition seems to have been due to the inferiority he felt in the face of Mr Challis's superior expertise, as already mentioned. He felt dependent on Mr Challis, he told us, and lived in fear of Mr Challis being induced by the City's higher pay scales to take his talents elsewhere:

'It is all very well now for people to say that I should have dealt with him in this way or that way, but what would they have had me do? We depended upon him. He stood head, shoulders, and waist above everyone else. There was no one who could take over from him.'

He had, he said, devoted thought to the problem of control, but had come to the conclusion that the only feasible way to deal with the situation was to recruit someone at the top of the organisation who was a banker or otherwise had City experience. Such a colleague, he said, he had frequently urged the Ministry to appoint, and this is a topic which we shall be discussing later (para 312 below).

#### **(4) The Credit Committee**

177. Checks upon the Finance Directorate within the Crown Agents organisation were therefore non-existent or ineffectual. However the Directorate did itself devise one measure to improve performance, and this, so Mr Challis informed us, was the direct result of the V&G affair. This was the setting up of a Credit Committee. It was initiated by the Head of Banking, Mr Clark, in the autumn of 1971 and consisted of himself and his deputy (Mr Hewins), the sterling and foreign currency investment managers (Mr Wheatley and Mr Blundell), and the accountant Mr Towse. Its first meeting was held on 7 September 1971. Its function was to consider the creditworthiness of applicants for unsecured loans and

to decide whether to put them on the approved list, and if they did, to impose a ceiling on lending. Mr Towse took a leading part in its deliberations: he analysed the applicants' accounts for the committee and the members reached their decision in the light of his expositions of the balance sheets together with such other information as they could obtain either from their own contacts in the City or from credit rating reports and the like.

178. We asked Mr Challis why he was not on this important committee. He answered:

'I thought about this. I thought it was better that I took an active interest in the Minutes of the Credit Committee, and I did not hesitate from time to time to say that I disagreed with the Credit Committee.'

In fact Mr Challis expressed his disagreement on occasions by his actions, and we shall be examining cases, notably as regards Mr Stern's companies (para 247 below), where he authorised unsecured loans contrary to the Committee's decisions.

179. As a discipline, the Committee suffered from other drawbacks. It did not deal with loans to associated companies, which were regarded as special cases, and it did not deal with secured loans. As to the latter, we asked Mr Clark:

Q Why was it limited to unsecured lending?

A Presumably because I felt this was a greater risk, and a greater risk in lending. After all, secured lending is secured. The security was probably vetted by a solicitor and one could rest on that, as I saw it at the time.

Q Did you leave to the solicitors the question of the adequacy of the security, the ratio of the value of the security to the loan and things like that?

A Yes.

Mr Hewins gave a similar answer: secured loans were not considered 'because of the decree, wise or unwise, that if you were secured it did not really matter to whom you were lending.'

180. At first the Committee met at approximately monthly intervals. But it came to an end in 1973. The minutes of its last meeting, on 13 March 1973, record that the Chairman, Mr Hewins, said:

'he would like the Committee to meet on the next occasion for the sole purpose of considering recommendations, which he would put forward, for sundry adjustments of ceilings to iron out seeming anomalies. He would also recommend a conventional formula to provide for borrowers to whom we should in practice be lending limited amounts but for whom credit limits would be inappropriate.'

However that next meeting never took place. The Secretary, Mr Cope, a young executive officer, was moved out of Finance Directorate in May 1973 and no successor was appointed. Mr Challis said he had noticed that they were not meeting, and

'when I said somewhere about the middle of the year "I have not seen any minutes of the Credit Committee recently," I was told that they had completed a full review of everybody on the list at that moment in time and, exhausted by their endeavours, they were breaking off for the leave season and would resume that autumn.'

He did not recall who had given him this information. Mr Hewins said he had intended to propose the rationalisation foreshadowed in the last minute 'as a piece of tidiness' but because he was 'extraordinarily busy' and because no new borrowers were coming along for sanction, the convening of the next meeting slipped his mind, and by the end of 1973 the financial crisis was upon him and after that the Credit Committee could have no useful function to perform. He accepted the blame for its demise. It was in fact belatedly revived in August 1974, after Mr Osgodby had succeeded as Head of Banking.

181. We have no reason to suppose that the Credit Committee was a purely window-dressing operation. Within its limits it performed a useful function, and some of its decisions doubtless safeguarded the Crown Agents from loss. But its authority was weakened by the fact that it could be and on occasion was overruled or ignored by the Director and others, and the fact that it could fade away without comment illuminates the Finance Directorate's attitude to rules and constraints.

182. Criticism within the Crown Agents had done little to alter the outlook or practices of the Finance Directorate. Now, in the second half of 1971, they were to face criticism from outside, from the press, from Parliament, and from the Ministry of Overseas Development. In recording these events we shall start with a substantial and well-documented account of the Crown Agent's financial transactions which appeared in the Guardian of 5 August 1971. And as a pre-requisite to understanding this development we must look at events occurring a little earlier at the ED Sassoon Banking Co Ltd.

## **XI Criticism: External**

### **(1) The Gramco Affair**

183. In 1969 Sassoons, in partnership with a French bank, were concerned in a placing of 1 million shares in an off-shore mutual fund management company called Gramco Management Ltd at the price of US\$10 per share. The issuing banks were assigned a number of shares for allocation to their clients, shareholders and employees. In the case of Sassoons there were 100,000 of these shares. As regards this particular issue this was a valuable right because the issue was over-subscribed and dealings commenced at a premium of about 100%. Two separate matters arose out of the allotment by Sassoons of their assigned shares. Firstly, some were allotted to the Crown Agents and to directors of Sassoons who had been or were connected with the Crown Agents. The directors at that time included Sir Stephen Luke, Sir Claude Hayes, Mr Challis and Mr Barley. Sir Stephen, Sir Claude and Mr Challis took 250 shares each, and the Crown Agents took 5,000. Mr Barley took none. The significance of these purchases lies in the fundamental civil service rule that public office must not be the source of private profit, and the purchases by Sir Claude and Mr Challis are open to criticism on this account. Sir Stephen Luke's attitude was, and is, that he was on Sassoon's board as an individual with a contribution to make and not in any way as a representative of the Crown Agents, although he continued to have a seat on the Crown Agents board. Sir Claude and Mr Challis maintain that it was represented to them that it was customary for directors of an issuing house to show confidence in an issue by themselves subscribing. Mr Barley told us that he had formed a strong determination never to deal in any shares or securities

'because in doing that I then removed any possibility of conflict of interest'. He said that this outlook of his was well-known, and he thought that it was because of this that he was not himself offered any Gramco shares. He would not in any event have taken them up. But he did know that they were being offered to his fellow directors, and indeed Sir Claude asked his advice about it. He told him that if taken up they should be taken in the name of the office. The shares, after an initial surge, became worthless, and Sir Stephen, who had held on to his, lost his investment. The Crown Agents shares were sold in September 1971 at 50c per share, a loss of \$47,500. Mr Challis told us that he sold his five or six months after purchase at a profit of 'some hundreds of pounds'; it had been represented to him that directors should hold on to their shares until a market had been firmly established. Sir Claude did not sell his shares, but he managed to escape paying for them:

A What happened was . . . that I was pressurised . . . to show confidence and so on by taking an allocation which the other directors were taking. I said all right, in that case let the bank allocate 250 to me, (that was the director's share) but I must clear it with Geoffrey Wilson. My recollection now is . . . that it was several months before I saw Geoffrey Wilson and meanwhile these shares were held by the bank for handing over to me.

Q And you paid for them out of your own pocket?

A No, I have never paid for them. They never came to me at all. They were never transferred to me. They were held by the bank.

Q What has happened to them now?

A The bank has taken them back in the sense of never handing them over.

\* \* \*

Q You still owe Sassoons \$2,500, I suppose?

A No, because I never had the shares and they were never, as I say, transferred to me.

For comment, see para 198 below.

184. The other matter connected with this issue was a serious dispute within the company over the manner in which the allocation had been carried out. The details are irrelevant, save to say that it had nothing to do with the allocations to the Crown Agents and its personnel, but it needs mentioning here because it led to the resignation from the board of Mr Yablon and one other, and to Mr Yablon's family interests in Sassoons being purchased by the other owners in May 1970, increasing the Crown Agents' stake in the company to 45%. It also had a bearing upon the feature article in the Guardian, because when a part author of that article, Mr Charles Raw (the financial journalist who had already explored the Crown Agents' investment in SIS, para 103 above) was seeking material for this article, he found Mr Yablon willing to help.

## (2) The Guardian Article

185. The Guardian article, headed 'How the Crown Agents Manage their £1,000m' by Charles Raw and Lindsey Vincent, occupied two pages of the paper's issue of 5 August 1971 and was accompanied by a front page statement describing the Crown Agents as the biggest force in the City's money market after the Bank of England, and ending with the following five questions:

'To whom are the Crown Agents responsible?



Who would have to foot the bill if they lost money?

Do the developing countries for whom they act know that their money is being used to buy parcels of London property, and is being put into banking and other enterprises, thus enabling a number of individuals to build up personal fortunes?

Are the Crown Agents sufficiently discriminating in the enterprises they back?  
Is it right for a Crown Agent to hold shares personally in a private company which his office has backed with many millions of public money?

186. The article itself reported a great part of the financial history which we have already outlined. It mentioned the sources of the funds and their investment in Sassoons and overseas banks, in SIS, FNFC, English & Continental, and in the Australian venture. It reported Sir Claude's purchase of Gramco shares, although it underestimated its size; it reported Mr Morris's investment in SIS. It made the point that the own-account activities were backed by no risk capital other than the £2m contingency reserve and the Crown Agents' own office buildings. It showed that the Crown Agents' partners stood to make large sums of money in their various enterprises, and 'the Crown Agents would make money too from their shares but they will have carried the great bulk of the risk—and gearing—through the huge sums of fixed interest money.' There was, the authors suggested, nothing wrong in partnering entrepreneurs, but 'because the Crown Agents are financially answerable only to their far off principals, and have neither an outside board of directors, shareholders or even trustees to whom they are responsible, they are not subject to the same sort of pressures that a bank or even pension fund might be. In short, however well-intentioned their new investment policy is, there is no automatic safeguard that the Crown Agents will use the huge funds they have at their disposal wisely, and not over-generously.'

187. The reason for the financial expansion puzzled the authors. They reported the Crown Agents' statement that the object was to try to make money so that they could improve their services to principals, but commented that 'it is hard to escape the conclusion that the "blossoming" out has been done largely for its own sake'. The writers concluded:

'The Crown Agents have moved into the hard bargaining world of financial dealing without giving sufficient thought to the full implications of what they are doing. The conclusion from this is that something ought to be done urgently to create a proper financial structure and direction for the Crown Agents. If this is not done the long-term risk is that the governments and authorities that provide the Crown Agents with their funds could eventually lose confidence and withdraw their money, creating a potentially massive outflow of money from this country.'

### **(3) Debate in Parliament**

188. On 5 August 1971, the day on which the Guardian article was published, Lord Selkirk had a question down in the House of Lords:

'To ask Her Majesty's Government whether they are satisfied that the investment policy pursued by the Crown Agents for Oversea Governments and

Administrations is calculated to render best assistance to the economy of this country.'

In the short debate which ensued the statements made in the newspaper were naturally referred to. One speaker described them as 'disquieting', and the government spokesman said that he had no reason to suspect that the article was substantially inaccurate, but that he needed time to consider it. Their Lordships appeared to be somewhat perplexed at the nature and accountability of the Crown Agents—a state of mind which seems to have assailed all those encountering that body for the first time. This discussion is important as marking the first occasion on which Parliament noted that there was a Crown Agents problem which needed looking into.

## **XII The Stevenson Inquiry**

### **(1) An inquiry mooted**

189. The question in the House of Lords, and the Guardian article, were widely discussed in the press and elsewhere, and it was clear that when Parliament re-assembled after the summer recess further questions would be raised. Fortunately for the Ministry, their dealings with the problem had reached a stage when they would be able to announce that an inquiry would be held. At para 111 above we left the Ministry at the end of 1970, when the brief on the Crown Agents had been prepared and Sir Geoffrey Wilson had tendered his advice to the Minister. A decision to hold an inquiry was speedily taken, being reached within the next month, but it took a long time to determine what form the inquiry should take and what were to be its terms of reference. The Treasury were informed in January 1971 that the Minister was thinking of an inquiry by a small committee such as that suggested in para 5 of Sir Geoffrey Wilson's minute, Appendix X. Sir Frank Figgures at the Treasury spoke to the Governors of the Bank of England about this on 20 January 1971, and he recorded:

'The Governors were categorical in their advice that a body composed of a senior Treasury official, an executive Director from the Bank of England, and someone from the Crown Agents, would be best able to formally advise on what would be the appropriate organisation for the Crown Agents in the future and their relations with the Government. Outside City advice would have very little understanding of what the problem was, and therefore what would be the appropriate advice to give.'

This view was conveyed to the Ministry, but on 25 February Sir Richard King wrote to the Treasury informing them that the Foreign and Commonwealth Secretary had now approved a recommendation by the Minister (Mr Wood):

'that we should seek advice on these matters in strict confidence from a small group of experienced people. . . . We have in mind a group of three people headed perhaps by a retired Permanent Secretary preferably with Treasury experience, and including a lawyer and a representative of City interests.'

190. Matters still moved less quickly than one would have wished. The composition of the inquiry, its procedure and its ambit were the subject of lengthy exchanges between the Ministry and the Crown Agents. This was due

to the department's wish to proceed by agreement. As Sir Richard King put it to us:

'We were trying all along to move by agreement with Claude Hayes. Much of the delay in getting the papers prepared and putting them to the Minister lay in reconciling his views and ours, which were quite different. As you know, he held views about our powers which were quite different from the advice that we had. Therefore, bearing in mind personality clashes and all that, it was very difficult to get things agreed. I think we were right in seeking at all costs to bring him along and get him to agree to things that were being done. Otherwise we risked having considerable trouble if he maintained, for instance, that we forced an inquiry on him against his will, with the wrong terms of reference and so on. We wanted to bind him into this inquiry, for obvious reasons, but that took a fair time, and because of these special factors, that was a very significant contributory factor to the delay.'

191. The Treasury also made its views known during these negotiations. The Treasury would have preferred an in-house investigation of the kind advocated by the Bank of England, and with its attention directed largely to the practicalities of the financial operations. The Ministry's attitude was ambivalent: at the level of the officials who dealt with the Crown Agents the disquiet at the financial risks was evident (para 106 above for example) but at the top these views were subordinated to the very real problem of how, if at all, to control the Crown Agents if control proved necessary or desirable: see Sir Geoffrey Wilson's minute, Appendix X. The supposed need to carry the Crown Agents in whatever was done had resulted in a brief which avoided controversial matters; it ended with the observation that:

'The choices appear to be:

- (i) Leave unchanged both the constitutional position and the present informal relationship between the Secretary of State and CA;
- (ii) Leave the constitutional position unchanged but set out in general terms, eg by memorandum the relationship between the Secretary of State and CA;
- (iii) Give CA an independent corporate existence, eg by Charter, Act of Parliament or under the Companies Act.'

The brief was described by a Treasury official at the time as:

'Rather complacent; in particular the points for consideration . . . tend to favour the status quo without really indicating that there is a potentially awkward problem for the Government.'

## **(2) Committee appointed**

192. However, although the formal brief had been watered down, the officials were not inhibited from advocating a stronger approach, and they secured a significant amendment to the terms of reference. As finally settled these were:

'To consider whether there is a need for any changes in the status, functions and financial operations of the Crown Agents, including particularly their relationship to HMG, having regard to:

- (i) developments that have taken place in recent years in the nature of their functions and in the constitutional status of their principals;

- (ii) the UK's own interests including the needs of the remaining Dependencies.

To make recommendations on the nature of any such change.'

In the original draft the words 'and financial operations' had not appeared. With those words included, the Committee had a clear mandate to inquire into the matters which had in fact led to their being appointed.

193. By July 1971 sufficient progress had been made to enable the Minister to decide that the Inquiry should be conducted by independent outsiders and to select the Chairman. This was Sir Matthew Stevenson, who had recently retired from the post of permanent secretary at the Ministry of Housing and Local Government; his career had included six years as an under secretary at the Treasury. On 7 July Mr Wood saw Sir Claude and told him that he proposed to include as colleagues to Sir Matthew a City representative and a lawyer; according to a memorandum of the meeting made by Sir Claude the Minister told him that he was free to propose what interests would be covered and that he would discuss them before action was taken. Sir Claude had reservations about a lawyer but agreed on a City man. Mr Wood's attitude was a conciliatory one: to us he said:

'I do not think we thought of the Stevenson Committee as a kind of inquisition but as a means by which I could be advised on this awkward constitutional point, and I was anxious that Sir Matthew Stevenson and his colleagues should find Hayes as co-operative as possible.'

The other members were appointed in August. They were Sir Glyn Jones, formerly of HM Colonial Service and lately Governor-General of Malawi; Mr M J Verey, then Deputy Chairman of J Henry Schroder Wagg & Co, the merchant bankers; and Sir Charles Whishaw, the senior partner of Freshfields, the City solicitors. The Committee thus exhibited expertise in governmental functions, overseas administration, the City of London and commercial law. No one could describe it as other than a strong and independent committee.

194. The appointment and terms of reference of the Committee were announced in the House of Commons on 8 November 1971. It should be noted that from the commencement of 1971 when the decision to hold an inquiry was taken, until March 1972 when the Committee reported, and indeed until such later date as was needed to digest its findings, all opportunity of obtaining information or exerting control by the Ministry or any other government department was lost. Any question could be parried with the argument that the relationship of the Crown Agents with HMG was under investigation, and no effective move was possible until after the report. Thus at least another 18 months went by.

195. The announcement in the House of Commons was in answer to a question by Mrs Hart asking the Foreign and Commonwealth Secretary 'whether he has considered the position of the Crown Agents and their relationship with Her Majesty's Government; and if he will make a statement about personal dealings in shares by Crown Agents'. In dealing with the second part of the question Mr Wood spoke of the purchase by Sir Claude of the Gramco shares

and the investment by Mr Morris in SIS, both of which had been reported in the Guardian article. As regards the former he said:

‘Mr Hayes was a director in his official capacity of a merchant bank, the directors and managers of which were asked to purchase a small number of shares of a new issue sponsored by the bank. He did so after discussion with the then Permanent Secretary of the Ministry of Overseas Development, while giving instructions that the disposal of the shares should be at no gain or loss to himself. I am satisfied that this purchase was not inconsistent with his office.’

As regards the latter he said:

‘Mr Morris is a director in his official capacity of Sterling Industrial Securities, in which the Crown Agents have a financial stake. In the summer of 1970 he told his Chairman, Mr Hayes, of his wish to purchase some shares in this company with the gratuity he would receive on retirement in September 1970. Meanwhile my Department, who had no knowledge of the proposed share transaction, agreed to the Chairman’s request that Mr Morris should remain in temporary employment as a Crown Agent for a period after his retirement from pensionable service. Mr Morris acquired shares in the company in October 1970. Last February Mr Morris became chairman of, and also purchased shares in, a private company which includes Sterling Industrial Securities among its bankers.

Looking back on this whole sequence of events, and taking account in particular of Mr Morris’s retention as Crown Agent for longer than was originally contemplated, I consider that the Crown Agents should have recognised that these arrangements might not be wholly compatible with Mr Morris’s continuing employment as a Crown Agent. I have discussed this with Mr Morris, who is coming to the end of a long and devoted career in public service, and, in recognition of this difficult situation he has undertaken to dispose of the shares without profit to himself.’

In fact they were sold to the Crown Agents at cost.

196. Mr Morris’s extended service was terminated on 31 December 1971. He thus left the Crown Agents under somewhat of a cloud. Today he is an embittered man, convinced that he has been unfairly treated. As to his investment in SIS he told us that he asked Mr Davidson’s advice as to the disposal of his gratuity, and among other possibilities Mr Davidson suggested putting it into their own company, SIS. He informed Sir Claude of his proposal so to do; and in his explanation of these matters to the Ministry, Sir Claude wrote that he was aware of the proposal and

‘I knew that when he retired SIS intended to invite him to become a director in his own capacity, when he would be expected to take a shareholding. I therefore did not veto his proposal. I think it is important that Morris complied with instructions and was perfectly open about his proposal.’

197. We would agree that it is a pity that Mr Morris made these investments. The trouble arose because of his staying on after retirement date, and he did this at Sir Claude’s request, and rather against his own inclination, because Sir Claude felt that his presence was needed firstly during the Stevenson investigations, and secondly because the officer who was to take over his responsibili-

ties could not then conveniently be released from his current activity. However he knew he was staying on at the time when he took the shares and it would have been prudent of him not to have done so. In fairness to Mr Morris we think we ought to say that it is difficult to see that any harm was or could have been done by these transactions: in the private sector directors are usually encouraged or required to take a stake in their companies, and no one could criticise his fellow-director Lord Mais for doing the same (para 141 above). In our view Mr Morris has suffered, as have other servants of the Crown Agents, from being called on to do work beyond his capacities. Those capacities in Mr Morris' case were of a high order in their sphere (para 163 above) but he was not equipped for the heady world of high finance into which he was thrust at the end of his career.

198. The purchase of the Gramco shares raises quite different considerations. It will be noted that the Minister said nothing of Mr Challis's purchase. This had not been mentioned in the Guardian, and was unknown to the Ministry. When that article appeared, Sir Michael Walker sent Sir Claude a questionnaire, one question of which asked 'Did any of the other directors or senior staff of Sassoons take up an allotment in Gramco, and, if so, who?' Sir Claude replied 'All directors except two, all managers except one; about 20.' By not answering the last part of the question he concealed from the Ministry both Mr Challis's purchase and Mr Barley's refusal to purchase. He also informed Sir Michael that his consultation with Sir Geoffrey took place after the issue of the shares, which accords with Sir Geoffrey's recollection. He produced a letter from Sassoons confirming that several months after issue he had given them instructions to sell when a break-even price was reached, but saying that the shares fell in value too rapidly for this to be done. The Ministry were advised by a merchant banker that it was most unusual for directors of an issuing house to be required to take up shares, but that there was nothing unethical in doing so. We think the Ministry dealt leniently with Sir Claude's actions in this affair. Sir Michael Walker told us that because Sir Claude took care to make no gain for himself he thought nothing improper was done, although he added that he would have been happier if the shares had not been bought. Sir Stephen Luke told us that he would not have bought them on his own behalf if he had still been active in the Crown Agents. For our part we think it unarguable that a Crown servant ought not to put himself in a position where, by virtue of his office, he may make a personal gain or suffer a personal loss. To have taken these shares was an error of judgment at least.

### **(3) Crown Agents' evidence**

199. The Stevenson Committee worked quickly. It started work in August 1971 and its Report was submitted to the Minister on 24 March 1972. It dealt with the whole range of the Crown Agents' activities, and grappled with the problems of constitution and accountability. It saw a large number of witnesses from within and without the organisation including those representing the interests of principals. Finance was only a part, although an important part, of its terms of reference, and one of the nine chapters of the Report is devoted to it. In considering what the Committee said about finance it must be remembered that they laboured under two drawbacks which do not affect the present inquiry. Firstly they were not in a position to make their own investigation of the Crown Agents' books and files and had to rely upon what the official wit-

nesses told them. (To this proposition there was one exception: what they learned about English and Continental led them to commission Price Waterhouse & Co to make a report on the history of the Crown Agents' involvement in that company. That report had not been completed at the time when Sir Matthew reported to the Minister, and a supplemental report was made on 25 May 1972 (para 216 below)). Secondly they had not the advantage which we possess of dealing with a management anxious to see that all relevant facts are brought to light. Contemporary records show that Sir Claude carefully monitored the evidence given to the Committee, having apparently as his prime object the diversion of the Committee away from any recommendation weakening the autonomy which he enjoyed. He suspected the Treasury of seeking to have it established that HMG would be bound to honour any Crown Agents' obligations and that this proposition would involve as its converse Ministerial control, which he seems to have been anxious to avoid at all costs. In this however he was not successful: the Committee did think:

'that in the last resort HMG would be bound to meet at least liabilities incurred by Crown Agents in respect of transactions which they entered into otherwise than as agents and which could not be met out of Crown Agents funds.'

200. In the same vein Sir Claude urged upon the Committee the view that all the financial operations, whether own-account or not, were for the Principals' benefit because all the funds belonged to the Principals (the co-operative view, para 23 above), or because profits made in finance enabled other traditional services to be rendered more cheaply. The Crown Agents' object seems to have been to blur the distinction between activities as agents for principals and own-account activities. The Committee however had no doubt that:

'On the banking side the legal relationship is that of bank to depositor; and the profits or losses on banking (and ancillary investment) are on the Crown Agents account.'

201. The evidence presented by the Crown Agents to the Committee on finance seems to have lacked completeness, and in some cases even to have lacked candour (see as to 'comfort letters' para 205 below). Own account activities were dealt with in a paper submitted by Sir Claude when Sir Matthew asked for written information on reserves. This paper described the objects of the activities in the following terms:

'There was no chance of building up a capital reserve of £7m from normal budgetary surpluses and it was considered that the only means of doing so was through expanding the profitable transactions of Finance Department. In 1967 it was already clear that Principals' deposits were being profitably deployed and it was conservatively estimated that this activity could be expanded to bring the reserve to £3m by 1971 and £7m by 1975. This estimate included small amounts invested in high-class property development where capital gain would come towards the end of the period.'

It also contained the following statement:

'The Crown Agents place about £200m in the money market, and in spite of careful rules and experience the deposit with V&G shows that there must always be the risk of a bad debt in this area.'

It would be charitable to suppose that when transmitting this Sir Claude had forgotten his minute about V&G which we mentioned at para 174 above.

### **XIII The Stevenson Report**

#### **(1) On finance**

202. In their chapter on finance the Committee first described the funds managed for principals and went on to describe what they termed 'banking activities and ancillary investment' which is broadly what we have been calling 'own-account activities'. They had the 1970 accounts before them. They noted the sources of the funds and that they were largely employed in the money market or in marketable securities; a fraction, they noted, had been invested in or lent to certain companies. They looked at the information provided by the Crown Agents about liquidity ratios and the matching of inward and outward loans, and they found these arrangements to be 'reasonably prudential'.

203. On reserves, they said:

'Crown Agents judge that of the £5m which they regard as desirable in relation to their financial activities, £4m might be the desirable level of reserves for their banking activities. Crown Agents place about £200m in the money market and there must always be the risk of a bad debt in this area, as occurred in the case of Vehicle and General Insurance Co Ltd. Much of the placing is fully secured and much of the rest is to banks and first-class finance houses where the risk is slight. In unsecured lending to commercial companies Crown Agents are in common with other money market operators liable to unforeseeable default. The total so lent is £21m. Even if several calamities came at once Crown Agents judge that an eventual default could hardly exceed £4m. We are informed that all property loan investments are fully secured (generally by first charges) at figures well within professional valuations.'

After considering the reserves needed by other activities they said that they did not quarrel with the Crown Agents' estimate of the desirable minimum at between £17m and £20m overall. They added:

'We conclude that in the years up to 1970 and at 31 December 1970 the general reserves were substantially below the desirable level: the Crown connection and the Crown status with its implied warranty have helped to offset the insufficiency of reserve strength and have enabled the Crown Agents to enjoy a credit rating which they would not have enjoyed on the strength of their balance sheet position alone.'

204. The Committee devoted considerable attention to the investments which had been the subject of public criticism. They said:

'We would not ourselves regard such losses as have occurred or are anticipated as exceptional in a large finance business. Some particular investments and loans—made directly by Crown Agents or in conjunction with associates—have had a risky or volatile element in them—eg loans to Vehicle and General and investments in Poseidon and in Minsec. The amounts at stake here were however small in relation to the total funds deployed. We think it more important to look at Crown Agents investment policy as a whole in action and we are concerned here with those investments which they make otherwise than as agents.'

They then looked at the amount of long-term investments, corresponding to the hard core of funds not likely to be called for at short notice. They appended a



table of 'hard core lending', which we reproduce at Appendix XII. It shows totals of £55.6m at June 1971, taken as the time of maximum exposure, and of £50.9m at December 1971. The Crown Agents' view was that the Table overstated the hard core lending because the loans to FNFC, Sassoons and SIS were at call, and they thought their hard core lending should be stated as £30–£40m. The Committee accepted this opinion and gave it as their own view that hard core lending of around £30m would not be excessive.

205. The Committee went on to criticise the concentration of investment. They pointed to the fact that out of the total £55m shown in Appendix XII no less than £41m (or 10% of all banking funds) was invested in two concerns, FNFC and English & Continental. 'We think,' they said, 'that a more conservative management might well have thought that the degree of concentration in one or two companies was excessive.' They devoted some paragraphs to an examination of English and Continental but these need not be mentioned here as they were overtaken by the subsequent report (para 214 below). It is however significant to note that at this stage they record that English and Continental's loan capital included £23m of unsecured borrowings of which they said:

'We understand that these loans are from outsiders having no connection with Crown Agents.'

Although it is true that the loans were from outsiders, someone had misled the Committee about the independence of the lenders: the loans, or much of them, were guaranteed by the Crown Agents by their 'comfort letters' (para 145–150 above).

206. The Committee listed the Crown Agents' other subsidiary and associated companies and noted the distinction between those concerned with the Crown Agents' traditional activities and portfolio investments. Their comment was:

'Trading and large single investments no doubt provide opportunities for greater profits. They also involve greater risks and are heavily dependent on the quality of the management. In general Crown Agents have found suitable partners but we think that in one or two cases their associates were perhaps not of a quality and standing which matched the status of Crown Agents. We think that the proliferation of trading and dominant investments must cause quite a management problem for Crown Agents, especially where changes have to be made for one reason or another. This is especially true of merchant banking business.'

207. As to performance, they noted that the 1970 balance sheet showed £2.7m net depreciation on quoted investments, and £1.9m specific losses realised or anticipated. However they thought that it would be a mistake to attribute too much weight to the position as at December 1970—the stock market had risen since then and unquoted stocks may have been valued on a conservative basis; and they commented:

'We have no grounds for saying that the investment performance has been bad; but we cannot say that it was outstandingly good in 1970 at any rate. Nevertheless over the years Crown Agents financial management has on the whole been competent and conscientious.'

208. In summing up the Committee thought that there would be a serious risk of damage to UK interests if the Crown Agents' financial business was

gravely disrupted or dispersed. They recognised that there was in the existing situation 'a significant area of risk', but thought this would be minimised by the measures they proposed. They were aware of the inability of the existing organisation to control the Finance Department. They said:

'The arrangements for accountability are less than adequate. . . . There is no effective accountability for the totality of the activities or for that significant part of the business (banking and ancillary investment) which Crown Agents carry on otherwise than as agents. There is no collectivity of principals or clients and there are no shareholders. The Minister and his Department in practice are perhaps not well placed by themselves to make up for the deficiency. . . . There are lacking also some elements or mechanisms of governance which are to be found in other sectors. There is for example no profit-making objective which can on occasions act as a brake on expansion; there are no shareholders' meetings which can serve the same purpose; there is no Board of Directors in the ordinary sense of the term; nor is there any formal limitation on the borrowing powers of Crown Agents and their main subsidiary.'

209. The effect of inadequate accountability and governance upon the financial operations they dealt with in the following paragraph:

'We think that too great a burden for investment policy and major decisions rests on the Finance Director. The 'board' as at present constructed would not be well equipped to lighten his burden. We believe that such losses and lapses as have occurred might have been minimised if there existed a largely independent board of persons skilled and widely experienced in these affairs, from whom the executive directors could obtain general guidance and wisdom in policy making and main decision taking.'

Moreover the staff labouring under these burdens was underpaid:

'Top officials in the Crown Agents office bear greater personal responsibility than counterparts in the Civil Service. The present responsibilities of the Director of Finance would in commercial circles command a salary of perhaps twice as much as his present salary. We think there is a significant degree of underpayment in the Finance Directorate which extends down as far as the investment managers and this affects the Crown Agents' ability to recruit and retain suitable staff.'

210. In their concluding commentary the Committee said:

'Our general conclusion is that, subject to the withdrawal of taxation privileges and to appropriate organisational and status changes, the Crown Agents' financial activities as a whole should continue: they offer an economical and advantageous service to overseas clients; they play a responsible part in the money market, and in the handling of large sterling balances and sterling investments: disruption could cause damage and loss to the Crown Agents and their clients as well as to the UK.'

In that paragraph we would underline the words 'subject to . . . appropriate organisational and status changes'. The Committee were convinced that these were necessary among other things to avoid financial risks. The Crown status, they described as 'a source of ambiguity, anomaly and risk, and of complaints

of unfair trading.’ The organisational defects they regarded as serious:

‘We cannot say that significant damage has been done, but risks have been taken and it would be desirable to reduce continuing exposure of HMG to them. We cannot therefore recommend the continuance of the Crown Agents with their present status, composition, and range of functions.’

211. In considering what changes were needed the Committee dealt with a proposal that financial activity should be cut back to the boundaries of some five years previously, ie the elimination of own-account activity. They rejected this as impracticable and undesirable:

‘Severe contraction or liquidation would be highly disturbing and damaging to the interests of overseas countries and the UK.’

They also rejected a more modest proposal that the Crown Agents should discontinue borrowing from the money market to finance their own-account activities. They felt that since the Crown Agents would be in the market anyway as lenders, their operations would be more efficient on a two-way basis, ie taking money from the market as well as placing money in it.

212. The constitutional changes suggested by the Committee need not be outlined here because they were not carried out. But what we find significant is their emphasis upon the necessity for any future Board to include non-executive persons expert in their fields. Strengthening of control and accountability lay behind and conditioned their approval of the continuance of the own-account activities.

213. A notable feature of the Report is its omission of any comment on the Australian adventure. The only reference to it is in the entry in the list of hard core lendings (Appendix XII) where Abbey Orchard Property Investments (Australia) Ltd is listed as a borrower of £6m and the listing of that company in a table of ‘associated companies’ with the accompanying comment that this and others were ‘substantially portfolio investments’. That company was the company set up in conjunction with Mr Fenston (para 59 above), but by the time the Stevenson committee were receiving evidence the agreements with Capital & Counties had been signed (para 153 above). When the audited accounts for 1971 were produced a year later they contained a Note (no. 27) recording these agreements and stating that under them:

‘The Crown Agents are required to provide or procure temporary advances by way of revolving credit to support capital expenditure of not less than A\$100m (£46.6m approximately) and to lend unspecified sums, estimated to total about £25m, necessary to complete an existing development programme. . . . At 31 December 1971 the Crown Agents had in fact advanced the equivalent of £20.66m by direct loans. . . . In addition they had also in connection with the property developments in Australia guaranteed without security a bank overdraft facility which may reach a total of A\$14m (£6.52m approximately).’

None of this vast commitment appears to have been mentioned to the Stevenson committee either by the Crown Agents or by the Ministry, which knew of its size from the events mentioned in paras 157 and 158 above. It is doubtful whether, had they known of it their comments on the Finance Directorate’s behaviour would have been as lenient as they were.

## **(2) On English and Continental**

214. As it turned out, their criticism hardened when they received the Price Waterhouse report on English and Continental. The accountants' report, dated 27 April 1972, recorded in detail the facts which we have outlined in paragraphs 75-77 and 142-145 above. Price Waterhouse had sight of the accounts of the company to 31 December 1971, by which date the capital employed was £45m and they noted that in early 1972 the company had bought Pirelli House for £2.5m and had contracted to purchase Bush House for £22m, after which their capital employed would be about £70m. Almost all of this was borrowed money; the report noted that the lendings by the Crown Agents had decreased and those by other lenders had increased, and they said:

'It is clear, and Mr Sly has confirmed this, that E&C has been able to raise funds from the money market, on the favourable terms noted elsewhere above, largely because of its association with the Crown Agents, and more specifically because third party lenders . . . know that the Crown Agents can be relief upon to support E&C if any difficulties should arise as regards payment.'

They commented:

'Legally CA has had and continues to have priority over other short term lenders (other than those with fixed charges) because of the security provided by the debenture. While therefore CA could abandon E&C (its subsidiary) if E&C were to find itself in financial difficulties, in practice it seems clear that CA would have to underpin E&C until such time as CA could demonstrate that E&C had become wholly independent of it. The political and commercial repercussions which would arise if CA were to allow E&C to fail to meet its commitments (if such an occasion were to arise) would be such that we believe this would not be contemplated other than in very exceptional circumstances.'

Price Waterhouse had not discovered the comfort letters, but they had nevertheless appreciated the Crown Agents' de facto obligations of which those letters were the written expression.

215. Price Waterhouse also criticised the relationship of E&C with Pridestoke (Construction) Ltd. The latter was owned by the Greene brothers (para 142 above) and carried out construction work for E&C. At the time of the report E&C had agreed in principle to acquire Pridestoke. Price Waterhouse commented:

'We have been informed by Mr Walker that all work has been done on the basis of fixed price contracts with normal escalation clauses, ie standard RIBA contracts, and all payments on account of work done, other than loans, have been made only against certificates issued by an independent architect. In any event we consider that this relationship between the two companies was unsatisfactory in its conception no matter what the safeguards may have been. There was a clear danger of conflict of interest in a situation where the Greene brothers and more particularly Mr R Greene, in his dual role as managing director, were substantial shareholders in Pridestoke. It is appreciated that this is a matter which E&C propose to deal with when the Pridestoke accounts have been finalised.'

216. In their supplementary Report transmitting the accountants' report to the Minister, the Stevenson committee expressed the view that 'all in all it might be thought that Messrs. Walker and Greene and the private participants have had a remarkably good bargain.' They found the procedures followed not to have been of the highest standard, and they criticised the entering into of the partnership without outside professional advice, and the transfer of the Crown Agents' properties (para 143 above) without professional valuation. They agreed with Price Waterhouse that the degree of the Crown Agents' financial involvement exceeded their apparent liability. They summed up the effect of the new information upon their previous Report as follows:

'We think that the Price Waterhouse report confirms the general and specific criticisms we have made in our own Report on certain aspects of Crown Agents' investment policies and control, and reinforces the case we have put forward for changes in the composition of the Crown Agents' Board, the Crown Agents' constitution and status. . . . We regard a new Board of the general kind we propose as some safeguard against some of the lapses and, as we see them, errors of judgment which have occurred—fortunately without serious loss or damage so far. There are difficult problems ahead including the extrication of the Crown Agents from E&C, and a fully formulated and controlled process for determining Crown Agents' investment policy and main investment decisions.'

### **(3) The Report considered**

217. The Stevenson report may perhaps fairly be described as having given qualified approval to the Crown Agents' own-account activities. It termed the financial management 'competent and conscientious' and applied the epithet 'reasonably prudential' to the matching and liquidity arrangements. It advocated the continuance of the operations generally, and in particular the borrowing on the money market. Such passages as these could be and indeed subsequently were prayed in aid in defence of the existing and continuing financial policies. On the other hand the Committee spoke of lapses and errors of judgment, were critical of the nature of the partnerships formed with outside interests, and were perturbed by the lack of accountability and control both internal and external. They clearly expected the Crown Agents to extricate themselves from English and Continental.

218. We feel that had the Committee been empowered to delve as deeply as we have been able to into the actual operations, and in particular if they had had before them information leading them to extend Price Waterhouse & Co's investigative brief to cover the Australian operations, their emphasis might have been different. The emphasis might also have shifted had they known of the Bank of England's concern. We have already mentioned the strange failure of the Treasury to pass this concern to the Ministry in 1970 (paras 109-111 above). The Bank's view was not brought to the notice of the Stevenson Committee, and this seems to have flowed from the fact that the Bank had felt strongly that a working party from inside government was the best way of examining the Crown Agent problem (para 189 above), and they did not regard the Committee as the most suitable form of investigation. They did give evidence to the Committee in response to specific requests, and largely on technical matters; it

seems that they were not asked for their views and they did not volunteer them. In his evidence to us the Deputy Governor said:

‘We rather took the view that when the Committee had made its report we should become involved with the Treasury and others in considering the action to be taken arising therefrom and we consequently felt it right rather substantially to limit our input of evidence to the Committee, feeling that we should not come in at two stages and that the Committee had better broadly determine its views, leaving us freer, as it were, to comment to the Treasury on the action rather than having contaminated the stream of thought from the Committee beforehand.’

A later passage in this evidence is as follows:

Q Was it perhaps the case that you had an objective in view and thought it more likely that an advisory body would hold to that result than the outside inquiry which in fact took place?

A I think it is certainly the case that we felt that if we were ourselves represented on the advisory body, it would give us a good platform for seeing that what we felt were the right questions were asked and that the solution advised would go as far as we could achieve in order to meet our view of what the situation required.

Q I am contrasting this attitude and a very understandable one, with what you eventually did when you decided to dissociate yourselves as it were from the Stevenson deliberations except in the provision of facts

A Yes.

219. We understand the Bank’s attitude, although we think its results unfortunate. Sir Jasper Hollom made the point to us that at that time the Bank had insufficient information about the Crown Agents’ operations to go further than feel disquiet; they had not the material on which to form a view that the operations should be curtailed or halted, although that was the opinion of some Bank officials. Had they been part of the investigating body they could of course have amassed this information, and it is likely that the subsequent history would have been different. But we think it fair comment to add that had they conveyed their disquiet to the Stevenson Committee, that committee would have been bound to take it into account.

220. The Report was not published. The decision not to do so was taken at an early stage, and was reported to the House of Commons when the appointment of the Committee was announced. On that occasion (3 November 1971) the Minister, Mr Wood, said:

‘It would not be appropriate to publish a report, since most of the work of the Crown Agents is now for independent governments.’

The Crown Agents had from the inception of the idea of an inquiry insisted that it be secret, primarily because of the confidentiality of their banking business with their principals, and also because they feared that publicity would harm the Crown Agents and the UK economy by deterring principals from utilising their services. These were reasonable views and doubtlessly honestly held, but they had an unfortunate by-product in that Parliament and the public learned nothing of the criticisms made. The fact that the Crown Agents have retained

their clients despite the publicity given to the events leading to our appointment shows that the fears were groundless. It is clear to us that if the report had been suitably edited to remove any reference to principals' affairs it could have been published, with beneficial results.

221. On 24 July 1972 the Minister announced the result of the Stevenson Committee to the House of Commons in the following words, circulated with the Official Report:

'The committee found that the Crown Agents are providing competent and economical services, of great value to their principals overseas, and that their interests and those of Her Majesty's Government and the remaining British dependencies, are best served by the continuation of this full range of services. I welcome these findings, which reinforce my confidence in the Crown Agents' work for their overseas principals.

The committee however commented on the constitutional position of the Crown Agents, and the Government's undefined residual responsibility for them. The committee recommended that there should be a clearly defined status, structure and responsibility for the Crown Agents, and made some suggestions for consideration. The Crown Agents, but not their subsidiary companies, have Crown exemption from taxation. The committee recommended that they should bear an appropriate liability to it. I accept these recommendations and am considering how best they may be given effect.'

222. This chapter of the story therefore closes with the Crown Agents' financial operations being apparently given a clean bill of health. But the Ministry knew, if the public did not, of the Stevenson committee's criticisms, and a fresh episode now commences in the long struggle of the Ministry of Overseas Development to control the Crown Agents. However before narrating these events we must look at their background, and deal with the further development of the Crown Agents' own-account activities in the period we have now reached.

#### **XIV The Finance Directorate: 1972-73**

##### **(1) Personnel**

223. In para 160 above we left matters at the end of 1971. During the year 1972 and most of 1973 the staff of the Finance Directorate underwent little change. Mr Challis remained in charge until 15 November 1973, when he left the Crown Agents' service (para 320 below). The other officers remained as before, save that in February 1972 Mr Clark left for another department, his place as Head of Banking being taken by his deputy, Mr Hewins. To fill the deputy's office Mr Eric Osgodby was brought in. His rank was principal; he had been in the Private Office from 1966 to 1970 and in the General Stores Department from 1970 till now. He had had no experience of finance; he told us that it was:

'A somewhat reluctant appointment . . . because I expressed the view at the time that I did not consider that I was professionally or temperamentally qualified for the post.'

Mr Wheatley, Mr Blundell and Mr Sly remained managers respectively of the

Sterling Money Market, the Foreign Money Market, and the Property sections. Mr Shuter remained head of Investment and Mr Towse, the accountant, of Financial Services. This was the team which handled the further expansion of own-account activity during 1972 and 1973. It was an expansion dominated by two major themes: firstly the disposal of most of the original English and Continental at a great profit and the emergence of a different complex of E&C companies, still partnered and financed by the Crown Agents but upon less favourable terms; and secondly the coming upon the scene of Mr William Stern. We start with the former.

## **(2) English and Continental**

224. We left English and Continental at the end of 1971. During that year it had made its mark on the commercial property world by buying two large office blocks in London, Burmah House and Cunard House, and its capital employed had risen to £45m. Expansion continued during 1972, the company's largest acquisition being Bush House in the Aldwych for £22m. At this time English and Continental was also purchasing development sites which, though they had possibility of great profit in the prevailing conditions, required time and much money to develop and were therefore more speculative. Some of these were afterwards sold along with the developed properties; these sites included Pirelli House and the Thorneycroft works at Basingstoke, both purchased in 1972 and costing £2.5m and £3m respectively. But three sites must be mentioned as they were retained and posed severe problems when the property market collapsed. These were:

- 1 the former Westinghouse Works near Kings Cross, London, for which a contract was signed in 1971 for deferred completion in 2 to 3 years; and two properties for which Mr Walker was negotiating during 1972, namely:
- 2 the Port of London Authority's Cutler Street warehouses, and
- 3 Manchester Central Railway Station, a deal described in para 233 below.

Also in 1972 English and Continental started investing in properties in France, but apart from small investments in Cyprus and Ireland this was the only overseas excursion. The housebuilding activities which had been the core of English and Continental at its inception had also undergone an important change. By the end of 1972 the companies involved had acquired land greatly in excess of the current housebuilding programme. This land bank was a fashionable speculation at the time but in a different economic climate it was to prove a major embarrassment.

225. The original proposals for English & Continental had been aimed at a public flotation in five years. By the end of 1972 English and Continental had capital employed approaching £100m. The property boom was at its height and the property portfolio showed a handsome profit if it could be realised. Meanwhile the Stevenson Committee had commented unfavourably on certain aspects of Crown Agents' investment in English and Continental (para 214 above). Sir Claude strongly rebutted the Stevenson criticisms in a letter to Sir Michael Walker, the then permanent secretary at the Ministry dated 4 July 1972. He vigorously defended the 50-50 partnership between the Crown Agents' capital and Messrs Walker and Greene's expertise. The Stevenson report had spoken of 'the difficult problem of extricating the Crown Agents from this investment': Sir Claude saw no difficulty in this and added, significantly, that



it was in any case the Crown Agents' policy to dispose of their interest in E&C within the next year or two. Mr Challis told us that the Stevenson Committee's adverse comments were not influential in persuading Crown Agents to seek to disengage. Be that as it may, there was obviously a conjunction of factors encouraging a sale: to some minds it might seem desirable to take profit, to others it might seem wise to accept the implication of the Stevenson report.

226. In mid-1972 negotiations were begun to sell E&C to FNFC. Because the Crown Agents held 9% of FNFC's share capital and Mr Challis was not only Crown Agents' finance director and chairman of E&C, but also a director of FNFC, independent advice was sought from S G Warburg & Co Ltd, the merchant bankers, as to the proposed terms. The sale to FNFC did not proceed, but Warburg's found another purchaser in the Post Office Staff Superannuation Fund (POSSFUND). Terms were agreed by the end of 1972, the sale was approved in principle by the Minister and the transaction was effected on 23 January 1973. The owners, FMI, Mr Ramon Greene and Mr Walker sold their E&C shares, for which they had subscribed £100,000, for £34m; 51% of the price accrued to the Crown Agents and 49% was divided equally between Mr Walker and Mr Greene. Thus, whether or not one agrees with Sir Matthew Stevenson that Mr Walker and Mr Greene had had a remarkably good bargain, this investment had proved extremely profitable to the Crown Agents and they were justified in regarding it with pride. Up until that time the own-account activities had not produced substantial profits; now at one stroke the aim to build up substantial reserves had been achieved. This success gave more weight to Sir Claude Hayes's arguments in resisting the Stevenson criticisms and made their task more difficult for those officials in the Ministry who wished to establish some control over the Crown Agents. But—and this does not appear to have been sufficiently realised at the time, either within the Crown Agents' office or by those at the Ministry to whom Mr Hayes reported his triumph—the terms of the transaction did not extricate Crown Agents from E&C. To explain this it is necessary to describe the reorganisation that had taken place at the beginning of 1972.

227. E&C had been reorganised as a group of companies controlled by a holding company. This was English and Continental Property Holdings Ltd and the separate subsidiaries for each aspect of the group's activities, were:

- 1 English and Continental Property Co Ltd, the original company, which became the property dealing subsidiary;
- 2 English and Continental Homes Ltd which took over the housebuilding activities which the Greene brothers had brought in and was to acquire the building company, Pridestoke Construction Ltd, following Price Waterhouse's criticism of that company's relationship to E&C (para 215 above);
- 3 English and Continental Investments Ltd, a property investment company; and
- 4 Anglohouse Investments Ltd, which managed the Anglo-American contract (para 142 above).

POSSFUND did not acquire two of the subsidiaries, English and Continental Property Co Ltd and English and Continental Homes Ltd; what it bought was the entire share capital of the holding company, which carried with it the

ownership of the greater part of the property portfolio. The two subsidiaries mentioned had been sold back to the original shareholders, and after the sale a new English and Continental Investments Ltd was incorporated. Thus after the sale the English and Continental organisation continued, but not as an integrated group. The assets which POSSFUND declined to acquire included the three important sites: Westinghouse, Cutler Street and Manchester Central; and the French companies and the housebuilding activities and associated land bank.

228. We have been told that it was Crown Agents' intention to run down or sell their remaining interests in English and Continental. In early 1973 there were negotiations which proved abortive to sell them to FNFC. We were told that it was because of their hope of this impending sale that the Crown Agents took their share of this 'rump' of the old English and Continental into Finvest, so that any further profit should not be subject to tax as it would be had FMI continued to hold the shares. Since the sale to POSSFUND had been arranged as a sale of shares in the holding company, the shareholders, including Mr Greene and Mr Walker received their profit directly and in cash. Nothing was retained to provide working capital for the surviving parts of the group. This was later to have serious consequences for the Crown Agents who were effectively underwriting what remained of English and Continental through their comfort letters (para 329 below). This meant that they carried the whole risk of loss and that their partners who had just made a profit of £8m each out of the company carried none of it. Meanwhile it is to be noted that the size of the 'rump' retained by English and Continental was considerable. We attach at Appendix XIII a reconstruction which we have had made of E&C Property's balance sheet as at 31 January 1973. Its significant features are that of capital employed of £29m, the Crown Agents had directly advanced £7m and were responsible under 'comfort letters' for another £21m, and that taking account of contractual commitments the size of the rump was £45m.

229. Mr Greene and Mr Walker invested their profits from the POSSFUND sale in a number of companies, most of which do not directly concern us. One, however, does; this was the new English and Continental Investments Ltd, which was set up during 1973. Its shareholders included well-known institutions and also FMI, which had 11% of the equity. There were ambitious plans for this company. It had only a small share capital, £450,000, but certain of the shareholders put up a further £9.5m by way of long term unsecured loans to provide the capital base for the company. Proposals produced in May 1973 showed a development programme estimated to cost £93m, including the three development sites and the French companies left over from the POSSFUND sale. These assets were in fact transferred to the new company, but Crown Agents did not recoup their finance, the price being left outstanding as a loan of £11.6m to E&C Investments. By the end of 1973 Mr Challis was chairman of this company; Mr Walker was deputy chairman, and there were five executive directors each at a salary of £20,000 per annum; Mr Ramon Greene, Mr B R Levy (who resigned his partnership in Davies Arnold & Cooper in order to take the post), Mr H Caplan, Mr A R Hay and Mr S Morris, who had been a partner in Silver, Altman & Co, Chartered Accountants.

230. Two of the new directors, Mr Caplan and Mr Hay, had been partners in a firm of valuers having close contacts with Davies Arnold & Cooper. Mr

Harold Caplan had been with the firm of Lewis & Tucker and in 1968 had set up his own firm in partnership with Mr A R Hay. Mr Walker had employed Mr Caplan while the latter was with Lewis & Tucker, had thought him able, and had later employed the new firm of Caplan & Hay for valuations for mortgage purposes (see para 136 above). Mr Walker had also introduced them to the Crown Agents. It was Caplan & Hay who had made the revaluation of the Crown Agents' own properties for the purposes of the 1970 consolidated accounts (para 124 above). The firm also figured in the Finance Directorate's books as borrowers: in May 1972 Mr Wheatley had lent them £155,000 for three years to enable them to purchase the freehold of their office premises at 42 Hertford Street, London W1. The loan was secured on those premises. Further advances were made against this security: £25,000 in March 1973 and £20,000 in July 1973. (For a final advance in 1974 see para 356 below). When they joined E&C Investments as full time directors Mr Caplan and Mr Hay sold their practice to Parnis Bird & Co, who continued as valuers employed by Davies Arnold & Cooper. In connection with joining E&C Investments Mr Caplan and Mr Hay were given a £1m five-year loan facility by E&C Property, with interest to be rolled up. The reason given to us for this loan was as follows. Mr Caplan and Mr Hay had previously agreed to enter into a joint venture with another company, which had undertaken to provide them with a £1m loan facility. To persuade them to abandon this venture and to join E&C Investments a similar loan had to be, and was, offered. Under it they, and companies controlled by them, drew a total of £675,000, and as at 31 December 1974 a further £152,000 was due in respect of interest. As will emerge, the funds to furnish this loan and others made by E&C Property came largely from the Crown Agents. Apparently E&C Property made the loan because the borrowers were directors of E&C Investments and therefore unable to borrow from the latter. E&C Property however had no reason itself to enter into the transaction and derived no direct benefit from it. The arrangement was informal, not being reduced to writing, and was not minuted by E&C Property's board until 3 April 1975, eighteen months after the event. However Mr Walker stated to us that the Crown Agents had been informed at the time.

231. The position at the end of 1973 was that the Crown Agents directly held 51% of the equity of English and Continental Property Co Ltd and 46% of the equity of English and Continental Homes Ltd. Through FMI they held 11% of the equity of the new English and Continental Investments Ltd. The Crown Agents were not represented on the boards of these companies, although Mr Challis who had recently left the Crown Agents was a director of E&C Property and was chairman of E&C Investments, a post he continued to hold until April 1977. The Crown Agents did not appoint directors to any of these companies until after Mr Cuckney succeeded Sir Claude Hayes.

232. Nevertheless in addition to their shareholdings the Crown Agents made large advances to the E&C companies. Primarily these came about because the financing of the 'rump' of the old English and Continental group continued to be arranged with the aid of comfort letters issued by the Crown Agents (paras 146-150 above). As the financial climate worsened from late 1973 onwards lenders declined to renew loans even against the security of these letters. Between September 1973 and September 1974 the amount of loans supported by comfort letters fell from £34m to £1m. Over the same period Crown Agents' advances

rose from £4m to £37m. See Appendix XIV, a graph which we have had prepared showing the totals of comfort letter guarantees and of cash advances from January 1973 to December 1974. It has already been mentioned (para 229 above) that Crown Agents financed the acquisition of the Cutler Street, Manchester Central and Westinghouse development sites by E&C Investments. Crown Agents lending to the E&C companies was all passed through E&C Property, which in turn on lent to the two other companies. Mr Hewins told us that, as a matter of policy, he directed Crown Agents lending to E&C Property on the grounds that it was a subsidiary and therefore under the Crown Agents' control. Lending to companies in which FMI held an investment was reported to, and sometimes commented on by, the FMI board. However as E&C Property was held directly by the Crown Agents, lending to E&C Investments via E&C Property Co escaped that scrutiny. Mr Hewins has told us that the FMI board were aware of the situation, but we doubt if anyone outside the Finance Directorate appreciated the amounts involved or the extent to which the Crown Agents were becoming committed to supporting companies they did not control.

### **(3) Manchester Central Station**

233. We mentioned in paragraph 224 above the purchase of the Manchester Central Railway Station site. We found the circumstances of this purchase so unusual that we have inquired more fully into it. What caused us concern was the fact that the property was taken into E&C Investments' portfolio at £5m, of which £4.1m was paid or credited to E&C Property, which had apparently paid that sum for it, and the balance of £900,000 was paid to a Jersey company called Arkle Holdings Ltd, which was jointly owned by Mr Walker and Mr R Greene. The query arising from this was why had those gentlemen not accounted for this sum to E&C Property, on whose behalf the site had been originally purchased. When asked about this Mr Walker furnished a full explanation, an explanation which may be summarised by saying that he and Mr Challis had agreed (i) that two properties, this one and the Westinghouse site at Kings Cross, should be transferred to the new E&C Investments at a profit, (ii) that the profit on Manchester should go to Messrs. Walker and Greene and that the profit on Kings Cross should go to the Crown Agents, and (iii) that the transaction should be so conducted as to escape UK taxation. In the case of the Kings Cross site we found that E&C Property had contracted to purchase this for £3.4m in May 1971, and had paid £400,000 deposit but completion and final payment were both deferred. In August 1972 the contract was assigned to FMN, the alter ego of the Crown Agents, but no accounting entries were made in Crown Agents books. In October 1973, after E&C Investments had been set up, that company acquired the contract and completed it, paying the balance of the contract price to the vendors and crediting the sum of £1.6m to the Crown Agents. The £1.6m was wholly profit; had it been taken by E&C Property it would have been liable to tax, but in the hands of a Crown body exempt from taxation no tax was payable.

234. The other side of the bargain was more complicated. The facts as we now know them are as follows. In September 1972 British Railways agreed informally to sell the Manchester site to two persons named McRae and Maple for £2,752,555. Those gentlemen owned the Jersey company, Arkle Holdings Ltd and that company was to be the purchaser. Prior to the formal contract between British Railways and Arkle being executed, Mr Walker and Mr R

Greene agreed to purchase the property on terms giving £975,000 profit to Messrs McRae and Maple and their bankers, Dalton Barton & Co. This transaction was effected by the purchase of the share capital of Arkle conditional on Arkle entering into the contract with British Railways. The share capital was not purchased directly by Messrs Walker and Greene but by a Jersey company named Business Expansion Consultants Ltd (BEC), which they acquired for the purpose. On 6 October 1972 BEC bought the share capital of Arkle and six days later Arkle signed the British Railways contract. The money was found by E&C Property: on 4 October 1972 that company transmitted £1.3m to BEC, out of which there was paid £500,000 to Messrs McRae and Maple, £475,000 to Dalton Barton and £275,255 to British Railways as deposit. The balance of £49,745 is unaccounted for. Subsequently on 26 March 1973 E&C Property paid British Railways the balance of the price, £2,477,000, and instructed the vendors to convey the property, not to itself, but to a 'shell' company obtained solely to hold the property. This was Boregrove Ltd the shares in which were owned by Mr R Greene and the Secretary of E&C Property; those gentlemen had executed a deed constituting themselves trustees of the company for Mr Walker, Mr R Greene and FMI in the same proportions as their respective shareholdings in E&C Property. Meanwhile on 12 January 1973 E&C Property had made another payment in respect of the price, namely a payment of £300,000 to Arkle. The transaction was completed when Boregrove Ltd, now re-named Central Square Manchester Ltd, transferred the property to E&C Investments and the latter on 11 November 1973 paid the £900,000 'profit' to Arkle.

235. The £5m odd paid by E&C Investments for this property was thus distributed as follows:

British Railways		£2,752,555
McRae & Maple		500,000
Dalton Barton & Co		475,000
Arkle (ie Walker and R Greene)		
(i) 4 Oct 1972, balance	£49,745	
(ii) 12 Jan 1973	300,000	
(iii) 11 Nov 1973	900,000	
	<hr/>	
	1,249,745	1,249,745
	<hr/>	
		4,977,300
		<hr/>

Of the payments to Arkle, Mr Walker at once acknowledged that the largest, the £900,000, was profit he and Mr Greene took out of the transaction. The £49,745 balance he thought could be accounted for by sundry expenses and interest payments. The £300,000 is more involved: when our staff asked E&C Property for a voucher for this payment there was produced an account dated 1 January 1973 from a company named Commodity Trading (Jersey) Ltd, transmitted to Mr Walker, c/o Arkle and showing £250,000 as due from Arkle for 'agreed commission now payable in respect of introduction made concerning properties at Central Station Manchester.' Mr Walker however denied that this was a debt of Arkle under his ownership; he had not, he said, paid it, and he could not say what the £300,000 was intended to cover. After giving evidence

he wrote in effect accepting that this payment was additional profit for him and his partner.

236. Mr Walker's evidence about the bargain was as follows:

A I said to Alan Challis that if events had worked out in such a way that we could take full advantage of them, 'If you take the whole of the profit which will arise on Westinghouse', namely £1.6m, assuming the sale went through at £5m, 'we'll take the profit that arises on Manchester.—'

Q Who are 'we' in this case?

A Ramon Greene and I —'because we can achieve it on an offshore basis because of the way in which the Manchester transaction had to be set up in the first place at the insistence of the vendors'. That was a proposition that Alan Challis saw no objection to. It clearly was advantageous, as I see it anyway, to the Crown Agents, in the sense that they would be getting a larger share than would otherwise have been the case. But had *we* made a profit on the Westinghouse transaction, the whole of it would have gone in tax, because it would not have been treated as a capital gain, it would have been a straightforward dealing profit and would have been taxed and surtaxed out of existence; whereas we were able, by a very complex set of measures . . . to avoid tax altogether on £800,000 which was the profit on Manchester. So that the net result was that the Crown Agents had £1.6m, we had £800,000, and out of the total therefore of £2.4m, instead of getting £1.2m, we had £400,000 less without paying any tax.

The figure of £800,000 was varied later in the evidence to £900,000, and later, in correspondence, as we have said above, to about £1.2m.

237. Mr Challis, when asked about the deal, was far from precise. He said: 'I am vague about it now. I recall that there were certain properties in the rump of the old E&C which in effect the Crown Agents had 51 per-cent of and Walker and Greene had 49 per-cent of, and the transaction was done in such a way that the Crown Agents received certain properties entirely and in consideration of their receiving in effect the 49 per-cent which was owned by Walker and Greene they surrendered this benefit to Walker and Greene. I am sorry I cannot be slightly more precise than that.'

When Mr Walker's account of the transaction was put to him he assented to it. His evidence continued:

Q Do you accept that the object of departing from the straightforward conduct of these two deals was to give Messrs Walker and Greene a tax free profit?

A Yes, I think that is right.

Q Which they would not have got if they had taken their profit out of E&C Property?

A Yes.

\* \* \*

Q As regards the Crown Agents side of this deal, the property at King's Cross was transferred not to any of the Crown Agents' own companies, but to Four Millbank Nominees on behalf of the Crown Agents. Was the object of that to avoid taxation?

A I would imagine so; I cannot think why else it would be done but then I am not quite sure how.

Q Property held by the Crown Agents through a nominee company or otherwise was not liable to UK taxation, was it, because it had Crown exemption; if this profit of £1.6m had been made by Four Millbank Investments it would have been subject to tax?

A I think that is correct.

He stated that the transaction had been discussed at a FMI board meeting, chaired by Sir Claude Hayes.

Q You say this was discussed at FMI: was the method of payment discussed—the fact that these arrangements were being made in order to avoid taxation to all parties?

A Yes.

Mr Challis's attitude to the deal was summed up in the following answer:

Q I am bound to ask you whether you think it is proper for a body of Crown servants to make such an arrangement to avoid UK tax?

A There was nothing illegal in the arrangements and I personally do not see any objection to people arranging their affairs so that they minimise their tax liabilities.

238. Sir Claude Hayes denies all knowledge of this 'deal', and denies that it was discussed in his presence at a FMI board meeting. We accept his denial. The whole transaction was kept secret at the Crown Agents end by those engaging in it. We have found no contemporary paper at all in the Crown Agents' possession referring to the agreement; our documentation has come from the E&C office. What is particularly striking is that the Finance Directorate's success in making a profit of £1.6m over one deal was not the subject of a congratulatory minute to the Chairman, in marked contrast to other successful transactions (para 260). As for the E&C, Mr Caplan has told us that the new directors of E&C Investments did not know of these transactions until at a late hour Mr Levy discovered them. Mr Caplan was, he said, 'very annoyed' and was deputed to confront Mr Walker, but was persuaded by the latter to accept the situation. He thought the Manchester property worth the £5m his company had paid for it.

#### **(4) Introduction of Mr William Stern**

239. Mr William G Stern is a US citizen, and step-son-in-law of the late Mr Osias Freshwater, who controlled the Freshwater group of property companies. Mr Stern for some years participated in the affairs of that group, and from 1964 to 1971 he was its joint managing director. In 1971 he left the group and developed his own companies. At the top of this organisation was Wilstar Securities Ltd. This owned the whole share capital of Stern Family Holdings Ltd, which in turn wholly owned Metropolitan Property Holdings Ltd, a company taken over from the Freshwater group. These bodies owned or controlled a number of other companies, mostly owning property but including the Nation Life Insurance Co Ltd—also an ex-Freshwater company. Mr Stern was a devotee of deficit financing; that is to say his property companies paid more in interest on their loan capital than they received in rents and other income, and the revenue deficit was met by the capital profits made from dealing in property on a rising market.

240. Mr Stern's first dealings with the Crown Agents date from his Freshwater days, when in 1969 Metropolitan Property Holdings borrowed £1m from them. This was a transaction effected through Mr Davidson and SIS, which had just been formed with Crown Agents' support (para 68 above). Mr Stern had told us that he obtained an introduction to Mr Davidson and regarded SIS as the real lender. What happened was that SIS took security from Metropolitan and procured the Crown Agents to lend the money against SIS's guarantee. In this triangular fashion a number of loans were made. The first £1m was lent to Metropolitan in December 1969 and repaid in February 1971; another £1m was also lent in December 1969, increased to £1.5m in October 1971, and repaid in October 1972; and a third loan of £2.5m was made in October 1970, increased to £3.75m in June 1971, and repaid on 29 June 1972. A loan of £650,000 was made to Freshwater Family Holdings in July 1970; this was transferred to the Stern group, and increased to £1,350,000 in May 1972: it has not been repaid. Mr Stern has told us that down to June 1972 he had dealt only with SIS and Mr Davidson and had met none of the officers of the Crown Agents except Mr Morris, who was a director of SIS:

'Mr Morris, with whom we had never discussed finance because he did not deal with it, was introduced to us in 1971 and became the Chairman of Nation Life, so when I say to you that I had never had any contact with the Crown Agents I mean on the financial side with Mr Challis, Mr Hewins, Mr Wheatley, but we had met Mr Morris. We knew he was about to retire. I had been advised he would accept Board directorships and he would become in 1971 the Chairman of Nation Life.'

241. But in the summer of 1972 Mr Stern came directly to the Crown Agents and obtained an unsecured loan of £1m and another unsecured loan of \$3m. His own explanation of how this came about was that he needed a dollar loan to enable him to fulfil a contract he had entered into to buy what he described as the largest private house building company in Israel. He also explained to us a complicated property transaction effected in May 1972 between one of his companies and FNFC apparently with profit to both. Mr Challis was a director of FNFC but he had not at that time met him. He also at about this time, as we have mentioned above, repaid a £3.75m loan obtained from the Crown Agents via SIS. He expressed himself as proud of this repayment, but his satisfaction appears to have clouded his recollection about the facts. What he said to us was:

'In June 1972 I, Metropolitan Property Holdings Ltd, was able to re-finance totally, and I was able to do that with the single exception of a share loan which was granted to Stern Family Holdings and which, being for three years, was a fixture and therefore was not, and was not intended to be, re-financed. But all the property loans, which I regard were in the approximate figure of £5m were re-financed back in June 1972, and from the proceeds of a new . . . loan I had arranged with International Westminster Bank, I was able to repay SIS, ie Crown Agents, for every single penny that they had loaned. . . . All the loans I had taken over 6 months earlier from the Freshwater group when I exited were repaid and if I may say so I felt quite heroic.'

This was not quite accurate because in addition to the three-year loan (which was the £1,350,000 advanced to Freshwater Family Holdings) there was still



subsisting the £1.5m loan to Metropolitan, which was in fact due for repayment on 28 July 1972 but was not repaid until 27 October 1972.

242. However Mr Stern had repaid a substantial loan. He went on in his evidence to refer to the FNFC deal, and said:

‘I asked myself who was the lender in London who under the basis of knowledge of this transaction would be prepared to lend me some dollars which I need, and I came to the conclusion that it would be of all people Crown Agents for two reasons: (1) I had just shown my creditworthiness in repaying a month earlier, in June, loans accumulated over a period of 2½ years and discharged them in toto; (2) Challis, as director of FNFC knew of course every detail of this transaction; therefore he was the one man in London to whom I could go without having to bring heaps of documents and say “You of all people know that my company had just made a very substantial profit and therefore could I please borrow some dollars?” and I rang up Challis just like that one evening and said “Could I please come and see you?”’

He said he saw Mr Challis at Luke House, and:

‘I had all the cards on my side. I had repaid a month earlier, and he knew it, £5m. I had just made as a private company a very substantial profit which to him as director of FNFC must have been a very substantial thing, even to a company the size of FNFC. Therefore as a borrower I was the most credit-worthy and likely individual to receive an answer to a request to be able to borrow whatever amount of dollars I needed at the time. Mr Challis did not deal personally with the technicalities of the loan. He told me he would ring back in a day or two and very soon afterwards, August 1972, I met Mr Hewins.’

According to Mr Stern, Mr Challis on the telephone said ‘go and see Norman’ ie Mr Hewins, which he did. He then met Mr Blundell, the foreign currency manager, and got his dollar loan. He had not, he said, met Mr Wheatley at this stage.

243. Despite his flow of information, and his reproduction of spoken words verbatim, we fear that Mr Stern’s memory again proves unreliable. The Crown Agents’ books and files show that his first direct transaction with Crown Agent officials, although it may have been prompted by a need for dollars, resulted in a sterling loan of £1m, made in fact on 30 June, the day following that on which the £3.5m was repaid. Mr Hewins described his first meeting with Mr Stern in these words:

‘I had reason to think that Stern was persona grata with Challis. When Challis introduced me to him as a prospective borrower he said—and I cannot remember the exact words—“Willie Stern, you know, was very helpfully involved with FNFC’s flats deal.” If I remember rightly Matthews of First National Finance had taken the decision, Challis at the time being a member of the Board, to dispose of the great portfolio of residential flats in First National’s portfolio. I do not know the circumstances in which that transaction was done I am afraid. I do know that Challis mentioned that Stern had been involved in it. He was introducing Stern to me as a prospective borrower from the Crown Agents. I received the impression, though I think it was not said explicitly, that Stern was quite definitely persona grata and

that Challis would be wishful of the banking department lending to him. By that I do not mean for one moment to suggest that Challis would have countenanced unbusinesslike lending.'

For his part, Mr Challis disagreed with that account. Mr Hewins's evidence was put to him, and the examination continued:

Q I do not know if you would like to comment upon that?

A Stern invited me to lunch on two occasions I think. On both occasions he raised with me the question of borrowing from the Crown Agents. On both occasions I told him the man to talk to was Mr Hewins. I gave him no encouragement on either occasion.

Q Mr Hewins said you introduced him as one who had been very helpful over FNFC?

A He had no involvement with that.

Q He says your words were, not necessarily the exact words, but words to the effect "This is Willie Stern, you know, who was very helpfully involved with FNFC's flats deal," and Mr Hewins thought that referred to the disposal of a portfolio of residential flats in that company's portfolio. You were on the Board of FNFC?

A I was.

Q Do you remember introducing him in these terms?

A I certainly do not. I cannot think why I should do it.

Q Mr Hewins thought you did it to convey a hint that he was, as he put it, *persona grata*?

A I have no recollection.

Q One to be obliged because he had been helpful?

A There are no grounds I think for obliging Mr Stern because he had obliged First National. I cannot think there was any connection.

Q Having told Mr Stern he should talk to Mr Hewins, did you in any way talk to Mr Hewins about an impending inquiry from Mr Stern?

A I told Hewins that I had said what I had said to Stern, yes.

Q But you did not give Hewins any kind of indication of whether he should or should not lend?

A In fact on both occasions—and, I must say incidentally, on other occasions with other people—it was always my practice to say 'You are talking to the wrong person. The man in the Banking Department is the man you should talk to'.

Q But did you give any instruction to Hewins in relation to Stern?

A No.

Q None at all?

A None at all.

Mr Challis later said:

'Far from being the source of introduction of Stern to the Crown Agents, the first introduction I am sure came through Sterling Industrial Securities, and through Wheatley as the common denominator of the director of Sterling and the money market manager.'

244. Further light on the first meeting is thrown by a handwritten note which has survived on the files. This was written by Mr Hewins to Mr Wheatley on 30 June 1972. It reads as follows:

‘Would you mind giving Willie Stern a ring on Monday? He would like to borrow £1m for 90 days either in one tranche or in 2 at £500,000.

‘He has been told by AHC [Challis] and also by me that we shall find it difficult to oblige him but will see if anything can be done provided he realises that it would cost him!

‘Stern Family Holdings has recently repaid you £3½m I believe, so this may look a bit queer—but at that time he hoped to borrow US\$ and we can’t oblige him there because he wanted them for too long a period.

‘Don’t do it if your judgement says “no”. I am happy with whatever you decide.’

The terms of this contemporary document indicate to us that Mr Stern was at that date rather better known to the Crown Agents’ personnel than either he or they would have us believe. Mr Osgodby, the then Deputy Head of Banking, told us ‘Stern was originally introduced through the Director of Finance, and the Director of Finance initially had an interest in Stern’ and ‘Challis . . . was certainly actively involved in lending to the Stern group’. No one seems anxious to take the credit for introducing Mr Stern to the Crown Agents, and not all their varying accounts can be correct; we are disposed to think that the accounts given by Mr Hewins and Mr Osgodby carry credibility.

#### **(5) Mr Stern’s borrowings**

245. Mr Stern was certainly a successful borrower. One of Mr Hewins’s comments to us was ‘I must say that Stern was extremely persuasive and was able to persuade people to lend to him with remarkable ease.’ Within a fortnight of the note reproduced above, we find Mr Hewins writing another note, this time to Mr Blundell, head of the foreign currency section. This was headed ‘Willie Stern (Stern Family Holdings)’ and it said:

‘BI are lending £1m unsecured and Stern can have equivalent up to a further £1m unsecured. Can we lend US\$1½m to him now? Shortish in first instance, no promise of certain rollover but do our best. PI consider and talk to him.’

Mr Blundell has told us that this note came after he had first been introduced to Mr Stern:

‘My first introduction to Willie Stern—I think I met him on three occasions—was his arrival in the office, and I was invited in by Mr Hewins to discuss the question of lending funds to, as it turned out, Wilstar. He was unable to produce accounts at the time but he said these would be forthcoming in a relatively short period of time, and it was agreed to make a ceiling at that stage of \$3m available.’

Mr Blundell said that Mr Osgodby was also present at this meeting, and that both Mr Hewins and Mr Osgodby were in favour of making the loan.

246. This unsecured loan was made to Wilstar in three tranches, on 17 July, 28 July and 16 August 1972. Mr Blundell was uneasy about the loan, but, he said, ‘here was a man that was known by my superiors prior to this and by that

I would be guided to some extent'. He asked for Wilstar's balance sheet. It was not forthcoming, and for this reason at the loan's maturity (three months) he converted it to call money.

247. These unsecured lendings, it will be noted, were within the purview of the Credit Committee (paras 177-181 above). That committee's approval had not been given. However Wilstar appeared on the agenda of the next committee meeting, on 25 July. No loan sanction was then given because no accounts had been produced. The Secretary's notes of the meeting record that 'judicious inquiries' were to be made. The minutes of a subsequent meeting, that on 31 October, include this minute:

'The accounts of Metropolitan Property Holdings Ltd were not considered adequate to discuss a ceiling for Stern Family Holdings Ltd and Wilstar Securities Ltd. No decision will be made until Mr Stern produces accounts for Wilstar Securities Ltd.'

However by the meeting of January 11 1973 the accounts had at last appeared and the Committee sanctioned Stern Family Holdings as a borrower, with a £3m ceiling. At that time the Stern companies were already over that limit, but no action followed. With reference to the July and October meetings we asked the Secretary of the Committee:

Q Was the Committee told, do you recall, that the Stern companies had already at that date been lent large sums, both of sterling and of foreign currencies?

A No, I am certain they were not.

Mr Hewins and Mr Blundell were members of the Credit Committee; they thought that the making of the loans prior to sanction had the approval of Mr Challis. The latter however denies this:

Q There was one remarkable case, that was to Stern, to whose company the Credit Committee refused to sanction any loans until it had seen a satisfactory balance sheet, despite which you sanctioned the loan as we understand it?

A That is certainly not correct.

Q You are not familiar with the instance of a loan to the Stern company at a time when the Credit Committee had not approved it unsecured?

A I certainly do not recall any such arrangement. Is it said that I approved a loan to Wilstar?

Q Yes, that is what was said.

A I have no recollection of that at all.

248. Mr Stern's progress as a favoured borrower was remarkable. By the end of 1972 his companies' sterling loans, secured and unsecured, amounted to £8,350,000. By the end of 1973 they had risen to £21,433,000. Many of the loans were straight lending to one of the companies against security of property owned by it or its subsidiary; here the evaluation of the security was, according to custom, left to Davies Arnold & Cooper (para 132 above). Their practice was to accept the borrower's surveyors' valuation, and in no case apparently did the Crown Agents ever employ a valuer of their own to advise them, even when as much as £5m was advanced, as it was to Metropolitan Property Holdings in December 1972 on property valued on behalf of Mr Stern at

£7,100,000. In the substantial majority of cases Davies Arnold & Cooper did take the precaution of getting the borrowers' surveyors to write confirming their valuation direct to the Crown Agents, so that a legal nexus was established. They regarded the ensuing right of the Crown Agents to sue if the valuation was negligent as an insurance policy. This particular valuation has since been described as 'over-exuberant' but over-exuberance is not necessarily negligent and the insurance policy has not proved effective in practice.

**(6) Mr Stern: The Nation Life affair**

249. Among the transactions making up the total of loans to the Stern companies, there are two which require further scrutiny. The first of these was the affair of the Nation Life Insurance Company Ltd. This company was 70% owned by Stern Family Holdings; it had surplus cash, but Mr Stern was aware that the Department of Trade would view with disfavour any investment of this cash in another Stern company. (This appears from the Parliamentary Commissioner's Fourth Report for 1975-76, where he deals with allegations of maladministration in connection with the supervision of that company's insurance business). And in early 1973 there was on its way through Parliament the Bill which was to come into force on 25 July 1973 as the Insurance Companies Amendment Act, 1973. Section 10 of this statute prohibited the investment in a connected company of assets attributable to the long term business of a life insurance company. This is the background to a transaction, the inception of which Mr Hewins described in these words:

'After we had lent secured and unsecured for some little time, Stern approached Wheatley with a proposition that a triangular arrangement should be arrived at . . . whereby Stern's company, Nation Life, would deposit money, as it had cash surpluses, with the Crown Agents for a fixed period, and in parallel the Crown Agents could lend to Stern's property operations for . . . a matching period. He had come up with this idea because we had told him we did not want to lend him any more money unsecured.'

250. Mr Hewins said that he and Mr Wheatley decided that they could not have a back-to-back arrangement with an insurance company; it would be 'a wrong thing to do'; and they rejected the proposal. Mr Hewins's evidence continues:

'The next thing I knew, I was phoned for by Challis. I went down and he said "You know this Nation Life arrangement that Willie Stern wants. You said we cannot do it. I understand why you said that, but, look, granted that it cannot be back-to-back, surely we could take his personal guarantee up to say £5m. . . . He must be a millionaire in his own right several times over. Do you not think we could take his personal guarantee?"'

Mr Hewins agreed. He now wishes he had not agreed, and he went on to explain why he so acted in a passage illuminating his relationship with his superior:

'I admired Challis all the time I was working for him. I did not always agree with him. It very often happened that when I went into his room wanting to disagree with him and carry my point, I came out again, not having carried the point, but having been persuaded myself that he was right and I was wrong. He was a very powerful personality and he was held to be outstandingly able. Without wishing to exculpate myself, I would like to say I felt

I was getting the firm message that this was something to say yes to. Accordingly I said yes.'

251. After this decision Mr Hewins wrote the minute to Mr Wheatley dated 13 March 1973 which we reproduce at Appendix XV. Its terms are not easy to reconcile with the oral account given above, but however willing a participant Mr Hewins was at the beginning, it is clear that he came to dislike the scheme because when, after Mr Challis left, he was in charge of the department, he paid off Nation Life's deposits prematurely. He said 'We disliked it intensely':

Q We know there was no legal or documentary link between the Nation Life deposit and the loan to Stern Family Holdings. The documents merely created Mr Stern's personal guarantee, but was there not an understanding that there was some correlation between the two? Was it not that understanding which made you uneasy?

A That is absolutely right. I am trying to draw a distinction, if it is valid, between an informal understanding and the formal position at law where it was quite definitely illegal if there had been a formal link connecting the parts of the triangle.

252. Others disliked the transaction. Mr Levy, the solicitor who drew the documents, said to us that it was not a transaction he liked and he believed he has said so at the time. Mr Osgodby said:

'We unwound that arrangement when it became clear to the Crown Agents that what they were in fact doing was conniving at something which was illegal.'

Mr Challis however was unrepentant:

A I knew that the law would in fact prohibit a direct loan from Nation Life to Stern.

Q But this was a way of avoiding that law, was it not?

A No.

Q Nation Life lent money to you, you lent it on to Stern?

A That was a way of making the law work, was it not.

Q That is how you regard it?

A I think that is in fact the case.

253. The ingenious Mr Stern had an entirely different version of the transaction. His account was that Nation Life had pioneered a guaranteed income bond and wished to invest its funds so as to obtain a high rate of interest. He persuaded the Crown Agents to grant this high rate by undertaking to borrow an equivalent amount from them at a still higher rate. He said he put this to Mr Challis, who agreed subject to personal guarantee.

254. The agreement embodying the formal part of this arrangement was drafted by Mr Levy and made between Stern Family Holdings, Mr Stern, and Four Millbank Nominees, and dated 11 April 1973. It imposed no obligation on Four Millbank Nominees to make any loan, but provided the terms upon which any loan was made. These included Mr Stern's guarantee, a £5m ceiling, and a promise by Mr Stern to insure his life in the lenders' favour for £2m.

Naturally there was no reference to Nation Life, but in a covering letter to Mr Wheatley, Mr Levy said:

'Obviously you will not make any advances under this Agreement unless you receive a corresponding deposit.'

255. Transactions under the arrangement took place on 11 June, 3 July, and 18 July 1973, on which days sums of £500,000, £300,000 and £200,000 respectively were both received from Nation Life and paid out to Stern Family Holdings. On 18 June and 2 July unmatched sums of £825,000 and £1,675,000 were paid under the agreement to Stern Family Holdings: these will be referred to in para 258 below. There was one further unmatched loan of £2m on 22 October 1973. And an unmatched deposit of £1m was received from Nation Life on 7 February 1974. The total advanced under the agreement was £5.5m.

#### **(7) Mr Stern: The Epsom site**

256. The other transaction which we single out for scrutiny is one relating to a development site at the town centre of Epsom, Surrey. This was one of Mr Sly's property investments (para 51 above). It was owned jointly by the Crown Agents and a developer named Mr Remo Dipre. But it became an embarrassment to the Crown Agents because of local hostility to the proposed development. Sir Claude had no wish to have questions asked in the House of Commons about his organisation's property investments: he told us:

'When I cottoned on to it I said we must get out of it. I did not think it was the sort of scheme in which we should be involved.'

Therefore inquiries were made among developers with whom the Crown Agents were in touch. They obtained an offer from their partner Mr Dipre, to buy them out at a figure which valued the whole at about £4.5m. They received an offer from Capital & Counties of £5.5m. (Valuations recently obtained by the Crown Agents have given the 1973 value as approximately £3m.) They then approached Mr Stern. Mr Sly has told us that Mr Hewins told him that Mr Stern was interested and he, Mr Sly, went to see him and came back with an offer of £7.5m. The proposed purchaser was Bradley House Investments Ltd, a subsidiary of Metropolitan Property Holdings, and on 12 April 1973 Mr Stern wrote to Mr Osgodby offering this sum, subject to contract, and saying:

'We would not intend to approach the Crown Agents for any finance in connection with this purchase.'

257. We have inquired why that phrase was put into the letter. We asked Mr Hewins:

Q Did you ask him to put into his letter the statement that he did not intend to approach the Crown Agents for finance?

A Yes, we did, because we made it clear to him that if he was going to be the buyer, we would not do it if in fact it meant we had to finance the purchase.

Mr Stern had a somewhat different version of events. He said one of his team of young property men named Jackson had come to him with news of a fantastic site being offered in the centre of Epsom, and as it happened he found that the Crown Agents were part owners. So he wrote the letter.

Q Is that the letter where you say you will not be borrowing the money from the Crown Agents?

A Yes.

Q Why did you put this in?

A There was competition for the site and Martin Jackson said 'Crown Agents will prefer a buyer who can arrange his own finance'.

The letter, we should note, concludes with the words:

'In light of the several discussions which have preceded the making of this offer in the first instance with Mr Sly, then with Mr Hewins and, finally, with your good self and Mr Dipre, I hope you will see your way clear to give an early and favourable consideration to this offer.'

In the light of what happened, we view with scepticism the recorded disclaimer of any intention to seek Crown Agents' money to finance this purchase at what we think was an inflated price. Indeed it got still more inflated. By the time the contract was made it had reached £8,225,000. And in the end almost the whole of this price was paid by the Crown Agents' money.

258. The sequence of events was this. On 15 June 1973 an option agreement was signed and Bradley House paid £822,500 deposit. On 18 June the Crown Agents lent £825,000 to Stern Family Holdings in order to finance the deposit. On 2 July the option was exercised. Of the balance of the purchase price £5.25m was lent by the Crown Agents free of interest and repayable on 31 December 1973, secured by a legal charge on the property. This was a notional loan, the reality was that payment of that part of the price was deferred to 31 December. Of the balance, the £825,000 loan for the deposit was extended to be repayable on 28 December 1973; a further £1,675,000 was lent on the same terms, and the final £475,000 was presumably paid from Stern's own funds. The two loans were attributed to the Stern guarantee agreement (para 255 above).

259. The six months' delay in paying the balance of the price was to enable Mr Stern to find the finance. He did not find it by the due date and on 19 December he applied to Mr Hewins for a £5.5m bridging loan pending receipt of finance offered by First Chicago Ltd, a subsidiary of the First National Bank of Chicago. He produced a letter from First Chicago dated 12 December 1973 and offering a £6.5m loan on Epsom Town Centre 'subject to Board approval'. Mr Hewins obligingly lent him his £5.5m and with it Bradley House were enabled to repay the notional interest free loan, with the result that the charge on the property was released but First Chicago did not make the advance and the £5.5m was not repaid when it fell due on 4 April 1974. Mr Hewins says he tried to attach the charge to the £5.5m loan:

'At that time and for, I think about two months thereafter I was under the firm impression that the lending was secured on the Epsom property, and so was Osgodby, and Osgodby had given a direction in writing to the money market branch that the loan was against the security of Epsom. For some reason which has never been I think properly explained, his direction to the money market branch was not actioned promptly and a chain of circumstances flowed from that which, as we afterwards found out, meant that we were not secured at all.'



However, it may be that there is in the circumstances some implied charge, and the question whether this is so, and whether certain subsequent actions have affected any such security, are legal matters which, we understand, are still engaging the attention of the Crown Agents' advisers. The point we wish to make is that, had proper attention been directed to the matter at the time, there would have been no difficulty in obtaining uncontroversial security—although whether it would have been worth £5.5m is another matter.

260. Meanwhile on 2 July 1973 Mr Hewins had despatched a congratulatory minute to Mr Challis:

'I am pleased to be able to report that after a protracted negotiation with our joint venture partner and the prospective purchaser we have succeeded in selling our entire interest in the property development at Epsom, Surrey, to Bradley House Investments Ltd, a property company controlled by Mr William Stern on terms which will result in a net profit to the office of a sum in excess of £1.75m for settlement by 31 December of this year. . . . As the Chairman is interested in the Epsom development, you will no doubt wish to pass this minute to him for his information.'

And this Mr Challis did, with the comment 'A satisfactory outcome of this somewhat controversial investment!' and Sir Claude instructed that the Ministry be informed of the sale. We suggested to Mr Hewins that it would have been better to mention in the minute that of the purchase price £5.5m was on interest free loan from the Crown Agents and that of the balance most had already been financed from the same source. His answer was:

'Things like this were not done in the dark in the banking department. Challis knew. Osgodby and I consulted him on this question of whether we should decline to deal with Stern because he wanted a bridging loan or not. Now I want to say to the Committee, because it is true, that I did not want to complicate a minute that Challis was going to pass on to Hayes, not because I did not want Challis to know—he knew—but because we did not want to complicate it for Hayes.'

261. The result of this lamentable transaction was that the Crown Agents parted with joint ownership of a valuable piece of property and got in return a few thousand pounds plus Mr Stern's guarantee of £2.5m and a questionable security for £5.5m. Truly Mr Stern enjoyed, as Mr Hewins said, extremely persuasive powers. As a footnote it may be added that although the Crown Agents' partner in the Epsom development, Mr Dipre, received his half share of the proceeds of the sale at so good a price, he was also given a further inducement to join in the transaction by being granted a loan of £1,200,000. This was advanced on 23 July to a company which he controlled; it was secured by the provision of shares in quoted companies and it has since been repaid.

262. Before leaving Mr Stern we must note the gifts which he made to those members of the Finance Directorate with whom he dealt. He explained to us that he was prevented from offering them hospitality other than an occasional lunch at his office because, as an orthodox Jew, he could only eat Kosher food. 'I have not and had not gone with them to night clubs, operas, movies, theatres,

...races, weekends, or anything of that sort.' Therefore 'as some sort of recompense' he gave generous Christmas gifts:

'I was known as a fairly generous Christmas gift giver, and generous means it could be a gold pen and pencil, it could be—I think in one instance it was—a desk set; I think in one instance a watch; the monetary value was from £50 to perhaps £400 once a year at Christmas.'

In accordance with this policy, he said, he had sent gifts to Mr Challis, Mr Hewins, Mr Wheatley and Mr Blundell.

263. There was some inconsistency in the evidence of the recipients of these gifts, and the recollections of two of them—Mr Challis and Mr Hewins—was surprisingly imprecise. Mr Challis said that at Christmas 1972 he had received a teaset, either silver or silver-plated, he did not know which; he had considered sending it back but thought it 'rather a marginal thing'; instead he wrote telling Mr Stern not to do it again; he did not know that other officers had received presents and had not been consulted by them. Mr Hewins said that at the same Christmas he had received a gift of desk stationery:

Q What exactly does desk stationery mean?

A This was quite an elegant set of the kind that you would get from Harrods, say. There was a paper knife, a pen and pencil, a blotter and there was a frame in which you could put a photograph if you wanted to. It was obviously sold as a set for an executive's desk

Q Were the pen and pencil gold?

A I think they were either gold or silver. I am sorry, I do not recollect.

Mr Hewins said he had consulted Mr Challis, who had received an identical desk set, and Mr Challis advised him to tell Mr Stern not to do it again. He wrote as advised. Whether Mr Stern heeded the advice he could not recall. He at first said there was only one gift, but then said 'I have a terrible feeling that in spite of what I have said I think he did send something else the next Christmas, but I do not remember what it was.' He said Mr Wheatley had also had a desk set at Christmas 1972. Mr Blundell's evidence was that he had had a leather briefcase from Mr Stern at Christmas 1972 and a gold pen and pencil at Christmas 1973. He had not consulted his colleagues about them but he was aware that they too had had presents from Mr Stern. Mr Osgodby also said that he had received a gift from Mr Stern. This was a gold pen and pencil given at Christmas 1973. He took the wise step of reporting the gift to the Director of Personnel, Mr Eaton. We comment upon this matter at para 408 below.

264. It will be seen from what we have said that by the end of 1973 Mr Stern had come to occupy a position of most-favoured-borrower rivalling that of English and Continental. One of the specific criticisms of the Stevenson Report, it will be recalled, was of the excessive degree of concentration of investment—£41m in two concerns (para 205 above). This criticism was not heeded: by the end of 1973 £75m was invested in three concerns, the Australian property developments, £36m; Stern, £21m; and English and Continental, £18m. Nor had the other warnings of Stevenson been regarded. The risks which that Committee feared continued to be run. We have investigated all cases in which provision has subsequently had to be made, and we must now mention briefly certain other loss-making transactions dating from this period, as well as briefly

continuing the history of on-going investments mentioned in our account of earlier years.

**(8) Other developments**

265. (a) *Singapore*

We noted at para 151 above the setting up of the Orchard Square Development Corporation to develop a commercial site in Singapore. In January 1971 this company had purchased from the owners, a local charity, an option for a 99-year lease on the site. Negotiations for planning permission were conducted with the Singapore government. These proved difficult, but on 29 March 1973 an agreement with the owners was signed under which the option was exercised, the 99-year lease was to be granted, and a ground rent starting at S\$1m per annum was to be paid. Management from London proved difficult; an unsuccessful attempt was made to enter into partnership with a local development company; no final planning permission has been granted, and no development has been carried out. Apart from S\$250,000 provided by Mr Walker and Town & Commercial for their shareholdings, all the costs of this abortive venture have been provided by the Crown Agents. They have expended some S\$17m, or £3.5m.

266. (b) *British Bangladesh Trust*

On 20 November 1972 Mr Shuter, the head of Investment Department, read in the press that the Crown Agents had invested in the British Bangladesh Trust, a banking company set up by Mr John Stonehouse, MP. As he had been previously approached to do this, and after consulting Millbank Technical Services had declined to do so, he wrote an indignant minute saying, inter alia:

‘It would be helpful to me if at an early date I could be advised of the policy and objectives of this investment, news of which has caught me flat-footed.’

He was told:

‘This is one which has been bought for us. Its profitability is questionable.’

What had happened was that Mr Stonehouse had visited Sir Claude Hayes on 19 October to express the hope that the Crown Agents would subscribe for shares in his new bank. Sir Claude had consulted with Mr Challis and had agreed to subscribe £50,000. This was subsequently increased to £100,000 when a rights issue was taken up in November 1973; on that occasion Mr Shuter minuted:

‘I have made it clear to Mr Hewins that this will be yet another example of “F” being committed to costly borrowing to purchase assets which are unlikely to show much return in the short or even medium term and will thus aggravate our realised loss figures.’

The Crown Agents also lent this company, which later changed its name to London Capital Group Ltd, a total of £350,000. Mr Hewins explained to us that this was Sir Claude’s wish, and that the object was to secure Mr Stonehouse as an ally in the House of Commons in the event of any criticism being directed there at the Crown Agents. It was a political rather than a commercial lending, he said.

267. (c) *Australia*

During 1972–73 the developments begun in association with Mr Fenston (paras

53-59 above) gathered momentum. Crown Agents also had to meet the financing requirements of Capital and Counties (Australia) Pty Ltd. There was also the prospective commitment of A\$50m to finance the new joint company, Abbey Capital Properties Pty Ltd. The activities of this new company were restricted by the depression affecting the commercial property market in Australia from 1971 on but the commitments for the other two companies crystallised; by the end of 1973 £36m had been expended by the Crown Agents directly from London. Further sums had been raised locally, this by necessity because in the autumn of 1972 the Australian government had imposed restrictions on importing funds into Australia. In November 1972 Mr Hewins went to Australia and arranged a A\$20m debenture issue secured on certain of the Australian properties. He also arranged a further A\$45m medium term loan against the Crown Agents' guarantee.

268. The local administration of the projects was placed under the control of Capital and Counties, and Mr Ottaway relinquished his post early in 1972. Another change was the recall of Mr W Walter, the Crown Agents' representative in Australia since 1968, who had played a significant part in the early years of the Australian property venture and had been Chairman of the Board of Abbey Orchard Property Investments Pty Ltd. Mr Walter's tour of duty ended early in 1973, and on returning to the United Kingdom he faced disciplinary proceedings because he had failed to account satisfactorily for cash withdrawals and other payments totalling some A\$23,000. He was required in the disciplinary proceedings to answer charges in connection with these sums and also an earlier advance of A\$7,000, which had been repaid. In reply to the charges Mr Walter admitted that he took these sums to meet stock exchange transaction debts and other debts, particularly gambling; and he resigned from the Crown Agents' employ. Now the Civil Service disciplinary code, which applies with slight modifications to the Crown Agents' staff, provides that 'if there is any doubt about a possible criminal offence, the police or Director of Public Prosecutions should be consulted immediately'. This was not done. It furnishes another instance of the Crown Agents' reluctance to take outside advice on any topic.

269. The above was not the only irregularity to have occurred in the administration of the Crown Agents' affairs in Australia. The evidence available in London also indicates that difficulty was experienced in monitoring the operations. We have not however investigated further: to do so would be impossible without conducting inquiries in Australia, and this would have unduly delayed the completion of our Report.

270. (d) *Sterling Industrial Securities*

This bank continued to grow during 1972-73. Its total deposits as at 31 October were: 1971, £12,080,000; 1972, £17,896,000; 1973, £26,327,000. But it remained heavily dependent on the Crown Agents' loans. These had risen from £3m (para 140 above) to £4.2m by November 1972, provoking Mr Towse (the Finance Directorate accountant) to minute that this represented no less than 22% of the SIS balance sheet and to comment that it had not been sanctioned by the Credit Committee. Mr Hewins replied that this was 'in-house' lending and not subject to the Committee's scrutiny. By 31 December 1973 the loan figure had risen to £5.6m.

271. (e) *Sassoons*

This merchant bank, one of the Crown Agents' first ventures into own-account ownership (para 30 above), had proved a disappointment. Its business was small and its profits unsatisfactory. Sir Stephen Luke, who remained on the Board until 1972, described the company as 'not quite first class' and attributed its stagnation partly to the unwillingness of the Crown Agents' staff to co-operate with them. He had expected a joint venture by the Crown Agents and so large a bank as the Continental Illinois to be more productive, and he thought that these two partners had never got on close enough terms. At all events, in 1972 Continental Illinois left, and a new partner came in, in the shape of an old established firm of East India merchants and merchant bankers named Wallace Brothers. The transaction was effected by the Crown Agents buying Continental Illinois's 45% shareholding and exchanging their now total shareholding of 90% for a 20% stake in Wallace Brothers & Co (Holdings) Ltd. (The remaining 10% of Sassoons' shares continued to be held in the Sassoon family.) The Crown Agents bought further shares in Wallace Brothers (Holdings), giving them a 25% interest. The total cost of the various share purchases conferring this interest was £2,971,000.

272. (f) *Sassoons Bahamas*

Sassoons had a subsidiary, E D Sassoon Banking International Ltd, based in the Bahamas. This was split off from its parent company when Wallace Brothers came in, and became jointly owned by the Crown Agents and Wallace Brothers. Continental Illinois did not want to continue in this bank: they had no wish, so their executive vice-president, Mr Alfred Miozzi told us, to assist in tax-haven operations for US citizens and were 'not terribly comfortable' with the bank's operations—as, he said, the Crown Agents well know. Later Wallace Brothers exercised a put option given them in 1972 by the Crown Agents, and the Crown Agents became the sole owners. This investment had cost them £483,000. The present name of the company is CA Bank and Trust International Ltd. We have had evidence from Mr D H Mansfield, its managing director since 1972, but we know little about its activities owing to the strict Bahamian laws on banking confidentiality. The Bahamas have of course been well known as a 'tax haven'. Mr Mansfield has however indicated that, partly owing to the UK dismantling the sterling area in 1972 there was then what he called 'a marked absence of good lending situations'. This led directly to the Crown Agents becoming involved with the GCA Capital Corporation, with unfortunate consequences.

273. (g) *GCA Capital Corporation*

This was incorporated in Ontario in 1973 and was intended to form the Canadian link in the Crown Agents' chain of merchant banks around the world. Because of Canadian banking law it could not function as a merchant bank as that term is understood in London, but it could deploy funds to take advantage of local situations. The seeds of this idea were sown during a visit by Mr Challis to Mr Mansfield, of Sassoons Bahamas, in Nassau in January 1973. Mr Mansfield says that Mr Challis suggested such a merchant bank; Mr Challis says the suggestion came from Mr Mansfield. The latter then went to Toronto to make inquiries, and produced Mr Jack Gilbert, a Toronto lawyer, as a likely promoter. Mr Gilbert formulated a scheme, which was supported by Mr Mansfield, and

followed by a visit by Mr Challis to Toronto to see Mr Gilbert. Mr Mansfield had apparently known and had dealings with Mr Gilbert for many years, and Mr Challis was favourably impressed. In consequence the proposal to form this finance house was put before the FMI board on 3 May 1973 and approved in principle. Mr Gilbert then came to London and met the Board, chaired by Sir Claude, at their meeting on 4 June, when the project was accepted. FMI took up 540,000 preference shares and 60,000 common shares. The other subscribers were Mr Gilbert 102,000 common shares, Sassoons Bahamas 60,000 preference and 20,000 common shares, and the same 'for a client' 18,000 common shares. The shares were of \$1 issued at par and paid for in cash. But \$800,000 was insufficient capital for such a money-lending business, and loan capital was needed. Not surprisingly this came from the Crown Agents. FMI guaranteed a bank facility of \$1,600,000, and themselves opened a \$2m line of credit. This last led to an incident with Mr Blundell, who was summoned by Mr Challis to meet Mr Gilbert and asked how much he had available to lend in dollars. Mr Blundell commenced to inquire what the loan was to be for, in order to satisfy himself that it was a proper investment to make, but he was sharply reprimanded by Mr Challis, who told him that it was none of his business. Mr Hewins was also, as he put it, 'carpeted' for allowing Mr Blundell to question a loan to an associate. Mr Hewins said in evidence:

'I think what Challis really meant to say was "Look, I do not want your middle management people to come down here and start cross questioning chief executives in Four Millbank Investments' operations when I am telling them this is the state of play and this is what they have to do."'

Nevertheless Mr Challis denied that the decision to make the loan available was his. He left it, he said, to the banking department.

274. There are one or two unsatisfactory features about the inception of the GCA Capital Corporation. In his paper put before the Board meeting which accepted the deal on 4 June, Mr Challis made no mention of any bank guarantee to be given or of any loan to be extended by FMI. He says these were not at the time known to be required. Next, the minute of that board meeting records:

'It was agreed that Mr Douglas Mansfield should be nominated to represent the company on the new Board during the initial period.'

But Mr Mansfield asserts that no-one had told him about this and the first he knew of it was when we showed him the minute:

A I have never seen this minute before and that particular decision was certainly never communicated to me.

Q Is that so?

A No, in fact I did go on the Board of GCA but I felt my representation on the Board of GCA was as a representative of E D Sassoon.

Mr Challis disagreed: 'That is incorrect. He knew perfectly well.' However this can have made little difference to events, as the Board never met. There seems to have been a lack of liaison between London and Nassau, because another curious feature is the fact that no one at the Crown Agents knew that the amount Mr Gilbert subscribed for his shares was lent to him by Sassoons Bahamas, nor that 'the client' for whom Sassoons Bahamas also subscribed was likewise Mr Gilbert, using money borrowed from Sassoons Bahamas. These matters

emerged later when, as will be narrated in due course, the company collapsed and the Crown Agents discovered that through FMI on the one hand and Sassoons Bahamas on the other, they were carrying the entire loss. A further matter is that Mr Gilbert had had some unsatisfactory associations in the past; this too was unknown to Crown Agents' officials, except Mr Challis, who knew that Mr Gilbert's father-in-law 'had problems' as he put it; but he had been told, he said, by senior managers of two leading Canadian banks that they held him in extremely high regard, and he felt these sentiments and Mr Mansfield's recommendation worthy of acceptance. There seems to have been an undue reliance upon Mr Mansfield in this affair. And after the corporation commenced business no attempt was made by the Crown Agents to monitor its performance: its affairs were conducted by Mr Gilbert without any supervision, as Mr Mansfield agreed, from the directors, or, he added, the shareholders.

275. (h) *Davies Arnold & Cooper*

At the very end of the year the Crown Agents lent their solicitors, Davies Arnold & Cooper, £460,000. This was for the purchase of a leasehold property in London into which the firm intended to move their offices. The leasehold interest was charged as security for the loan; it was valued at £575,000 by Parnis Bird & Co—the firm to whom Mr Caplan and Mr Hay had sold their practice when they went into E&C Investments. On this valuation the loan was in excess of the 70% of security which was supposed to be the Crown Agents' rule; but the partners in the firm were also guarantors. The Crown Agents were not separately advised on this transaction. It is said that they told Mr Wheatley that he should be separately advised, but he declined. Advice might have disclosed the existence of onerous repairing covenants in the lease. Davies Arnold & Cooper did not effect the necessary repairs and the freeholder later served a forfeiture notice alleging that £250,000 worth of repairs were needed—a sum exceeding the value of the leasehold after the slump in property values. That slump had already started at the time of this transaction (31 December 1973) and this seems to have been an ill-advised venture for both borrower and lender.

276. (j) *Murrayfield Securities Ltd*

Murrayfield first approached the Crown Agents for finance in April 1973 and a loan of £220,000 for a term of one year was made in May against a charge on property valued at £355,000. This loan was repaid with interest when it fell due. In December the Crown Agents made a larger loan—£2.4m. As before this was secured, on a number of properties valued in the aggregate at £3,335,000. However, a first mortgage was outstanding for £1,350,000, thus the net value available to the Crown Agents was only £1,985,000. As secured lending, this transaction fell within Mr Wheatley's authority and correspondence indicates that he took the decision to proceed although the shortfall in the security available was pointed out to him by the Crown Agents' solicitors, Davies, Arnold & Cooper. Another notable feature of the transaction was a last minute variation in the terms which further prejudiced the Crown Agents' security. Apparently because of legal technicalities the loan was divided into two parts, secured against different properties and with no right of consolidation. Advances totalling £700,000 were secured against properties valued at £960,000, but an advance of £1.7m was secured on a property which after deducting the first mortgage had a value of only £1,025,000. Mr Marcus, then the partner in Davies

Arnold & Cooper handling the Crown Agents' affairs, did not point out the deleterious effect of this variation in the terms and it seems that no one at the Crown Agents realised its effect until Murrayfield defaulted when repayment was due in December 1974.

**(9) Position at end of 1973**

277. We have now mentioned the major events of the 1972-73 period. For the rest, the ordinary money market operations continued. These years were the height of the secondary banking and property boom and the Crown Agents' own account activities were apparently more successful than in earlier years. The balance sheet at the end of 1973 can be summarised as follows:

	£m	£m
SOURCES OF FINANCE		
Deposits by principals		287
Borrowed on the money market		152
Other liabilities		33
		—
		472
Reserves		36
		—
		508
		—
INVESTED IN		
Banking assets and advances		381
Investments		
Quoted	24	
Associates and others unquoted	15	
	—	39
Property development		61
Property for own occupation		27
		—
		508
		—

The reserves, at £36m, show an increase of nearly £30m in two years. The traditional services of the office had continued to make small losses (£200,000), but own account financial activities showed a realised profit of £22m, most of which came from the sale of English & Continental in January 1973 (para 226 above). There was also a further substantial revaluation of the Crown Agents' offices in the 1973 accounts, producing a surplus of £16.7m; some of this had to be written back the following year when property values declined. Provisions for losses on loans and investments were made totalling £13.8m. These included provisions on Mersey Docks & Harbour Board, Republic Corporation and Great South West Corporation (para 160 above) and also the first provisions flowing from the secondary banking collapse. However as the 1973 accounts were not published until mid-1975 these provisions were merely a hypothetical reconstruction of what Crown Agents might prudently have provided at the end of 1973 had they prepared accounts promptly.

278. The general picture at 31 December 1973 may be summed up by saying that the adventurous policies initiated between 1967 and 1969 had continued,



despite the achievement of the original object of the exercise, the attainment of a £7m reserve. Mr Hewins put it like this:

'It is my own impression that the concept of building the reserves, whilst at all times valid, merged into the concept of running what was in effect a merchant banking operation as such. I do not mean to suggest that the two are irreconcilable, but there is an impression that I have that the general opportunities that would be afforded by what seemed to be the Crown Agents' capability to run effectively a merchant banking operation cast a lot of glamour over the whole operations and not necessarily from the point of view of narrow Crown Agents' self-interest. It was also very relevant really from the point of view of benefit to principals.'

The own-account operation had now become part of the Crown Agents' life, and no doubt it gave satisfaction and perhaps excitement to its operators. It had been a time of euphoria in the fringe banking and property speculation world on which so much of the own-account activity impinged, and we have been told by more than one witness of the prevailing atmosphere of enthusiasm, confidence, and self-assurance. Men who were bringing off coups at home and attending to affairs from Canada and the West Indies to Singapore and Australia might well feel the satisfaction of doing skilled and important work. As one witness said:

'We were all getting a little bit cocky. We were going round feeling we are as good as those people in the City. . . Now with dreadful hindsight we realise we were not as good.'

279. Whether anyone other than the Director of Finance could see the whole picture is doubtful. The Chairman presided over meetings of the boards both of the Crown Agents and Four Millbank Investments, but the traditional activities of the Crown Agents occupied much of his time and involved him in extensive travelling overseas. He got very little in the way of broad information. If the accounts had been prepared expeditiously both he and the boards might have received a clearer picture. But extraordinary delays took place in the finalising and auditing of the accounts. Those for the year ending 31 December 1971 were not signed until 23 August 1973, and the accounts for 1972 were signed on 31 January 1975—25 months after the end of the period to which they related. By that time the financial bubble had burst and the Minister had had to make public funds available and so start the chain of events leading to our appointment. As a matter of history these accounts are a useful source, but as an instrument of management control or of information to the Ministry or the Treasury they were useless.

## XV The Audited Accounts

### (1) Delays

280. The following table lists the delays in finalising and certifying the consolidated accounts:

Year of account ended 31 December	When certified
1970	January 1972
1971	August 1973
1972	January 1975
1973	June 1975
1974	October 1975

These extraordinary delays occurred because no one who had any concern with the accounts treated them as a matter of urgency or importance. These people were (1) Mr Towse, the Finance Directorate accountant (2) Mr Towse's superiors, namely Mr Challis and Sir Claude Hayes (3) the Exchequer and Audit Department who were responsible for the audit of the consolidated accounts and (4) the recipients of the accounts, that is to say the Ministry of Overseas Development and the Treasury.

281. Mr Towse told us that his effectiveness in the accounts area was reduced by his commitments as Executive Director of FMI, a post which he described as being Mr Challis's 'leg man' (He had succeeded Mr Johns in this post when the latter was seconded to Australia in 1972). When asked about the delay in preparation of the accounts he said:

'Where on earth does one start? First of all, the management of the organisation regarded the accounts as a bore. There was no enthusiasm or pressure on me to produce the accounts, and so little was in fact thought of the accounting work that I was, as I mentioned earlier, directed to being Mr Challis's PA in Four Millbank Investments, on the basis that this was more important, and I could fit in the accounting work as and when required. This is one point. The other point, of course, is that in my opinion the Exchequer and Audit Department materially understaffed the audit team. The result was that although my output of accounts work was minimal, it was sufficient to keep the Exchequer and Audit team fully occupied, and they were not kept waiting so they did not report back to their supervisors that the new accountant was not delivering the goods, and so what ought to have been a watch-dog was a non-event.'

282. Mr Challis and Sir Claude Hayes both agreed that there were delays in respect of 1971 following computerisation of certain of Crown Agents' accounting records. Discrepancies that arose following computerisation were the subject of a report by the Comptroller and Auditor General. Sir Claude also mentioned problems in obtaining information from Australia. Asked whether staff shortage was a factor he said:

'I think it was probably the leisurely way in which quasi government institutions set about it and with respect the leisurely way in which the C&AG sets about it.

Q Is that a way of saying that no very high priority was accorded the accounts and that they were regarded as a sort of nuisance?

A I think it is fair to say that the importance and urgency of having up to date working accounts was not realised.'

283. According to the Exchequer and Audit Department's evidence to us, the main causes of delay were (1) the audited accounts of subsidiaries were not available until up to 12 months after accounting dates (2) slow production of first draft accounts by the Crown Agents and of revised drafts following audit comment (3) cumulative delays, later years' accounts had to await firm figures for previous years. Sir Douglas Henley, the Comptroller and Auditor General, agreed that the Crown Agents were understaffed on the accounting side and that they were ill-equipped to set up the procedures necessary to account for their new operations. He also agreed that the E&AD had found it difficult to put as much staff as it might have wished into the developing operations. Punctual completion, audit and publication of annual accounts are prescribed by law as essential features both for Companies Acts accounts and for the system of public control over the amount and regularity of the financial operations of Government in respect of services for which the Government is accountable to Parliament. Thus for Civil Departments, the Exchequer & Audit Departments Act 1866 lays down that a Department, having closed its accounts for the year ended 31 March by 31 July, must send them to the C&AG by 30 November; the C&AG must send them to the Treasury with his report on them by 15 January; and the Treasury must submit the Accounts with the audit report to the House of Commons by 31 January. Punctuality is prescribed by law, or secured by the requirements of Parliament, for other public accounts and funds audited by the C&AG for which statements are presented to Parliament. But the Crown Agents' Accounts were not presented to Parliament, and were exempt from any statutory or other requirement to be punctual, apart from the general provision in Section 3(2) of the Exchequer & Audit Departments Act 1921 that the C&AG should make his examination 'with as little delay as possible'.

284. We have already noted that the Crown Agents' accounts took up to 25 months to appear. We consider that the C&AG should have applied a greater sense of urgency to this assignment. We are surprised that he did not report to the Treasury on the delays, but we are more surprised that neither the Treasury nor the Ministry insisted on more punctual reporting after they had learnt of the Crown Agents' ventures into the world of high finance.

285. Ministry officials told us that it was their deliberate policy to confine the regular financial information they received to the annual accounts and that they were concerned about the lateness of these accounts. However we do not find any expression of this concern in the correspondence between the Ministry and the Crown Agents on the subject of the 1971 and 1972 accounts. The Treasury were responsible for the form of the accounts and had laid the minute under which the C&AG did the audit. A Treasury witness was asked:

Q You did not believe that your responsibility for the accounts extended to a concern over their delay?

A You have referred to the period 1969-70. As I recall the position, the delay was not seriously excessive at that stage. It was excessive in later years.

Q It was the 1971 accounts that were badly delayed. There were many

reasons for the delay—the consolidation and so on. Did you feel either concern or responsibility for that delay?

A It does not appear to me that the Treasury felt much responsibility for the delay, but later in the preparation of the 1972 and 1973 accounts very substantial delays built up and the Treasury did express concern at that stage.

Q What did they do about it?

A It appears from the papers that there were some oral inquiries made to the ODM, but I have not traced anything in writing.

The witness went on to say that, unless the C&AG had reported on a particular year's accounts (as in 1971 over the computerisation troubles) the Treasury did not necessarily receive a copy. He blamed the generally unsatisfactory state of affairs on the 'half world' in which the accounts were:

'I think that this stemmed in a way from the fact that the accounts were not laid before Parliament. Had they been laid before Parliament, there would have been a regular annual process and very loud alarm bells indeed would have rung if the accounts had been delayed. They would have had to be ready by a certain date. I have no doubt at all that they would have been ready by that date. As I see it, the trouble was that the whole status of these accounts was somewhat peculiar and unclear. They were not missed in the way that an Appropriation Account would be missed.'

286. The last accounts that were published before the government were called, upon in December 1974 to support the Crown Agents, were those for 1971 dated 23 August 1973. These accounts occasioned correspondence between the Treasury, the Ministry and the Crown Agents which lasted until the beginning of 1975, this was because the audit certificate was qualified by the Comptroller and Auditor General in the following words—"subject to the possible errors following computerisation referred to in note 15 . . . the Accounts . . . exhibit a true and fair view.' Note 15 explained that 'provision of £350,000 has been made for any loss that may arise from possible overpayment of invoices and errors in Principals' Accounts which have arisen since the adoption of computerised accounts which have not been fully reconciled.' In addition to his published certificate the C&AG made a formal report to the Treasury which elaborated on the accounting discrepancies following computerisation and raised a further matter: namely that the accounts of FMI's subsidiaries had not been consolidated as required by the Treasury when they prescribed the form of Crown Agents' consolidated accounts. The principal subsidiary in question was English and Continental.

287. The difficulties Crown Agents found themselves in with their computer were eventually resolved after writing off £70,000 on principals' accounts which could not be traced. These differences arose because the system originally put into use by the Crown Agents failed to provide for regular reconciliation of the balances on principals' accounts with the amounts shown on bank statements. As such it was a simple and unnecessary error, but one which has been paralleled by many organisations introducing computerised accounting. It is symptomatic of the lack of care Crown Agents devoted to accounting matters but otherwise not within the mainstream of this inquiry. The failure to consolidate E&C in the accounts repeats the failure to include Finvest in 1967-69 (para 86 above).

It is another illustration of Crown Agents' desire to hide their newer activities from public view. The reason given at the time strikes us as unsatisfactory. Crown Agents' accounts merely record that this was 'in accordance with the treatment in the audited group accounts of Four Millbank Investments Ltd.' This was true as far as it went, but the separate accounts of the subsidiaries were bound in with the accounts of FMI. This was not done in the Crown Agents' accounts, which nowhere drew the reader's attention to the scale of E&C's activities.

288. The 1971 accounts revealed, for the first time, the extent of the Crown Agents' property investments in Australia. In note 27 they set out the commitments incurred by the agreements with Capital & Counties Property Co Ltd (para 153 above) in these words:

*'Future Commitments*

The Crown Agents have entered into agreements with Capital & Counties Property Company Limited and other parties for the purpose of developing property in Australia. Under these agreements the Crown Agents are required to provide or procure temporary advances by way of revolving credit to support capital expenditure of not less than A\$100m (£46.6m approximately) and to lend unspecified sums estimated to total about £25m necessary to complete an existing development programme. The Crown Agents are prepared to provide finance by making direct loans and guaranteeing bank overdrafts etc, but expect to procure the bulk of the finance required from third parties without contingent liability to themselves. At 31 December 1971 the Crown Agents had in fact advanced the equivalent of £20.066m by direct loans in Australian and other currencies. In addition they had also in connection with property developments in Australia guaranteed without security a bank overdraft facility which may reach a total of A\$14m (£6.52m approximately). This amount is included under guarantees of bank and other loans at note 14'.

This information and the C&AG's report caused the Treasury to write to the Ministry seeking further information and explanations. The most noteworthy feature of the ensuing correspondence was its dilatoriness, as is shown by the following table:

21.8.73	C&AG reports to the Treasury
5.9.73	The Treasury write to the Ministry on the points raised
20.9.73	The Treasury write again to the Ministry affirming that it is for the Ministry and not Treasury to raise the matter with Crown Agents
31.10.73	The Ministry write to Crown Agents enclosing the C&AG's report
9.1.74	Reminder by the Ministry
21.1.74	Crown Agents reply apologising for the delay
6.2.74	The Ministry press for a substantive reply
21.2.74	Crown Agents reply explaining the computerisation problem and why the subsidiaries of FMI were not consolidated

29.3.74	The Ministry pass Crown Agents' reply on to the Treasury with their own comments
9.7.74	The Ministry put up to the Treasury a draft reply to Crown Agents
23.7.74	The Treasury reply to the Ministry asking for the draft to be strengthened
30.7.74	The Ministry reply to Crown Agents with the joint views of themselves and Treasury (copied to C&AG by Treasury 8.8.74)
23.9.74	Crown Agents reply to the Ministry
25.10.74	The Ministry copy Crown Agents' reply to the Treasury with the comment that 'Sir Claude's letter does not really appear to meet the criticism . . . we cannot perhaps usefully take this much further in relation to the 1971 accounts.'
20.1.75	The Treasury reply and agree that matters on the 1971 accounts probably cannot be taken much further

This correspondence thus closes inconclusively over three years after the end of the period to which the accounts in question related, and nearly a year and a half after it began and a month after the government had had to announce their massive financial support for the Crown Agents.

289. This chronology shows how slow Sir Claude Hayes was in replying to the Treasury's questions passed on to him by the Ministry. Sir Claude was probably unable to reply much more quickly than he did because of the Finance Directorate's preoccupation with the secondary banking crisis which had struck at the end of 1973. Mr Towse, who was immediately responsible for accounting matters, was left to grapple unaided with the problems of FMI after Mr Challis's resignation (para 320 below). The delays on the part of the Treasury and the Ministry are an illustration of their lack of concern with the accounts as a source of financial information about Crown Agents.

## **(2) Other shortcomings**

290. It was not only in permitting lengthy delays that the audit fell short of the standards prescribed. We do not think that the E&AD can be criticised for not detecting the comfort letters (paras 146–150 above) in view of the steps taken by the Finance Directorate to conceal them. But we do think that the auditors should have inquired more fully into the Crown Agents' treatment of bad debts. The own-account business obviously carried risks, and good practice in the circumstances would have called for a systematic review of the recoverability of advances as at balance sheet date. The Crown Agents had no such practice, the accounts made no provision for potentially irrecoverable advances, despite the warnings given by the cases of Vehicle & General and Mersey Docks and Harbour Board (para 160 above). The actual losses in those two organisations were the subject of provision, but so casual was the Crown Agents' accountancy that two other actual defaults were overlooked (para 160 above). The auditors did conduct sample checks on the due payment of interest and of capital when due for repayment, but these checks failed to detect the two defaults in question. We do not think that E&AD should have relied on sample checks as an adequate

control over such matters in the absence of an accounting practice providing for a systematic review.

291. We are also unhappy about the treatment in the audited accounts of the sale of the E&C assets to POSSFUND (para 226 above). Note 2 to the 1972 accounts reads 'The accounts of English & Continental Property Holdings Ltd have not been consolidated. In the directors' opinion this would be misleading since Four Millbank Investments Ltd sold its holding in this company on 23 January 1973 . . .' No mention is made of the 'rump' of the group that was retained and put into Finvest (paras 227, 228 above). This treatment was the same as that adopted in the accounts of FMI, audited by Price Waterhouse & Co. As regards FMI it was an acceptable treatment because FMI had completely disengaged from E&C. But it was not properly applicable to the Crown Agents because E&C Property had now become a direct subsidiary of the Crown Agents. The E&AD qualified the audit certificate with the words 'As stated in Note 2, the accounts of a subsidiary company have not been consolidated at 31 December 1972 in view of the sale of this company on 23 January 1973.' By the date of this certificate the Crown Agents had lent some £36m to E&C Property. The effect of making the second E&C a direct subsidiary of Finvest instead of a subsidiary of FMI, as the old E&C had been, was, whether intentionally or not, to obscure what was happening (see para 232 above) and it is unfortunate that the audit lent itself to deepening the obscurity. The E&AD did not seek to justify their treatment of this matter; Sir Douglas Henley the Comptroller and Auditor General agreed in evidence that the retention of the E&C companies 'should have been brought out more clearly' in the accounts.

## **XVI Action following the Stevenson Report**

### **(1) First reaction**

292. This section of our Report covers action following the Stevenson Report from March 1972 when the Report was delivered to December 1973, when a new organisation for the Crown Agents had been announced to Parliament and the defects in the financial structure of the Crown Agents started to manifest themselves. We look at these events mainly from the standpoint of the Ministry and the other public authorities—Treasury, Civil Service Department and Bank of England—concerned with three aspects of the Crown Agents' affairs: the reform of the constitution, working arrangements pending the reform, and staffing.

293. As regards reform of the constitution, the requirements to be met were laid down by the Minister on 13 July 1972, and after a year of obstructive negotiations a set of principles was in effect imposed by the Minister on 29 August 1973 and embodied in the proposals for the Crown Agents' constitution published in Parliament on 21 November 1973.

294. The working arrangements consisted of the provision of information by the Crown Agents—the request made by the Minister to Sir Claude in August 1972 for advance notice of new ventures including significant extension of existing business—and after August 1973, the expectation that the Crown Agents would manage their business in accordance with the principles then laid down by the Minister and particularly the principle that investment was to be conducted on the "trustee analogy". In the event these arrangements were completely

ineffective, and in one important instance, positively misleading. This was in November 1972 when the Ministry was assured by Sir Claude that once the sale of E&C went through there was no further need for venture investments.

295. As regards the Crown Agents' staffing, the record for the period shows no initiative by Whitehall to intervene and a mainly passive response to such staff matters as Sir Claude chose to refer to them. Generally the Whitehall position was that there were matters in which decision and action were Sir Claude's responsibility, coupled with a growing reluctance to take a hand till Sir Claude had been replaced.

296. Throughout this period Whitehall frequently showed signs of exasperation but never a sense of urgency. No doubt the gap in the Crown Agents accountability and the potential liability of the Exchequer were borne in mind; for after all, the object of the constitutional reorganisation was to fill the one and protect the other. But the reorganisation could take its time, because the Ministry trusted in the Crown Agents to operate the 'working arrangements' for information and control. Also Whitehall seem to have thought that time was on their side, seeing that they had been told that venture investment was a thing of the past and believed that the trustee analogy would govern investment for the future, while staffing problems would diminish with the reduction in the Crown Agents' banking activities and the appointment of a successor to Sir Claude who might be expected to be more co-operative.

297. We now give a more detailed account of events in the period that we have summarised above.

298. The terms of the Stevenson Report silenced for the time being those in the Ministry who wished to stop the Crown Agents' own-account dealing (paras 94 and 97 above). Mr Burr delivered a last forlorn blow on 2 March 1972 when he wrote a carefully constructed criticism of these activities. It commenced:

'I should like to set down some thought about the Crown Agents problem as I see it partly because I am a bit afraid that Sir Matthew Stevenson's Committee is likely to bless the continuance of the Crown Agents' operations on their own account whereas I regard their termination as essential to a solution of the difficulties we at present encounter . . . While the thing was on a small scale this did perhaps not matter, but now I think it is a nettle which has to be grasped—and killed.'

He spoke of the danger involved in the money market operations of having to have recourse to the Exchequer if there were a sudden drop in the market, and as regards property he said:

'I think they are exposing themselves in quite a disastrous way.'

He concluded:

'I feel quite strongly therefore that the right solution is for the 'own-account' operations to be unwound and for us to concentrate on creating (or continuing in existence) an efficient and effective body to continue procurement and trustee operations for existing principals as long as they want it. Such a body would not take a participating interest in any outside firms.'

299. But any action on these lines was hardly possible after the Stevenson Report. It would have been difficult for the Ministry to flout the finding of their



own independent inquiry that the own-account activities should continue. The only course open to them was to consider the future constitution of the Crown Agents and to reorganise and define their status as appropriate for continuing the full range of their present activities, own-account included. And here they were in another difficulty, because although the Committee had proposed four different 'models' for a future constitution, none of them was thought to be workable. Sir Claude would not have them, because he wanted to keep the status quo; the Bank of England thought them impracticable, and so did the Treasury. The Ministry officials themselves thought this part of the report unhelpful, and one of them went so far as to describe to us the overall effect as 'disastrous'. A further complication was that Sir Claude was now on the offensive: he felt he had been vindicated by the Report and was encouraged to fight such further measures as the Ministry might take.

300. The Report was dated 24 March 1972. In grappling with it the Ministry had first to take soundings in Whitehall, and this it did without delay. The outcome of these soundings was a paper dated 28 June with proposals for the Minister's consideration and on 13 July a meeting took place between the Minister and Sir Claude, with attendant officials. Mr Wood told Sir Claude of his forthcoming statement to Parliament (para 221 above) and said he wanted to make it clear to Sir Claude that the prospective changes would involve three specific elements, ie specific terms of reference including a defined relationship with the Crown and Government; a proper management structure; and a defined accountability in respect of all activities. In addition the Crown Agents were to be subject to normal taxation.

301. Mr Wood's statement in the House of Commons was followed by a meeting with Sir Claude on 15 August, after which the Minister wrote to Sir Claude:

'I should like to get on as quickly as possible, but the consultations are bound to take some time and, while they continue, the constitutional position of the Crown Agents will remain unchanged. I therefore think that you and I ought to reach an understanding about working arrangements during this period. You have in the past agreed that the Minister should be given advance notice of any new venture that the Crown Agents have in mind. I should like this arrangement to continue and to define a new venture not only as a completely new initiative but as a significant extension of existing business. This information would keep us usefully in touch with what you are doing and would be in the spirit of our recent talk together.'

Sir Claude accepted the understanding, but took an unusually narrow view of its ambit. He kept the Ministry fully informed of the progress and completion of the sale of English and Continental to Possfund, but the Ministry were never told of the massive lending to Mr Stern, nor of the setting up of the GCA Capital Corporation. Sir Claude has told us that:

'I didn't regard all the involvement we had in Stern and other companies in so far as I knew about it at all—as being investment. To my mind this was part of the daily money market business.'

Even by this definition the GCA Capital Corporation should have been reported but was not.

302. Nor was the Ministry informed of the heavy investment in a reorganised English and Continental. They were given the impression that the Crown Agents had got out of property. In a letter of 14 December 1972 reporting the progress of the sale of E&C, Sir Claude had said:

'This leaves a rump of the trading and house building companies which we have hopes of disposing of separately early next year.'

No step was taken during 1973 to disabuse the Ministry of the impression that the whole of the business was being wound up, still less to tell them that many millions were being channelled through E&C Property to the ambitious new E&C Investments. On 13 May 1973 Sir Claude did indeed write to Sir Michael Walker to report on the formation of the new English and Continental Investments Ltd, in which the Crown Agents would have a 10% shareholding (nominal value £50,000). He disclosed that the new company would not only acquire the remaining assets of the former E&C, but would also conduct two major long-term developments in London and Manchester, each 'with a potential of some £60m', with Mr Challis 'to remain the Chairman of the Company until all the arrangements have been completed'. (Mr Challis remained the Chairman until April 1977). The Ministry noted the unexpected size of the revived E&C operation, but did not question Sir Claude's assurance that the Crown Agent's involvement was confined to investing £50,000 in its shares as part of their long-term investment portfolio, and seem to have assumed that the new company's finance for acquiring the old assets and making the great new developments would be drawn from other sources. It was not until the Ministry were able to scrutinise the 1973 accounts, published in June 1975, that they learned of the massive lending by the Crown Agents to the E&C companies, and wrote (November 1975) to point out the discrepancy between this involvement and Sir Claude Hayes's reports of December 1972 and May 1973.

303. One result of Sir Claude's lack of candour with the Ministry was to reduce the feeling of urgency over the restructuring of the organisation. The Ministry felt firstly that an expert body had found the Crown Agents' finances to have been reasonably managed. A major property venture had been sold, realising a cash profit of £17m. The notice given by the Crown Agents under the working arrangements was not of a new venture, but that there would be no further need for ventures. There was an important meeting between the two bodies on 15 November 1972 to discuss the future constitution, at which the Treasury and the Bank of England were also represented; at this meeting Sir Claude is reported in the official minutes as saying with regard to investment policy:

'The original aim had been to make a profit which would remain invested, thereby preserving its value. They now had reserves of about £15m, which was the level that had been aimed at and was adequate. Assuming that the E&C sale went through, there was therefore no further need for venture investments.'

Sir Michael Walker, who presided, referred to this as 'the plateau point', and the papers show that for a long time thereafter no one at the Ministry, the Treasury or the Bank suspected that the Crown Agents Finance Directorate was carrying on as before. This may well have accounted for the slowing down of the pace of progress which becomes noticeable in 1973. The Stevenson Committee's warning that reorganisation was necessary to curb the risks run by the Crown Agents may not have been lost sight of, but evidently it was thought that the risks had

receded with the changes that the Crown Agents were themselves carrying out in the scope of their investment business.

## **(2) Discussions**

304. What happened was that there was a series of meetings and a volume of correspondence which bore no fruit until August 1973, when the Minister in effect imposed a series of principles to govern the Crown Agents in the conduct of their affairs and their relationship with Government. These were embodied after the summer recess in a statement to Parliament made on 21 November 1973. The exchanges between the Ministry and the Crown Agents were notable for Sir Claude's stubborn adherence to his thesis that the independence of the Crown Agents must not be assailed, and his insistence that the Treasury bore no ultimate financial responsibility. This last we mentioned at para 200 above; Sir Claude's adherence to his view was unshaken by the dissent from it of the Stevenson Committee, and of the Attorney General, who was consulted by the Ministry. The 'you are on your own' thesis (para 12 above) remained an article of faith within the Crown Agents. Sir Claude suppressed the ruling to the contrary that he had received from the competent government and legal authorities. Such officials within the Crown Agents as knew of the legal position—Mr Osgodby for example, who minuted his knowledge of prior legal opinions as early as March 1970—seem to have crossed it off their minds. This omission was to have dire consequences when the markets collapsed and the responsibility for Crown Agents' losses ceased to be an academic question and became an actuality.

305. Another argument pressed with vigour by Sir Claude was to the effect that the interests of principals would be harmed by any change in the financial services rendered; although fallacious this argument was effective in that the Ministry was bound to be mindful of the interests of overseas government. The atmosphere of these protracted exchanges was summarised by a newcomer to the scene, Mr D L Pearson, who succeeded Mr Smith as Principal Finance Officer at the Ministry in November 1972, when he told us:

'Sir Claude Hayes showed himself to be very strongly wedded to his own ideas and argued them with sincerity and passion.'

Mrs Hester Boothroyd, then an under secretary at the Treasury, was present at the 15 November meeting, where she found Sir Claude's opposition to reform so intransigent that it crossed her mind to wonder whether an immediate change of management was not called for; she discussed this internally in the Treasury and decided that it would be quite impossible to supplant Sir Claude at that stage. Another difficulty in the negotiations was caused by the suspicions entertained by Sir Claude about the motives of Mr Burr and Mr Smith, whose concern for the public purse he interpreted as a bid for power. Mr Wood told us that he found the relationship between his Ministry and the Crown Agents 'very difficult indeed'.

306. These difficulties were partly responsible for the ignorance at the Ministry about what the Finance Directorate were doing. Right down to the end of Sir Claude's regime they had no adequate picture of the kind of investments or the extent of the risks they were talking about. In part this was due to Sir Claude's own ignorance: owing to lack of management accounts, comprehensive information was not available, and the Finance Directorate could not be said to have briefed their Chairman fully, moreover on occasions they withheld information

because they thought Sir Claude would prefer not to have it. Mr Shuter made an illuminating remark when, speaking of Sir Claude, he said 'He had an extraordinary capacity for not being informed.' In part the ignorance was due to Sir Claude's view that when he gave information about Crown Agents investment he was entitled to exclude Crown Agents lending (para 301 above); this led to the basic misconception over the extent of the involvement in E&C and to statements such as that made in Parliament and to be mentioned in para 311 below.

### **(3) The Statement of Principles**

307. The principles which were eventually imposed on the Crown Agents by the Minister are reproduced at Appendix XVI. They were far removed from the new constitution that the Stevenson Report had asked for. The main novelty they incorporate was a decision to hive off the financial activities to subsidiary companies. Of course Four Millbank Investments already partly fulfilled this function, but the matter was taken further in two important respects: (1) it was proposed that all financial operations should be transacted by the companies, and (2) it was proposed that the companies' boards should include non-executive directors appointed by the Minister. It was contemplated that these directors would be persons with City experience, able to provide informed surveillance of the financial operations. The investments, according to para 4 of the principles, were to be conducted 'on the trustee analogy' but with the qualification that 'other investments which are prudent and consistent with the name and standing of the Crown Agents would not be excluded'.

308. The Ministry thought of these principles as part of the working arrangements for the Crown Agents' business from the time of their imposition in August 1973; they were not published however till announced in both Houses of Parliament on 21 November 1973. This was 28 months after the selection of Sir Matthew Stevenson to chair the inquiry. With hindsight the Ministry now acknowledges that affairs should have moved more quickly. We are satisfied that much of the delay was due to the effective rearguard action that Sir Claude was fighting during the whole period.

309. In fact, the rearguard action was so effective and frustrating as to lead the Ministry to revive the idea that in spite of Stevenson, a new constitution might be dispensed with if the Crown Agents own-account activity were stopped altogether. It seems, however, to have been decided that there was nothing for it but to soldier on with the reform of the constitution, presumably because it was too late to go back on the Whitehall advice, accepted by the Minister in July 1972, that Stevenson was right in recommending that the own-account activity was in the public interest and should continue. Sir Claude did not see himself as obstructing: rather as pushing a supine Ministry into action. But in expressing this opinion, we believe he had staffing action in mind rather than the action on the constitutional and accountability issues which the Minister had laid down at the outset as the subject of the negotiations (para 300 above).

310. The Bank of England was the one body within the government ambit which could best assess the realities of the Crown Agents' financial operations. They were kept in the picture by the Ministry. But they thought that the re-organisation question was one primarily for the Ministry to deal with. They might well have concerned themselves with the interim 'working arrangements' laid down for the Crown Agents by the Minister, and noticed the absence of any

flow of information from the Crown Agents on new ventures or extensions of existing own-account business. The record shows however that they did not and were content to assume that no news was good news. As the Deputy Governor said to us:

‘We were certainly conscious that time was running on and very little was happening except accumulations of paper. However, I think we were still not conscious of the scale at which the business was developing.’

It should also be noted that the Bank of England were represented at the meeting of 15 November 1972 when Sir Claude reported that thanks to the profits from the E&C sale the invested reserves would be adequate and ‘there was therefore no further need for venture investments’ (see para 303 above).

311. The statement in Parliament on 21 November 1973 came at a time when public anxiety had been aroused by the surge in property prices and the unattractive nature of the practices employed by some of the property speculators. Mr Wood faced supplementary questions from Members who seem to have known more than the Ministry about the Crown Agents’ continuing participation in the property world. In answer to one of these the Minister stated that ‘the percentage of the Crown Agents’ investment at the present time in property is one per cent’. This figure could only be justified on a very narrow definition of investment, excluding both the Crown Agents’ interests in Australia and in the rump of E&C. With these included the proportion was over 10 per cent. If advances to property companies, such as Mr Stern’s are also included, as the question might have been thought to require, it was more like 20 per cent. This answer demonstrates the ignorance still prevailing at the Ministry (and the Treasury and the Bank of England) over the Crown Agents’ participation in the then current property boom. The ignorance was not the fault of the Ministry: see para 306 above.

#### **(4) Pay and status of Chairman**

312. Contemporaneously with the discussions over organisation there went on a dialogue between Sir Claude and the Ministry over the pay and status of the Chairman and the questions of appointing a Deputy and the appointment from outside of a Chief Executive with the particular objective of finding someone who could bring banking expertise into the Crown Agents’ boardroom and could comprehend the workings of the Finance Directorate. By the Autumn of 1973 these discussions turned to the recruitment of expert staff to serve the banking and other investment companies that were to be incorporated under the new Crown Agents’ constitution announced in Parliament in November 1973.

313. There were sporadic discussions about the grading of the Chairman and other top personnel. Sir Stephen Luke had on his retirement in 1968 suggested upgrading the Senior Crown Agent from the status of deputy secretary, to which the post had been and continued to be equated. The Ministry was not unsympathetic but the matter was overtaken by the decision to hold an inquiry, and this in itself deferred consideration until after the Stevenson Report. After that Report had commented on the under-payment of the Director of Finance the question was taken up again, and eventually Sir Claude’s office was upgraded as from 1 April 1973, not to the status of permanent secretary for which he and his predecessor had pressed, but to a point and pay-scale half way between permanent secretary and deputy secretary. In the ordinary way the pay at the

top conditioned the pay of those beneath and this advance, when it came, went a little way towards enabling a less unrealistic salary to be offered to some financial expert or advisor. Mr Challis's salary at that time was £8,675 pa, equated with the rate for an under secretary. We notice however that neither he nor any other senior staff at the Crown Agents was upgraded to match the advance in the Chairman's status.

314. In addition to the provision of a financial expert the appointment and status of a deputy to the Chairman was discussed. From the time when Mr Morris retired in December 1971 Sir Claude had had no deputy. He put forward a name for a successor to Mr Morris, but this was not accepted; the Ministry view was that no such appointment should be made until the shape of the future structure was settled following the Stevenson Report. By May 1973 they were however prepared to appoint a deputy, but this time it was Sir Claude who demurred, suggesting that the matter be shelved until he could bring in someone with City experience under the new structure. In November 1973 the Ministry suggested Mr Smith as deputy, and in May 1974 they suggested seconding Mr Burr to cover the Chairman's absences abroad, but neither was acceptable to Sir Claude who rightly suspected that the Ministry's objects in proposing both appointments included the prospect of the Ministry being better informed about the internal affairs of the Crown Agents.

315. The contemporary records of these exchanges are not consistent. Our witnesses treated the deputy appointment and the financial expert as separate questions. Sir Claude would have us believe that he was continually pressing for the latter. We are not sure that he was. He seems to have thrown out the idea from time to time and then not to have pressed it. His relationship with the Ministry officials deteriorated as time went on. We have referred to the difficulty felt by the Ministry over his methods of negotiation; he in turn was suspicious of the Ministry's motives. He saw the Minister alone on 13 July 1972 (after the meeting with officials referred to at para 300 above) and according to a record which he made at the time he complained bitterly about the way the Crown Agents had been treated by the Ministry. He used such words as 'discourtesy' and 'hostility' and the tenor of this record, and of his evidence to us, makes it clear that the relationship between the two bodies was marred by his distrust. This was a major factor in the delays that took place. Sir Claude was urging in correspondence and at meetings that speed was essential, but was taking steps to prevent decisions other than those he favoured being taken.

316. At this same private meeting with the Minister, Sir Claude's record indicates that he referred to 'our need for a man of weight and substance, in some capacity and part time'. He also referred to his own pay and position (then not yet decided). In the minds of the Ministry these questions—the status of the Chairman, the upgrading of those beneath him, and the bringing in of financial expertise—were interlinked. To some extent Sir Claude seems to have thought so too. Referring to the management question he said to us 'The problem, as I am sure you are aware, is that it was all wrapped up with the level of my own post.' He amplified this statement by saying:

'I was in a difficult position, being perhaps more modest than some officials in that I didn't want to appear to be pressing anyone to "upgrade Hayes to a higher level" but was saying, in order to get anyone in between the Chairman and the Directors—but unfortunately the issue was treated very much in the

Ministry . . . as one of “upgrading Claude Hayes” and I don’t think sufficient attention was paid in the Civil Service Department to the structure that was required. Whether there was any attention paid to it in the Ministry, I think is a different question, but all I am saying is that it was this question which caused me some difficulty in pressing it too much. I did go at one point and say to the Minister that we must have professional or experienced City people, and it didn’t matter to me if they were paid twice as much as I was.’

317. Sir Claude had another meeting with the Ministry on 8 August 1972, when he saw Sir Michael Walker. The Ministry’s note of this meeting refers to the re-grading of posts within the Crown Agents and continues:

‘Mr Hayes made some general comment about Mr Challis. He regarded him as a very able operator indeed in his own sphere, but he was not always sufficiently sensitive to what was or was not suitable to a body of the Crown Agents’ standing. This was one of the reasons why Mr Hayes had wanted to get somebody in from the City if only on a part time basis so that this aspect in particular could be watched and Mr Challis given some general guidance on investment policy. However, it was agreed that it would be difficult to get in somebody else during the present interim period while a new structure was being devised. Sir Michael Walker said that he would consider the matter of grading and speak to Mr Hayes again later on.’

318. However at the long meeting of 15 November 1972, held to come to grips with the future status of the Crown Agents (para 303 above) Sir Claude is recorded as seeming doubtful whether outside expertise would have much to contribute. He felt that the Crown Agents knew their business better than many other organisations and doubted whether an outsider could offer useful additional expertise. But later, during 1973 when the idea of a banking subsidiary had crystallised, Sir Claude had come round to the idea of having a Chief Executive with financial expertise. Such an appointment was rendered the more urgent by Mr Challis’s resignation, an important event with which we must now deal.

319. On 13 May 1973 Sir Claude had a meeting with the Minister. The minute of this meeting shows that there was some discussion of the recently agreed upgrading of the Chairman, and goes on to record:

‘Mr Wood asked about the position of Mr Challis and . . . Mr Hayes said that if Mr Challis went the Crown Agents would be in a fix and would have to pay a considerable amount to get the services of someone of equivalent calibre. Although in demand in the City, Mr Challis would probably not go if his salary could be improved. Mr Hayes would like this to be put right, together with the salary of the Director of MTS who ought to be paid more than at present in view of his responsibilities.’

## **XVII Resignation of Director of Finance**

320. Within two months the Crown Agents were in the fix that Sir Claude had spoken of. On 2 July 1973 Mr Challis wrote to Sir Claude, saying:

‘After a great deal of deliberation and heart searching I have decided to accept an offer which has recently been made to me by First National Finance Corporation to join them in the role of Joint Managing Director, and I must

therefore ask you to accept this as formal notice of my resignation from the Crown Agents.'

He went on to offer to defer his departure for some months if that would assist—an offer that was accepted. Mr Challis had been a director of FNFC since October 1970 and his Finance Directorate had had extensive dealing with FNFC since 1969. Mr Challis did not ask the Chairman permission to join the company. Sir Claude nevertheless addressed his mind to the question of permission. On 3 August he spoke to Sir Michael Walker at the Ministry about it, and on 9 August he wrote to him, quoting Estacode (the Civil Service code of conduct) and saying:

'In the spirit of Estacode . . . I think that my assent is necessary, and as the Minister has a general responsibility for the Crown Agents' conduct of their affairs I think it necessary to consult the Minister.'

He referred to the Crown Agents' holdings of 8.5%, formerly 10% of the company's equity, and the consequent appointment of Mr Challis as a director 'to watch our interests'. He said:

'I am satisfied that FNFC would not get an unfair advantage over their competitors by employing Challis since he has no specific knowledge or information which could benefit FNFC in its work as against other companies. FNFC do not work in collaboration or partnership with the Crown Agents, and this investment is our only contact with them.'

It was a little misleading to say that 'this investment', ie the shareholding, was the only contact. The relationship of the Crown Agents to FNFC has been mentioned in paras 73 and 138 above. However that may be, Sir Claude told the Ministry that he saw no reason to withhold his consent. The Ministry took advice, and on 24 September 1973 intimated that they did not wish to intervene. Mr Challis's appointment as joint deputy chairman of FNFC was announced on 25 September and he left the Crown Agents to take it up on 12 November 1973.

321. Mr Challis's move from the Crown Agents to FNFC attracted criticism. This was voiced in Parliament when on 21 November 1973 Mr Wood announced the future structure proposed for the Crown Agents; Mr Wood answered the criticism by saying:

'I should tell the hon gentlemen that the Chairman of the Crown Agents, when the appointment was mooted, considered Mr Challis in the way in which a civil servant would be considered. He consulted me, and I consulted others. I therefore share the responsibility for it. I had no reason to object to this appointment because I believed it was in line with the rules that apply to the civil service.'

But the critics were not silenced, and when later on Mrs Hart as Minister announced the provision of £85m to assist the Crown Agents, the matter was again raised and Mrs Hart said:

'If there is an inquiry whatever form it takes, it might well be a proper subject for the inquiry.'

Mr Challis then issued a statement, pointing out that his move had been considered and permitted by the Chairman and the Minister, stating that he would welcome



an inquiry, and saying:

‘The continued implied allegation of some irregularity in my appointment not only casts a cloud over me personally, but also harms First National Finance Corporation. In these circumstances I feel I cannot continue as an Executive of the Company and I have therefore decided to tender my resignation from the Board.’

When he appeared before us Mr Challis expressed the hope that we would be able to say that we see no impropriety in the procedures which were followed (see para 328 below).

322. The Ministry witnesses told us that the Civil Service Department had been consulted as to the correct interpretation of Eastcode, and that they, the Ministry, felt that there was no alternative to passing the application. Mr Burr said the Ministry’s reaction was that in the last resort no one could stop Mr Challis resigning:

Q Is that so? Is there no means of preventing it?

A He could not be prevented from leaving the Crown Agents and taking up this other job, and I was told at the time the normal penalty of losing his pension could not now apply because of changes in the pension position and the transferability of pension rights, and there was no sanction that would bite on Challis. It caused a good deal of bitterness inside the Crown Agents that he was allowed to go.

323. The key position of Director of Finance was now vacant. Sir Claude had had since early July to consider whom to appoint as Mr Challis’s successor. No one was appointed. Sir Claude wanted, he told us, a man with City expertise to come in from outside, and Mr Challis says that in discussion he had advised this course as the ideal solution. Sir Claude says he approached the Bank of England, but they were unable to produce anyone; he asked the Ministry but they do not seem to have appreciated that there was any urgency in the situation, regarding the matter rather as a part of the long-term selection of the Chief Executive for the banking subsidiary, not yet set up. Of the non-appointment of a successor to Mr Challis, Mr Pearson said:

‘I cannot remember concerning ourselves with that, and we would have regarded it as very much their own business. At that time all appointments in the Crown Agents were made by Mr Hayes.’

And Mr Burr said:

‘One ought to have been aware of course that Challis’s departure raised the question of the succession to Challis. I think the impression we had at the time was that Hayes regarded himself as competent to cope with all these things.’

The Bank of England attitude was that Sir Claude was due to retire in 1974 and although they were prepared to help with advice:

‘It was felt preferable to await the choice of Sir Claude Hayes’s successor before finalising the details.’

324. Sir Claude’s own evidence to us on the question of the succession was as follows:

Q No successor was appointed: why was that?

A The reason was that we had asked the Governor of the Bank of England and the Minister for a banker, and we were hoping to get a professional banker.

Q But your experience up to that date must have led you to be a little doubtful whether you would get one at the very moment Mr Challis disappeared, surely? Here was he, Director of Finance, the kingpin in the whole machinery. What did you anticipate was going to happen after he left you? Who was going to take the decisions?

A It was, in effect, Hewins, but I did not appoint Hewins to be the Director of Finance straightaway, . . . This was because I had no knowledge of Hewins's capabilities. He himself said that he was not a professional and as I say I was constantly hoping we would have a banker appointed particularly when the Minister said in November that we were to set up a banking company. The first thing I asked for was a banker to come straightaway to help set it up.

Q Did you make the point that the matter was of extreme urgency?

A Yes, frequently.

Sir Claude's evidence to us is consistent with the contemporary record of his correspondence with the Ministry in September 1973, in which he refers to Mr Challis's departure in October and says that his post as Director of Finance disappears under the new arrangements in the new Crown Agents constitution for the incorporation and staffing of banking and other investment companies. But the result was that the Finance Directorate was left without a head, without any substitute for the man who had fashioned its policies and who alone, probably, could see the financial picture as a whole. A minute of the Crown Agents Board meeting of 30 October 1973 reads:

'For the interim period, Heads of Investment and Banking Departments and the Controller of Financial Services would run day-to-day business, but in matters of special importance, or in cases of conflicting interests, would seek approval or guidance from the Managing Director.'

325. The Managing Director was Mr R S Newman. Since 1 January 1972 he had held that post, with responsibility for the general oversight of all Crown Agents' operations except Finance and MTS. Previously he had been Director of Management Services; during a career with the Crown Agents which had started in 1938 he had never been in the Finance Directorate. He had long been on the board of the Crown Agents and of FMI but there he found that:

'We were shielded from the activities of the Finance Directorate. We were not welcome if we raised questions.'

(The 'we' in that sentence includes the other non-financial members of the boards.) Under his guidance, which could hardly be other than nominal, each of the departments of the Finance Directorate was apparently expected to run itself, under its Head—Mr Shuter of Investments, Mr Hewins of Banking, and Mr Towse of Financial Services. They did not find this easy. Mr Shuter said to us:

'I thought I was in the most appalling position.'

He referred to the interval between the announcement of Mr Challis's departure and his leaving, and said:

'During that intervening period I could get little help, and Challis himself, very

properly, said in policy terms he was not the right man to advise me, and I understood that. At that stage, on my own initiative, I began to take a much more conservative line . . . I expected at this stage Hewins would rapidly be promoted. That did not happen and there was this absolute vacuum which I never envisaged at all, and into which in some sense Newman was pitchforked . . . He himself took the line that an outside replacement was imminent and would come not later than 1 January 1974, but of course that did not happen and it did not happen and what did happen was the Israeli war and the collapse of all the world markets.'

326. Mr Towse found that, because there was now no one else to do it, he had to carry on the running of FMI and engage in such correspondence as that with Mr Gilbert of GCA Capital Corporation in Toronto. Mr Hewins bore the heaviest burden. He said 'I felt exposed. I felt very responsible'. He was beset by problems but he did not feel able to discuss them with Sir Claude. He now feels blameworthy for not so doing; he said to us:

'I very much wish I had opened the whole hand of cards that the Crown Agents were holding to Hayes earlier than I did . . . Until he was fully aware of the situation—and I think the Committee can date that from the month of April 1974—he had in fact been somewhat cold towards me. Truth to tell, I do not think he rated me particularly high and I had found him previously a difficult man to approach. I imply no criticism of him—criticism of myself if anything. But when I had been to see him about business previously, as sometimes happened as sometimes he sent for me rather than for Challis, I came out of his room feeling distinctly limp, in fact wondering if I had still got my head on, so to speak.'

His task was not made any easier by the fact that in February 1974 Mr Sly resigned his post as property manager.

327. No one was to know in November 1973 that the heavens were about to open and the deluge to fall. But it is not only with hindsight that Sir Claude's action in leaving the Finance Directorate rudderless can be criticised. This action played a major part in the ensuing catastrophe. Mr Challis in his evidence termed it 'quite ridiculous' and said:

'I thought it would have been better to have made a bad appointment but put someone who was clearly responsible in charge, rather than leave a sort of vacuum on top.'

328. Why did Mr Challis leave? Mr Matthews has told us that his company was looking for mature talent and that Mr Challis had told him that he was 'fed up' with his job at the Crown Agents. Mr Matthews thought it likely that Mr Challis would leave and join forces with his friends Mr Walker and Mr Greene, but he offered him the post at FNFC and Mr Challis accepted. The salary was £15,000 pa, against the £8,675 which he was receiving as Director of Finance. Mr Challis said the increase in pay was a factor but not a major factor in his going. He was indeed 'fed up', he said, particularly with the lack of progress in clarifying the Crown Agents' constitutional position, and the cavalier rejection of his proposal for corporate status (para 165 above) rankled. He said:

'I had got to as far as I was ever going to get within the Crown Agents as it existed and since there was no clarification of what was happening to the

Crown Agents in the future it made me feel perhaps somewhat restless and frustrated.'

He added that in view of his age, then 54, if he was ever to move it had to be then. Having conveyed his decision to Sir Claude, the latter went through the required steps, and we can confirm that the proper procedures were followed. Mr Matthews found his new colleague less of an asset than he had expected. He described him as 'vague', and said:

'I think he had a tremendous gift for dealing with a problem. I thought he had no gift at all for following it through and tying up the loose ends.'

He gave us the impression that, had Mr Challis not resigned from FNFC in December 1974 he would soon have been asked to leave. Mr Challis is now a shareholder and executive of United Merchant Securities Ltd, described as an international investment and trading company; there are three other shareholders, Mr J J Walker, Mr R Greene, and one other.

## **XVIII Financial Crisis**

### **(1) Fringe banks in difficulties**

329. It was towards the end of 1973 that the world oil crisis commenced, following the Middle East war of October. There had already been indications in London of a check to economic expansion: in September the Bank of England had asked banks to restrain lending to property developers; and rising interest rates and the calling in of special deposits by the Bank had damped the rise in property prices. By December the secondary banks were encountering cash difficulties. The change in the banking climate was immediately felt at the Crown Agents. As leading dealers in the London money market they appreciated that borrowers were plentiful and lenders scarce. They had their own sensitive index in the shape of their comfort letters given to lenders to the E&C companies: during December they had to lend as much as £9.9m to E&C to enable the comfort letters to be honoured (see Appendix XIV). If further evidence that a crisis was upon them were needed, there came the difficulties of three secondary banks, London & County Securities Ltd, Moorgate Mercantile Holdings Ltd, and Cedar Holdings Ltd. The stock exchange quotations of the first two were suspended early in December and the third went into receivership later in the month. The Crown Agents were shareholders in Moorgate Mercantile, having taken up 650,000 shares in February 1973 at a cost of £253,000; they had also lent the company £500,000 unsecured. Mr Hewins was approached for a further loan on 7 December: he refused and shortly afterwards the share quotation was suspended. The Crown Agents also had a direct interest in London & County, to which they had lent £1½m; by the year-end a consortium of bankers was endeavouring to support this company. To Cedar Holdings Ltd they had advanced £1.4m and were further indirectly affected, so Mr Walker told us, because a certain Pension Fund with an investment in Cedar Holdings had been about to make a sizeable advance to E&C but in the event had to divert its funds in an attempt to prop up Cedar Holdings, thus increasing E&C's dependence upon the Crown Agents for needed funds.

330. One of the most remarkable facts to emerge in this history is that the Finance Directorate exhibited no corporate reaction to these events. It might

have been expected that the sudden change in the banking environment would have led to consultations within the directorate, to discussions with the Chairman and to the formulation of a set policy to deal with the situation. Nothing of the kind took place. Each event was apparently dealt with in isolation as it occurred. E&C's comfort letters had to be honoured; they were honoured. Lending on the money market went on unabated. No doubt the lack of a Director of Finance played its part in this picture.

331. One attempt was however made to secure a change in financial policy. This was made by Mr Nowers, whose previous criticisms we have noticed at paras 21 and 167 above. He now, in December 1973, wrote a paper entitled 'What Went Wrong' and circulated it to a number of senior officers in departments of the Crown Agents other than the Finance Directorate with a view, if given sufficient support, or making an approach to the Chairman. As it happened he did not obtain support—although had he done so it does not follow that Sir Claude would have heeded his representations. From the evidence of one of the officers approached we have gathered that Mr Nowers 'had something of a reputation for crying wolf' and he, and other non-financial officers, felt that they had insufficient knowledge to assess Mr Nowers' strictures. Moreover, as this witness said, 'we had a Crown Agent who was not always the easiest man to approach and who had some reputation in fact as a financial man'. It was unfortunate, although understandable, that Mr Nowers's repetition of his David-and-Goliath assault upon the Finance Directorate had earned him the reputation of one crying wolf, because his appraisal of the situation as set out in this paper was sound. He pointed to the risky investments, the inexperience of many of the officers concerned, the disregard of sound banking rules, and to this: 'in the pursuit of profitable investment too little attention was paid to the ethics of some of the enterprises in which we participated.' For remedy he suggested first a definition of what the office stood for, namely the promotion of service to principals and not money-making and second:

'A thoroughgoing review of all the financial activities designed:

- (a) to extricate us from the situations which are producing losses.
- (b) to ensure that we are no longer engaging in activities which are in any way improper for such an organisation as this.
- (c) to fine down our activities to dimensions over which control can be exercised and to operate a firm control over all operations.
- (d) to concentrate our operations in fields where risks are minimal and returns of sensible proportions are reasonably assured.'

332. The year 1974 commenced with the Crown Agents being asked by the Bank of England to take part in one of the rescue operations then being organised to help secondary banks and prevent a more widespread collapse of confidence. One of the principles which the Bank applied in these situations was expressed to us by the Deputy Governor in these words:

'If there were responsible institutional investors who had put their money in and lent the support of their name as well as their money to a fringe banking organisation we pressed upon them the argument that they therefore had a responsibility to rectify the problem, and not just leave it to the support group to step in and, as it were, release them from responsibility.'

The support group (or lifeboat operation) was a consortium of banks formed to give assistance to those secondary banks which had cash problems but which were expected, with assistance, to be viable. Many of the companies survived with the aid of these measures; others failed despite them. One of the failures was Triumph Investment Trust Ltd. The Crown Agents had deposited funds with this secondary bank from 1968 onwards, and at 31 December 1973 had £2.5m lent to the company, and £14.8m to its banking subsidiary, G T Whyte & Co Ltd. Of these loans £13.8m was secured by sterling certificates of deposit. On 2 January 1974 the Crown Agents were called to a meeting at the Bank of England together with five other institutions, to discuss this group's position. The Bank felt that the shareholders and the lenders should mount a support operation. Mr Wheatley, who attended on the Crown Agents' behalf, undertook to roll over existing loans, and to advance a further £5m, provided that others joined in and that the joint advances of the supporters be secured by a floating charge. The company went into receivership in November 1974 but at that time the Crown Agents had not been called upon to contribute their promised £5m. This was however called for, and paid, in April 1975, and later both Triumph and its banking subsidiary went into liquidation.

## **(2) Attempted rescue of Mr Stern**

333. Also during January 1974 the connection with Mr William Stern produced an acute problem for the Crown Agents. We have seen how the Crown Agents were over-committed to Mr Stern's companies (para 264 above). Mr Hewins appreciated this, and when he found himself free of Mr Challis's overlordship he sought to reduce these loans. He saw Mr Stern in November 1973 and asked him to co-operate in a gradual winding-down of his short-term commitments. In his note of the interview he said:

'I have said to him that we shall not positively require him to repay all his short borrowings at the first available opportunity, but that we shall look to him to consider his position just before each maturity date and make repayment if he feels able . . . I have in mind that by the end of 1974 he should have cleared all or very nearly all of his debt maturing up to that time, leaving him in possession of the longer term loans which we have matched with similar borrowings . . .'

334. Instead of winding-down however, there was increased lending. We have already noticed the £5.5m furnished on 19 December and intended as a bridging loan pending receipt of finance from a Chicago bank (para 259 above). In January a further £1.5m was advanced, unsecured. This was money needed by Mr Stern to meet commitments and Mr Hewins and Mr Osgodby felt that the Crown Agents had no alternative to engaging in such support lending. This was the start of a series of support loans which by 11 April had reached the total of £13m, bringing Stern's total indebtedness to the Crown Agents to the staggering figure of £35m. No attempt was made at this stage to assess the viability of the Stern group or to ascertain whether this was throwing good money after bad. The view was taken that the continued existence of the Crown Agents depended on lending Mr Stern whatever he needed. Mr Hewins explained his reasons for this view as being based on the facts that (a) the Crown Agents were finding it increasingly difficult to draw funds from the money market; (b) if the Stern companies failed the extent of the Crown Agents losses would become known,

and this would result in (i) inability to borrow further, and (ii) a 'run on the bank' by principals withdrawing their deposits. As he put it in a subsequent memorandum:

'The considered view taken was that a collapse of Stern would mean the end of CA. The reason for this view, mistaken though it doubtless appears now, was that at the material times we were walking a tight-rope of confidence in the money market, where our borrowings were supporting the whole edifice of our own-account activity, and on the best evidence available to us we believed that a disclosure of bad debts to the amount already committed with Stern would cause a run on the bank which would be the end of us.'

There was of course a fallacy in this argument, in that the government would be bound to come to the rescue if the Crown Agents lost the confidence of the market or of depositors, and with government backing there would be no run on the bank. But no one in the Finance Directorate knew that the Ministry and the Treasury had accepted this residual liability as far back as 1970. They were still convinced that 'you are on your own'. Sir Claude Hayes knew, but for his own reasons did not accept it (paras 200, 304 above) and never imparted the information to his subordinates. Nor did they consult him on this occasion. Mr Hewins acted on his own and many millions were thrown away.

335. In his evidence Mr Hewins left us in no doubt as to the agonising nature of the decision to support the Stern companies. 'We were living in a waking nightmare,' he said. And:

'We had so much with him by then, wrongly though it be, that he came into the category, as we saw it, of people whose collapse would trigger off our own collapse through a crisis of market confidence or, as Wheatley put it . . . "If Stern goes bust, then as soon as the market knows that we are lending him (however many millions it was then) then that is curtains".'

And, in another passage, he said:

'During those difficult times we in the Finance Directorate thought we were walking a tightrope of confidence in the market which we must not fall off; in other words we could only survive if we had a continuing ability to borrow, however short, just enough liquidity to meet our obligations. This was the task. Now it seemed to us, rightly or wrongly, that quite apart from any other consideration if one of our subsidiaries or associates had been allowed to go to the wall, it would have sounded the death knell for ourselves. At this time I myself had no awareness at all that the British Government would, in fact, rescue the Crown Agents, if rescue were asked for . . . At this time we were very, very conscious that the responsibility of whether there was an on-going office or not was in our hands and that if we fell off the tightrope of confidence, that was the end of the office.'

336. Some of the support lending to the Stern group was unsecured. One loan of £2,250,000 was secured on property valued at £2,200,000. Another loan of £1m was to be secured on nine small properties, but when the security came to be investigated it was found that much of it was pledged elsewhere. Not until 28 March, when Mr Stern came asking for a further £2.5m to meet pressing commitments, did the Crown Agents seek further security, and they then found that a debenture had been taken by another bank, and guaranteed by Mr Stern.

The Crown Agents then took a floating charge on Wilstar's assets. We asked Mr Hewins:

Q Why did you not seek some security of that kind earlier than March?

A Well, I cannot give a very valid explanation of that, Sir.

Q Once you had started the support operation you had Stern over a barrel, had you not? You could say "We shan't lend unless you give us whatever you can" and here was a debenture which he could have given earlier?

A I must frankly admit that I cannot explain why I was so belated in concerning myself about trying to maximise the security. I would certainly agree I should have taken this point earlier.

337. Until March Mr Hewins had made the support loans to the Stern companies on his own responsibility. In March the responsibility became too heavy for him to bear, and he went to Mr Newman, from whom he was supposed to seek guidance on matters of special importance (para 324 above). He told Mr Newman that he had to lend still more money or the office would sink. Mr Newman had never heard of Stern and had little option but to agree that no other course was open. Mr Hewins then consulted the Bank of England; also two other lenders to the Stern group—the National Westminster Bank and FNFC, where he saw Mr Challis about the matter.

### (3) Chairman's optimism

338. At this time Sir Claude Hayes was abroad. He had left England on 1 March 1974 to visit principals in the Pacific area, and did not return until the 3 April. Before leaving he had had some correspondence with the Ministry about the crisis. When, on 6 February Mr Pearson had written pressing for an answer to his earlier queries upon the 1971 accounts (para 288 above) he had added:

'It seems equally important for the protection of the Minister's position that he should have some information from you about the implications of the current turmoil in the share and property markets for the overall financial position of the Crown Agents. It is no doubt difficult to be entirely specific; but an indication of the way you now see the situation would I am sure be valuable to him if you would provide it.'

Sir Claude replied on 21 February. He commenced by saying:

'This is not the sort of matter on which we are equipped to write papers. If there were anything causing us serious anxiety I should have raised it myself.'

He went on to say that by reason of the drop in share prices their equity portfolio had necessarily fallen in value, but in property there was a £2m realised net profit. On banking he said:

'In banking we have not incurred any bad debts and the present evidence is that no provision will be required at 31 December 1973 for possible accidents in the rescue process of the secondary banking institutions; in particular Moorgate Mercantile is being brought under the control of a bigger institution and its creditors, including ourselves, look like being satisfied in full.'

339. This rosy picture was partly derived from a note prepared for Sir Claude by Mr Hewins on 19 February 1974. Mr Hewins had seen Mr Pearson's letter; his passage on banking is as follows:

'No bad debts have actually been incurred and all the present evidence is that



no provision will be required by our Auditors at 31 December 1973 for possible accidents to upset the rescue of the lame ducks . . . Our profit and loss account performance in the Sterling and Foreign Money Markets was mixed, but overall we seem on present evidence to have finished up about £100,000 on the right side if realised and unrealised profits and losses are netted off. I find myself much embarrassed at not being able to give you precise figures but unfortunately FS division are having extreme trouble in finalising their figures for 31 December. The corresponding overall profit for 1972 was £691,000.'

As an answer to an inquiry about the implications of the current turmoil in the share and property markets for the Crown Agents overall financial position, both the note and the letter are misleading. They were written at a time when the Crown Agents had promised £5m to the Triumph lifeboat operation, had attempted to rescue the Stern group by loans amounting at that date to £3.75m, and had had to lend £19m to honour E&C comfort letters. They were written when Mr Hewins was 'walking a tightrope' and facing the 'waking nightmare' of a Stern crash bringing down the Crown Agents. Mr Hewins's note would appear to represent a panic-stricken determination to conceal the true state of affairs from the Ministry.

340. To a lesser extent the true story of affairs was also concealed from Sir Claude Hayes. He told us that he was aware of the Finance Directorate's part in support operations to the extent of not calling in loans upon maturity, but that he had not been told of any unusual further advances:

'I was not aware that we had been putting amounts into institutions with which we already had loans, merely to keep them going.'

And Mr Hewins agreed:

A During those early months of 1974 I do not think I sufficiently informed Hayes . . . I was very conscious of a load of responsibility. Indeed, it might have been comforting to share it, but I was very afraid of crying wolf . . . Now the Chairman was in a somewhat delicate situation. . . I know that he was not minded to tell a tale of woe to the Ministry. It was not in fact until the beginning of April . . . that it seemed to me correct to say to him in effect, 'Look, we really are in trouble, particularly on this man Stern.' I do blame myself for that.

Q Are you saying that Sir Claude did not know there was a support operation necessary and being started?

A Yes, I am saying that, Sir, and I am blaming myself for the fact that he did not know.

341. Sir Claude returned to England on 3 April, and on 8 April Mr Hewins plucked up his courage and went and told him about the Stern support operation and about the effect Stern's failure would have on the Crown Agents. To his surprise, he was not blown out of the Chairman's office:

'Then my whole situation with regard to him was quite transformed once he knew the whole position. . . He could not have been more generous to me or more helpful and co-operative from the time he knew everything until the time he left the office, which obviously makes me think that it was a major error of judgement on my part to try and steer the ship without going to him and saying "please, Sir, what shall we do"—instead of doing just that.'

342. On the next day, the 9 April, Sir Claude and Mr Hewins saw the Governor of the Bank of England about the Stern Group situation. The Bank would not in this case mount a lifeboat operation, because the group was not a bank, but it used its persuasive powers to assist. The same day Sir Claude and Mr Hewins conferred with the Chief Executive of the National Westminster Bank, and the decision was taken to commission Peat Marwick Mitchell & Co, Chartered Accountants, to investigate the position. Meanwhile the Crown Agents and the National Westminster Bank agreed to meet Stern's immediate obligations in equal shares. This accounted for a further rescue lending of £1,615,000 by the Crown Agents. On 18 April the Crown Agents also lent £1,640,000 to enable the group to complete the purchase of a site in Epsom town centre contiguous with the site purchased from the Crown Agents (para 256-259 above). The object was to enhance the worth of the two sites and improve the security which the Crown Agents thought they had. The new site was also to be the security for the new loan, but unfortunately the Crown Agents' solicitors, Davies Arnold & Cooper, did not register the charge within the 21 days required under the Companies Acts, and the charge is invalid against the liquidator.

343. On 6 May Peat Marwick Mitchell & Co reported on the finances of the group. The National Westminster Bank and the Crown Agents found the size of the funds needed to keep the group afloat to be too large for them to think of continuing the support operation; and after various meetings Wilstar, the holding company, went into liquidation on 6 June. Mr Stern's personal guarantee was found to be worthless because, although he had been a paper millionaire, his fortune vanished with his companies, and he was found to have given personal guarantees totalling over £100m. The total support leading by the Crown Agents to the Stern group was £16.3m, and the grand total of loans to the group was £38.7m, plus \$3.8m.

344. Meanwhile the Crown Agents' own financial position has to be considered. On his return from the Far East Sir Claude found awaiting him a letter from Sir Richard King dated 7 March. Sir Richard had read in the Times a report that the Crown Agents were 'thought to have become heavily involved in the rescuing of hard pressed secondary banks', and he wrote pointing out that if this were true it ought to have been reported to the Ministry, under the principles which had been agreed (para 307 above). Sir Claude replied on 11 April. He agreed that active rescue operations would be a new departure and would fall within the principles. He drew a distinction between the passive rolling over of loans, and the active support of fresh lending. He said they had given passive support to the extent of some £45m, and went on:

'later on, however, we were encouraged to make our support rather more active by placing more with particular institutions than we might otherwise have done . . . This amounted to some £15m and the recipients of it are a fully authorised bank and two of our own associated merchant banks. With hindsight I think that when this part of the support began to happen we might have considered that the third principle was beginning to operate . . . The fact is that a senior member of the secondary market cannot back out of the front line and in effect we were remaining in it.'

The references to 'a fully authorised bank and two of our own associated merchant banks' can be identified as references to Keyser Ullmann and to SIS and Wallace Brothers.

345. That letter was written two days after Sir Claude's visit to the Bank of England and at a time when £13m had been poured out to support the Stern group. Sir Claude can say he omitted to mention them because the inquiry which he was answering was about secondary banks, and Stern was not a secondary bank. This is disingenuous; and we have no doubt that the facts should have been reported. Sir Claude went further in his defence of the Crown Agents' finances when he had an interview with Sir Richard King on 10 April 1974. (This was primarily about matters mentioned below at para 365). Sir Richard made a note of what was said, which we accept as accurate. The relevant part reads as follows:

'I asked Sir Claude Hayes about the general state of the Crown Agents finances in the light of the recent heavy fall on the Stock Exchange. He assured me that the Crown Agents were wholly solvent. The book value of the reserves had no doubt fallen somewhat from its previous level of £30m, but the assets were certainly still more than sufficient to cover all liabilities. There would have to be a transfer of about £2½m this year from reserves into principals' accounts in order to cover losses incurred there.'

Referring to assets tied up in property, Sir Claude added:

'The present situation was that such assets could not be readily realised at present so that if there were to be a run on deposits with the Crown Agents there might well be a liquidity problem. However Sir Claude Hayes said that in his opinion this situation was not dissimilar from that in which a number of other finance houses found themselves at the present time.'

Sir Claude repeated this view of the Crown Agents finance at another meeting with Sir Richard on 10 May. On that occasion he said they would not be unbalanced by losing the whole of their lending to Stern. Asked if there were any other 'Sterns' in his portfolio, he said he had about £10m in Metropolitan Estates and an aggregate of about £1m in other property companies but felt no anxiety about them. 'Metropolitan Estates' was a mistake, it was British Land in which £10m was invested. But the £1m in other properties was wildly inaccurate. The figure was in fact over £82 million.

#### **(4) Consultation at the Treasury: Government support**

346. Thus, Sir Claude was presenting a confident front to the Ministry. However the Bank of England had no illusions about the effect of the prospective collapse of Stern; indeed they thought that if and when the news broke there might well be a withdrawal of deposits with the Crown Agents both by the market and by principals. In consequence a meeting was held at the Treasury on 13 May 1974. The Deputy Governor attended for the Bank; Sir Claude and Mr Hewins for the Crown Agents; and Sir Richard King for the Ministry. Sir Douglas Wass, the Permanent Secretary to the Treasury, was in the chair. The Deputy Governor told us:

'We went into that meeting perfectly clear that in all ordinary terms the Crown Agents were bust, or were capable of being bust.'

Sir Claude maintained that they would not be seriously affected by the collapse of the Stern group alone, but admitted that if this led to a run on the bank they would be in serious difficulties. Mr Hewins was asked to produce a rough balance sheet. He had not come prepared with this, and, oddly enough, no one had

previously asked for one, but he constructed one there and then on the back of an envelope. It was as follows:

**CROWN AGENTS 'OWN ACCOUNT' BUSINESS: APPROXIMATE  
BALANCE SHEET POSITION AT MAY 1974**

	£m		£m
Capital	37	Main Investments:	
Main Current Liabilities:		Stern Group	40
Money Markets	120	Other Property	36
Overseas Principals (Sterling)	160	Banks and Finance	
		Houses (Sterling)	120
		Direct Investments	50
		Commercial Houses	12
		Discount Market and Treas- ury Bills	15
Overseas principals (Currency)	160	Overseas short term deposits with Foreign Companies	160

This table confirmed the opinion of the Bank that the Crown Agents were insolvent. Now that that position was established, some action had to be taken to meet it. The state of the finances was that after allowing for bad debts the Crown Agents were unable to meet their obligations as they fell due—a state which, had they been a company under the Companies Act, would have required them to cease trading. That they had not suffered a run on the bank—and never in fact did suffer one—was due to the belief held, so far as we can see by everyone concerned except the officers of the Crown Agents, that if the crunch came they would be backed by the government. The meeting at the Treasury was immediately followed by another at which the same persons, except the Crown Agents, were present; it was then and there decided to prepare submissions to the Ministers concerned regarding a government guarantee of own-account business. In the result, the government agreed, and a statement by the Chancellor of the Exchequer was prepared ready to be released if there did come the anticipated crisis and run on the bank.

### **XIX Crown Agents' Lending in 1974**

347. It is appropriate to give here a more general description of the Crown Agents' financial operations in 1974 down to 1 October when Mr J G Cuckney succeeded Sir Claude Hayes and financial policies and practices underwent a fundamental change. We divide these activities into three categories:

- 1 Support operations undertaken alongside the Bank of England's Support Group;
- 2 Lending to Crown Agents' associates and others on whose survival the survival of the Crown Agents themselves was thought to depend; and
- 3 Other operations of the sterling money market section headed by Mr Wheatley.

348. First, the support operations undertaken alongside the Bank of England's Support Group, designed to rescue stricken secondary banks. The Crown Agents' promise of £5m to Triumph Investment Trust has already been mentioned (para

332 above). Other companies which had dealings with the Crown Agents and were also the subject of the Support Group's operations were: SIS, FNFC, The Burston Group and Northern Commercial Trust Ltd. In none of these cases did the Crown Agents make fresh advances in conjunction with the Support Group. What they (as already substantial lenders) did do was to refrain from withdrawing funds, following the principle outlined to us by the Deputy Governor (para 332 above). In the case of SIS the Crown Agents had themselves advanced £9m by June 1974, when the Support Group was asked to assist. Subsequently the Support Group agreed to put up £2m to assist the Crown Agents controlled run-down of SIS but it cannot be said that the Crown Agents were persuaded to put up further money and thereby incurred further losses in SIS: it was an associate to which Crown Agents felt bound to advance whatever sums were needed.

349. FNFC, which had reached a peak borrowing of £20.5m in November 1973, had repaid all its loans by May 1974. In view of the very large shareholdings held at one time (para 138 above) it should be recorded that the Crown Agents dealings in FNFC shares over the period resulted in a small profit. Nor were any share purchases made after Mr Challis left. But, although FNFC repaid its own borrowings, in March 1974 it asked the Crown Agents to grant a loan facility of US\$11½m to one of its customers, Tulone Investments NV of Curacao. The whole of this facility was drawn in March and April 1974 and the loan was guaranteed by FNFC. When the loan fell due the following year the borrower defaulted and the Crown Agents acceded to a request from the Support Group to defer enforcement of the guarantee, thereby affording a measure of indirect support. The guarantee has since been met.

350. As the loan was designated in US\$ it was made by Mr Blundell's section. We discussed the transaction with him and he told us:

'The occasion of that was a visit by Mr Challis to the office. I was invited in by Mr Hewins and the circumstances of the loan were revealed to me, . . . I commented that I did not think we were the people to whom the approach should be made.'

Mr Blundell went on to tell us that he declined to grant the facility but that he was on the same day instructed by Mr Hewins to do so.

351. Burston. The Crown Agents had considerable dealings with the Burston Group during 1974. Burston Group Ltd was a holding company carrying on business chiefly through two subsidiaries, Burston Finance Ltd and the Burston & Texas Commerce Bank Ltd, in which the Texas Commerce Bank, a substantial American bank, held a 35% minority interest. In January 1974 the Support Group went to the aid of Burston Finance Ltd. The Crown Agents, whilst they had no dealings with this company, lent heavily to the other two companies. During April their advances for a time exceeded £17m; over £12m of this was unsecured, though the credit limit was only £5m. We asked Mr Hewins:

Q Why go on lending at a time of increasing financial stringency?

A The correct answer, though not perhaps a very good one, is that we were receiving a nod and a wink from the Bank of England. In fact at the time of which you are speaking this was part of the support operation . . . We know that we were getting a message and what we did was to implement the message.

We asked the Deputy Governor of the Bank to comment on this. He told us that the Bank were not aware that there was any specific request to the Crown Agents to increase their deposits with the group and that it would appear from the Bank's records that it was not until August 1974 that the Crown Agents' involvement with Burston was considered in relation to the Support Group operations. He added that it is not unlikely (though he has no specific record) that the Crown Agents were told over the telephone that Burston Finance Ltd was being assisted by the Support Group and that the Texas and Commerce Bank were believed to be standing behind the Burston and Texas Commerce Bank Ltd.

352. In lending so heavily to the holding company, Burston Group Ltd, the Crown Agents failed to distinguish between the separate companies in the group and failed to assess their individual creditworthiness. We believe that they went beyond what was expected of them by the Bank of England in their lending to the Burston Group Ltd. Their loans, which had been £5.5m at the end of 1973, passed £6m in April 1974, £8m in May, and reached £9,050,000 by the end of July. Of these loans, £6m had been covered by security in the form of sterling certificates of deposit, lodged with Lloyds Bank to the order of the Crown Agents. From time to time Burston Group Ltd exchanged these certificates for others of like value, with the Crown Agents' consent. But on 30 July a director of Burston Group Ltd telephoned Mr Dorrington (as assistant to Mr Wheatley) and asked for the release of the certificates then deposited 'on the usual terms'. Mr Dorrington agreed. The next day a letter arrived from Burston, asking for written confirmation of release for presentation to Lloyds Bank. Mr Dorrington signed it. He said:

'It never entered my mind at the time that in actual fact the stock would not be replaced.'

But there was no replacement, and the Crown Agents lost their £6m security. Burston's case was that the certificates were security for certain dollar loans to the Burston bank, which were repaid, and there may have been a misunderstanding between the parties about this. Following this mishap the Crown Agent's remaining advances to the Burston & Texas Commerce Bank were withdrawn on maturity. The £9m lent to the Burston Group Ltd remained and that company is now in liquidation.

353. Northern Commercial Trust Ltd. The Crown Agents had taken a small shareholding in Northern Commercial Trust in 1972 (168,750 shares costing £296,251). They had been regular lenders since 1972 and in 1974, when the Support Group came to Northern Commercial Trust's aid, they found themselves with £3.25m outstanding, which they agreed not to withdraw.

354. In summary, Crown Agents either lent or did not call loans and guarantees to four concerns aided by the Support Group, totalling some £26m as follows:

	£m
FNFC (Tulone guarantee \$11½m)	5
Triumph Investment Trust & G T Whyte & Co	9
Burston Group	9
Northern Commercial Trust	3
	<u>26</u>

355. There was support in a different sense for those companies in which Crown Agents were so heavily involved that Mr Hewins believed that the Crown Agents' own credit, and indeed survival, were dependent on that of the borrower. Pre-eminent among these were the Stern group who received £16m in the circumstances described in paras 333–342 above; and English and Continental. In paragraph 329 we related that in December 1973 the Crown Agents had been obliged to lend £9.9m to English and Continental to enable comfort letters to be honoured. By the end of 1974 their advances under this head had reached £35m. Thus £51m was laid out to these two concerns, concerns that in the circumstances of the time could not have been regarded as creditworthy on normal commercial considerations. Smaller sums were advanced to SIS: this company suffered a run on deposits during 1974 and was kept afloat by further Crown Agents' lending which increased from £5.6m to £12.2m during the year. It has since been run by a management committee controlled by the Crown Agents.

356. Thirdly, as we have mentioned in paragraph 330, the ordinary operations of Mr Wheatley's money market section went on as before. Moreover in circumstances where more prudent lenders were drawing in their horns the less creditworthy borrowers' demands on the Crown Agents increased. Mr Wheatley had full power to make secured loans up to an unspecified amount. For example, see the loan to the Crown Agents' property solicitors, Davies Arnold & Cooper, para 275 above. Also, on 31 January 1974 he made a further advance of £125,000 to Mr Caplan and Mr Hay on the security of their Hertford Street office building (see para 230 above). And on 22 February 1974 £750,000 was advanced to Mr Finley's Big City Finance Ltd (see para 69 above). Likewise between November 1973 and February 1974 £5.25m was lent to Barlcays Hotels (see para 135 above). As to unsecured loans, many secondary banks received these in excess of the credit limits laid down. Thus in August 1974 advances to Dawney Day & Co reached a total of £4.7m against a credit limit of £1m; at various times advances to Morris Wigram Ltd exceeded their credit limit of £500,000; for long periods lending to the Trade Development Bank exceeding their credit limit of £10m—at 30 September 1974 this lending stood at £15m; for much of August and September 1974 lending to Western Trust and Savings Ltd stood at £2.5m against their credit limit of £1m; during the same months lending to Bowmaker Ltd varied between £5m and £10m whereas their credit limit was £5m. All these unsecured advances were repaid on the due date, but in other cases, such as Stern and Burston, which we have discussed in more detail, they were not.

357. As a background to the Stern failure and to the Crown Agents' other lending operations of 1974, we must remember their heavy commitment to property development in Australia. A further £5m was advanced during the year to meet their contractual obligations. In addition arrangements had been made to borrow some A\$89m (£50m) locally, of this A\$40m (£23m) had been drawn by the end of 1974. This brought the total lent from the UK to £41m, a significant sum to be tied up in long term development and not earning any income.

358. From this general survey we now return to three other noteworthy matters. Among the Crown Agents' transactions with the Burston & Texas Commerce Bank were many accounted for by a remarkable device employed

during the search for money to lend to Stern and others. The Finance Directorate are said to have laid down a rule that their various funds, such as Finvest and the JCF must be kept separate, and no money must be lent by one fund to another. This alleged rule had not prevented the use of the JCF for own-account investment in 1970 (para 125 above), but in 1974 the use of principals' money to prop up ailing property companies would not have looked well. We quote from the evidence of Mr R C Dorrington, an assistant to Mr Wheatley in the sterling money market division:

A Broadly speaking, most of the involvement with the Burston Group was through having to finance sectors which we were responsible for in the office, and it was decreed by the Head that all fundings of those particular operations had to come from the outside market.

Q Which Head are you referring to?

A That would be Mr Hewins, I think, about that time. We were asked to fund long-term money to the sectors, where possible, but there did come a stage later on when, in fact, we could not raise the money in the market any more to fund these particular operations . . . We had a problem, inasmuch as we, on our own money book, had surplus funds, and since it was decreed that we had to go outside to lend in the market, it was arranged that, if we could find an intermediary in the market, that would act as a post office to re-lend the money back to us on the same basis as we were lending it to them, very much on a short term basis . . . we were not allowed at that stage to lend internally so we would have to go outside and lend and it would be re-lent to us on the other side. That is really the broad basis of these loans to Burston.

So, for example, the Crown Agents lent the Burston bank £5m on 15 July, repayable on 30 July and Burston on the same day lent the Crown Agents £5m repayable at the same time. The price of this accommodation was a turn of  $\frac{1}{4}$ % pa, the difference between the lending rate and the borrowing rate. For this price the Finance Directorate was able to say that principals' funds were lent on the market and support funds were borrowed on the market. Mr Hewins acknowledged that the device was a form of window-dressing, although he put it in different words:

'This device—which I think is the best word to describe it—did mean that people like Sir Claude Hayes had some sort of defence against the allegation that money of principals was being directly lent into own-account operations, and this I think you will find is the philosophical genesis of this internal arrangement.'

359. The Crown Agents had from time to time lent foreign currency to the Israel British Bank (London) Ltd. In May Mr Blundell, the foreign money market manager, put a stop on lending to this company, together with some others of the smaller banks. By a stop he meant that he would not roll over loans on maturity and would not make fresh loans. In July Mr Blundell was on holiday and during his absence one of his dealers made two loans to this bank in disregard of orders. One loan matured on 8 July and was repaid; the other—US\$2m—matured on 17 July, but on 9 July the Bank suspended payment, and defaulted on this loan together with prior loans of Swiss Fr 2m and DM 620,000.



360. Thirdly Crown Agents divested themselves of their television associate: Television Recordings Ltd (para 31 above) had been merged in 1970 with another company to form Television International Operations Ltd. Before and after the merger losses were made. The Crown Agents finally sold their interest to Plantation Holdings Ltd in February 1974 and emerged with a total loss of approximately £600,000

361. Throughout this period of turmoil the organisation of the Crown Agents remained the same. No person with City experience was appointed. The Finance Directorate remained without a head—until Mr Hewins was belatedly made Acting Director of Finance in June 1974. The financial subsidiary companies had been incorporated but not activated. Slow though the pace of change was, it was further slowed by two events taking place during the year. One was the change of government, the other the impending retirement of Sir Claude Hayes.

## **XX Change of Government: New Guidelines**

362. The change of government took place in early March, 1974, and Mrs Judith Hart returned to the Ministry which she had left four years earlier. The change necessarily involved a period of inaction while Mrs Hart familiarised herself with the current position and in particular with the Stevenson Report and its aftermath. The principles enunciated by Mr Wood did not appeal to her as a solution to the constitutional problem, and action upon their implementation was deferred. In any event it later became evident that the banking subsidiary could not be activated because the Crown Agents had insufficient funds to endow it with the reserves necessary to obtain recognition as a bank.

363. Thereafter new proposals were formulated; these were discussed with interested departments and with the Bank of England on 3 June, and on 31 July 1974, the Minister informed the House of Commons of her decision upon the constitution. She announced a new structure, and new guidelines. After referring to the Crown Agents' excellent services to their principals, she said:

'In recent years, as is I think well known, they have extended their financial operations on their own-account with the objective of building up their reserves. Some of these, particularly those concerned with property, have become the subject of public comment. Given the ultimate responsibility of the Crown Agents to Government, I have therefore decided to make changes in their structure which will not however affect their relationship with overseas Principals. . . I am appointing a Board of Crown Agents which will have a full-time Chairman and will include up to seven part-time members . . . The Board will be required to transmit to me an Annual Report and Accounts which I propose to make available to Parliament. The Board will be responsible to me for the organisation and general administration of the Crown Agents' business and I reserve the right to give them directives from time to time.'

With regard to the own-account business, the Minister said:

'I shall direct that the Board pay due regard at all times to the best standards of banking prudence and do not engage in transactions which might embarrass HMG or conflict with the interests of their overseas Principals. They should not engage directly in the property market, other than in respect of property

for their own occupation, any extension in the property field being subject to my prior approval. Of course I do not intend that existing obligations should be called in question or interfered with.'

364. It will be observed that the period necessarily devoted to the reconsideration by the new government of the constitutional question was short; but, short though it was, it covered the period when a part of the Crown Agents' financial plight became known in Whitehall. This presented a cogent reason for speeding up the transition to the new regime, under which the new Board was expected to include the financial expertise so notably lacking hitherto. The date of this transition was largely conditioned by the retirement of Sir Claude Hayes, to be mentioned below, and was in fact 1 October 1974. But one might have expected the adoption between May and October of some interim measures to monitor or control the own-account activities which had caused such trouble. Prior to May the Ministry had no doubt been lulled by Sir Claude's reassurances, but once the decision had been taken to announce (if needed to stop a run on the bank) a measure of government support, it might have been expected that the Treasury, as custodian of the public funds, or the Ministry, on whose vote any support payment would fall, would require some stern supervisory measures. Sir Richard King has rightly made the point to us that the Ministry had not the means to monitor details and had to rely on what they were told; but one course which seems obvious to us would have been to put in consulting accountants to ascertain the true state of affairs with greater precision than the figures on the back of Mr Hewins's envelope—particularly because neither the 1973 nor the 1972 accounts had yet appeared. But nothing of this kind was done. The Ministry had had a scheme in February 1974 to put in Mr Burr as a temporary Crown Agent to cover the transition to a new Chairman, but this had been vigorously repelled by Sir Claude, and no further attempt to get inside the organisation was made. Sir Claude remained in charge, unsupervised, to the end, and he failed to convey the Crown Agents' plight, so that Sir Richard King could say to us:

'Even at that stage we had no idea of the extent of the involvements and risks that they were running. It was not until October, when Mr Cuckney took over, that this was revealed.'

According to Mr Cuckney this view was shared by the Treasury, he told us that shortly before he took office they said to him:

'They had been told in May of a possible crisis, but that seemed to be over; that the Crown Agents had about £47m of problem lending but had £41m reserves and had indicated that the situation would be all right if there were no run on the bank.'

## **XXI The Successor to Sir Claude Hayes: Delay**

365. There was no fixed retiring age for a Crown Agent. Sir Claude had reached the age of 60 on 23 March 1972. When the office of Chairman was upgraded in 1973 (para 313 above) his increased salary took effect from 1 April. On 16 May 1973 Sir Claude had an interview with Mr Wood, the Minister, and for this the department prepared a brief, pointing out that if Sir Claude were to

derive any benefit in terms of increased pension rights from his rise in salary, he would have to stay in post at least until 1 April 1974, but adding that:

‘Normal Civil Service practice would not permit a senior officer to serve on to such an age, even against the background of the pension consideration mentioned above.’

The record of the meeting of 16 May states that Mr Wood said that:

‘He had been particularly concerned that Mr Hayes should have the full pension benefit of the increase, which depended on the completion of a full year’s salary at the new level. He therefore proposed that the effective date should be 1 April 1973.’

Thus the long delay in upgrading the post, coupled with a desire to secure for Sir Claude pension rights based on his new salary, meant that he would not be asked to retire before 1 April 1974.

366. Subsequently the retirement date was advanced to 30 June 1974, upon Sir Claude’s plea that he should stay until the 1973 report came out. And after the change in government, in order to cover the time needed for the reformulation of ministerial policy, it was advanced to 30 September. Meanwhile the Ministry had been searching for a successor. This involved consultation with the Civil Service Department, to which the first approach had been made on 29 October 1973. By the end of January 1974 names were being canvassed, and on 1 February 1974 Sir Richard King wrote to the Civil Service Department protesting at the delay:

‘I must express my very serious concern at the possibility of further delay in making this appointment—we have after all been discussing it for some months.’

He protested again on 11 March:

‘Unless we were prepared to extend Claude Hayes’s term of office, which I would not recommend, the Chairman designate needs to be in office, at any rate part-time, early in April.’

But by then the government had changed and soon afterwards the date for the change of Chairman was advanced to 30 September. A high-level decision was then taken to postpone the selection of the new Chairman until the future structure of the office was determined. After that the situation was reappraised and the decision to offer the post to Mr Cuckney was made shortly before the new structure was announced. Mr Cuckney had been sounded out in February; he was interviewed by the Minister on 19 August, and appointed. It had all taken a long time.

## **XXII Mr Cuckney’s Discoveries: Government Action**

367. Mr Cuckney took office on Tuesday, 1 October. The rest of that week he spent familiarising himself with the office and attending necessary meetings with principals’ representatives. He had some surprises:

‘I was surprised at the lack of financial information available and the lack of up-to-date management accounts and generally the lack of financial discipline and control over the Finance Directorate’s operations, especially the sterling market. I asked for some draft management accounts and a draft

balance sheet for the situation at 30 September (for the nine months of the year), which in longhand were produced I think about . . . the 11 October. There was a great lack of information, it seemed to me, with the fact that there were no audited accounts later than 1971, and there seemed to be no sense of urgency over producing up to-date audited accounts; there was a general lack of financial discipline in controlling the department. Divisions and departments within the directorate operated in a very autonomous manner.'

Moreover the staff was dispirited, They were under instructions not to discuss affairs with their opposite numbers at the Ministry or the Treasury:

'Any working relationship . . . was strongly discouraged, and where it was conducted it was on the basis "tell the chairman nothing". There was a real fear over this. It sounds like an exaggeration but it is not.'

In the Finance Directorate Mr Cuckney found 'a lot of extremely unhappy people doing jobs well beyond their capabilities without having the right experience, and they were suffering under great strain.'

368. That first week-end Mr Cuckney took home and studied what financial information was available. On 16 October he called in Sir Henry Benson, the senior partner of Coopers and Lybrand, Chartered Accountants, and asked him to investigate and make an urgent report on the Crown Agents' present financial position and future prospects.

369. After intensive work by a team of accountants, that report was submitted on 27 November 1974. It foreshadowed the necessity for substantial provision to be made against irrecoverable sterling loans, which would lead to a real possibility of an overall capital deficiency. It noted that defaults on interest payments due to the Crown Agents on current loans were running at no less than £18m per annum. It said:

'The implications of carrying on a deposit taking business while having a deficiency are serious and we think that legal advice should be obtained. In addition, and as a matter of urgency, we think that you should take whatever steps are available to you to avoid the possibility of an overall deficiency before 31 December 1974, the end of your financial year.'

In this respect it recommended the obtaining of standby sterling facilities equivalent to the amount owed to principals (£210m) plus a margin for contingencies and running losses which they put at £20m. It was following upon this Report that Mr Cuckney made a formal request to the Government for financial assistance, and on 18 December the Minister announced the immediate provision of £85m of public money together with standby credit facilities of £50m arranged with the Bank of England. It is the circumstances leading to this request for financial assistance that we are charged with inquiring into, and our chronological account of what preceded it stops at this point.

### **XXIII The Losses**

370. We can now look at the general picture presented by seven years of own-account dealing. Appendix XVII sets out this picture in figures extracted from the Crown Agents' accounts over the period Table. 1 is a summary

of the consolidated balance sheets for the years 1966–1974. Under the heading ‘Banking assets’ we see, following the inception of Finvest, a rapid swing from the conservative deployment in 1966 towards an emphasis on advances to secondary banks and property companies in 1968. The history of lending to particular customers is summarised in table 2. Quoted investments include FMI’s holding in FNFC, the overseas investments of the FD Overseas Banks Settlement Unit Suspense Account and Finvest’s portfolio of UK and Australian equities. Own-account property investment includes the direct investments of Mr Sly’s section and the investments in E&C and in Australia. An analysis is set out in table 3. It should be remembered that this shows only the actual sums invested at any time. It does not include either the amounts committed by comfort letter guarantees to E&C, or the forward commitments in Australia arising from the agreements with Mr Fenston’s company, Pennine, and with Capital and Counties. A notable feature in both E&C and Australia is the small equity base compared with the amount of the Crown Agents’ loans.

371. Turning to liabilities, the principals’ deposits were taken into the JCF, the JMF and in Finvest. In 1966 these deposits were wholly in sterling, but from 1968 Mr Blundell’s section took foreign currency deposits for the joint funds and this activity grew so that by 1974 it amounted to £220m and rivalled the sterling side. The other source of funds, borrowings from non-principals, was taken mainly by Finvest from the London money market but there were also some currency borrowings, nominally by the JCF but used to finance the own-account overseas investments. The table shows that at all times money market borrowings took second place to principals’ deposits. One feature of the balance sheets, which is highlighted in table 4, is the increasing diversion of banking liabilities, that is principals’ and money market deposits, to finance long term investment in unquoted companies and particularly in property.

372. Table 5 sets out the revenue position year by year. It demonstrates that non-financial services were generally being run at a loss but were being subsidised by revenue from the traditional financial services. The results of the own-account financial operations themselves are seen to be mixed. Much of the profit in the profitable years 1968 and 1971 came from revaluations of investments and was not realised in cash. The annual results shown by table 5 may be summarised as follows:

	Aggregate 1967—73	1974
	£m	£m
Results of:		
Traditional services	(0.7)	(0.4)
Own-account financial operations	10.2	(128.8)
Non-trading items		
Revaluation of property in own occupation	23.5	(7.0)
Government grant	—	85.0
	—	—
Surplus/(deficit)	33.0	(51.2)
	—	—

The sale of E&C to POSSFUND in 1973 realised a profit, less tax, of approximately £12m, thus the rest of the own-account financial operations showed a small loss over the period which demonstrates how unsuccessful was all the

effort put into the own-account operation. The main source of the surplus over the period 1967-73 is the unrealised surplus on property revaluation of £23.5m.

373. The 1974 figures in table 5 show £124.6m provided for the losses incurred in the own-account financial operations. These resulted in the deficiency, after crediting the Government grant of £85m, of £14.7m, compared with reserves of £36.5m a year earlier. Further loss provisions have been made in 1975 and 1976 as the situation has become clearer, but even today, two and a half years after the Minister announced the Government's financial assistance for the Crown Agents and two years after we were appointed, it is not easy to ascertain the extent of the Crown Agents' losses. In some of their enterprises it is already known what part of their investment or loan has been lost, but in many cases the amount is still uncertain; these include cases of liquidation or composition with creditors where some dividends are still expected and cases such as the Australian property investments where the return is uncertain and is a long way ahead. The best guide to the amount of the loss in such cases is the amount of the provision made in the Realisation Revenue account, forming part of the Crown Agents' audited accounts for 1976. This shows a deficit of £212m. We give below a list of the losses as represented by amounts already written off and amounts currently provided for in this account. In drawing inferences from this list it has to be borne in mind that even a prudently conducted bank would be bound to have incurred some losses during the secondary banking and property crisis and all the insolvencies that flowed from it in 1974 and 1975.

TABLE OF LOSSES

	TOTAL	Amount of equity included in total
	£m	£m
English and Continental	42.8	0.1
Stern companies	41.2	
Australian property development	33.1	5.0
Sterling Industrial Securities	10.0	0.4
Big City Finance	1.8	
Sassoons Bahamas—now CA Bank and Trust International Ltd	8.6	4.4
GCA Capital Corporation	1.9	0.3
Wallace Brothers	3.3	3.3
Caribbean Bank	6.5	6.5
Barclays Hotels	6.5	
Triumph Investment Trust and G T Whyte	6.0	
Burston Group Ltd	5.2	
Orchard Square Development Corpora- tion	3.5	
Casserley Hotels	3.5	
Murrayfield Securities	2.0	
G S Gill Hotels	1.4	
Losses of £1m or less, totalling	8.0	
	<hr/>	<hr/>
	185.3	20.0
Losses on overseas investments of the JCF (including £4.5m premium on pur- chase of investment currency)	10.1	10.1
	<hr/>	<hr/>
	195.4	30.1
	<hr/>	<hr/>

The £8 million aggregate figure includes the following losses relating to advances mentioned earlier in this report:

	£ million
Mr Caplan and Mr Hay	0.2
Davies, Arnold and Cooper	0.3
Galico Investments Ltd	0.2
Great South West Corporation	0.5
Israel British Bank Ltd	1.0
London Capital Group	0.2
London and County Securities Ltd	0.8
Republic Corporation	0.1
Vehicle and General Insurance Co Ltd	0.5

Since the realisation account was segregated from the Crown Agents' on-going activities at the beginning of 1975, it has incurred operating losses of some £17m, bringing the total deficit to the £212m shown in the accounts. The principal cause of this operating loss is that no income is being received from the advances and other investments listed above. This loss of income remains a continuing burden.

374. As the above table shows the Crown Agents heaviest losses were incurred on their advances, although in many cases these were to companies in which they had a substantial shareholding. The Crown Agents took many other equity shareholdings in the course of eight years of own account activity. Pre-eminent among these was that in FNFC, both by virtue of its size (the holding's market value reached £6.4m at the end of 1971—see para 138 above) and because of the other aspects of the relationship between the two organisations. The last part of this shareholding was sold in September 1975, the net result after taking account of the surplus on revaluing the shares in 1971 was that the Crown Agents made a small profit on the FNFC share dealings. The table shows the losses on overseas investments. Other investments have been sold at an apparent loss, but are not included in the table because without tracing the effect on each holding of the various revaluations effected in the accounts for earlier years, a laborious task which we have not undertaken, we cannot say whether these losses were merely reversals of surpluses on earlier revaluations, or were real losses. What we can say is that the results of these share dealings were not significant compared with the loan losses that were the immediate cause of the need for financial support from the government.

375. To round off the story we now mention the fate of the principal loss-makers:

*English and Continental*

The collapse in property values destroyed the prospects upon which the second version of the E&C companies was founded. At the end of 1974 E&C Property owed the Crown Agents £37m, secured by debenture. Its main assets were advances of £18m to E&C Homes and £13m to E&C Investments. However Homes and Investments were both in difficulties. E&C Homes was adversely affected by the fall in property values and its land bank shrank substantially in value. E&C Investments was left with its extensive development sites—principally those mentioned at para 224 above—greatly depreciated in value; the company was unable to repay any of its debt to E&C Property unless and until those sites were sold. In fact the French developments were sold profitably. The Cutler Street site has reverted to the Port of London Authority as E&C Investments was unable to meet the deferred instalments of the purchase price. The remaining sites are now worth much less than they cost. Thus both Investments and Homes are insolvent and as a consequence so is E&C Property Co. Indeed it seems that the Crown Agents will lose the greater part of their advances.

376. *Stern*

When Wilstar Ltd, Mr Stern's company, went into liquidation in June 1974 the Stern Group owed the Crown Agents a total of £40.3m. The Crown Agents have recovered small amounts of those loans which proved to be effectively secured. But, through failing in most cases to take adequate security, they stand to lose by far the greater part of their advances.

377. *Australia*

In July 1976 the Crown Agents reached new agreements with their partners, Capital and Counties and Pennine, whereby they are now the majority shareholders and control the group. The financial burden of the development programme has been eased to some extent by sales of properties. During early



1977, a medium term loan facility of \$220m was arranged with a consortium of banks, releasing the Crown Agents' other funds tied up in this venture.

378. *Sassoons Bahamas and GCA Capital Corporation*

These companies came to grief over a Florida land deal. A company called Life Investors had acquired an option to purchase a lease of land in Florida, using money borrowed from GCA and also from Sassoons Bahamas. Periodical payments were needed to keep open the option, represented to be valuable, and GCA and Sassoons Bahamas advanced further sums, all provided by the Crown Agents. After the change in Chairmanship, the Crown Agents commissioned an inquiry into the situation, and were advised the lease was valueless. No further funds were provided, and GCA was put into liquidation. Its assets have proved to be valueless; in consequence the Crown Agents have lost the entire investment of £1.9m. These and other apparently imprudent advances cast doubt upon the viability of the Sassoons Bahamas, and to ensure its solvency the Crown Agents took over £4.2m of possibly irrecoverable loans, of which £3.9m related to GCA and Life Investors.

379. Subsequently the Crown Agents commissioned inquiries into Sassoons Bahamas and into the Caribbean Bank and its subsidiaries. They learnt that both of these concerns had made unwise property loans and substantial provisions have been made for anticipated losses.

380. *Wallace Brothers*

During 1974 Crown Agents acquired a further 26,750 Wallace shares at a cost of £300,000 from Mr Fitzgerald, one of the family proprietors of the original Sassoon company. This purchase arose out of a put option that the Crown Agents had given Mr Fitzgerald as part of the arrangements under which Sassoon and Wallace merged in 1972. Wallace Brothers incurred losses in 1976 which cast doubt on its viability. The Crown Agents sold their holding to the Standard Bank Ltd. No price was paid at the time but the Crown Agents may receive a maximum of £277,500 in 1982, if Wallace Brothers prospers. In the meantime the Crown Agents have made full provision for the £3.2m cost of their shareholding. No provision is required against advances.

## **XXIV The Late Mr Bernard Wheatley**

381. In July 1977, when our Report was almost complete, we learned that Mr Bernard Wheatley, the former sterling money market manager, had died. At his death he was awaiting trial upon corruption charges connected with loans made by the Crown Agents to Big City Finance, and because these matters were sub judice we had refrained from commenting upon them in this Report. His death does not release us from this constraint, because Mr Sidney Finley, the managing director of Big City, is now facing similar charges (see also para 3 above). There is however one aspect of Mr Wheatley's employment with which we can now deal. That is his employers' attitude to his gambling activities and to other complaints about his conduct.

382. It was common knowledge within the Finance Directorate that Mr Wheatley was a member of Crockford's and was a frequent and habitual player at the gaming tables at that club. So well known were these facts that other Crown

Agents officers made use of Mr Wheatley's membership, if they wished to entertain a visitor who favoured this form of diversion. Sir Stephen Luke was aware of the facts. He told us:

'I knew he was a member of Crockford's. I knew that towards the latter part of my service here. I was slightly disturbed about that because it seemed to me that he was very junior and it was a very odd club for him to belong to. I discussed the matter with the Establishment Officer and he also felt that it suggested that we ought to keep an eye on Mr Wheatley. He in turn had a talk with Mr Challis. There was no allegation of corruption made to me against Mr Wheatley or anybody else; it was merely that one has to be very vigilant. . . All you can do is to tell the people concerned. . . that this is a subject for anxiety and that they must keep a very close watch on him and not put him into the position where he can be corrupted. . . I felt that having warned the Establishment Officer, and the Head of Finance that this was a young man who must be watched because of his membership of this club, that was all I could do.'

383. The Establishment Officer or Director of Personnel at that time was Mr A E W Gaston. He was worried about the situation but, taking the view that 'What a chap does after hours is very much his own business', he contented himself with passing on Sir Stephen's warning to Mr Challis and adding to it his own expression of concern. Mr Barley, who was Director of Finance at that time and later became Director of Personnel did not receive the warning: he said in evidence that he knew that Mr Wheatley was a member of Crockfords but did not know it was a gambling club. He received no intimation when he took over from Mr Gaston that Mr Wheatley should be watched. There is no note of the matter on the relevant Personnel Directorate file, and Mr H T Eaton, when he became Director of Personnel in succession to Mr Barley, was ignorant of the situation.

384. A further danger signal reached the Crown Agents in 1971 when a journalist told Mr Challis that there were rumours in the city that Mr Wheatley had been favouring one organisation in a field in which he dealt to the exclusion of its rivals. This was investigated at Sir Claude's request, but no substantiation was found. Nevertheless Mr Challis felt misgivings. He remembered Sir Stephen's warning, and said he had 'reservations' about Mr Wheatley. He recommended to Establishment that he be moved to another department. He said:

A I made, I think, two separate suggestions to Establishment that he should be moved but, as I have explained before, I really had no status in this matter.

Q And he was not moved?

A No.

Q Did you not think it right to impose some limitation on his power to make loans in consequence of this trouble?

A No.

385. The decision not to move him was Mr Barley's. He explained his action as follows:

'I was asked what view I had of the situation. Whether it would justify my taking official action to find some other employment, but I also had to balance

that against the fact that this was only talk, that Wheatley had demonstrated himself as a really competent money market manager. Could I deprive the office of that expertise and put him in a position where he would be doing something entirely different?’

386. Later in 1971 another allegation was made against Mr Wheatley, this time to the Stevenson Committee, who passed it on to the Crown Agents, who procured their solicitors (E F Turner & Co) to conduct an investigation. The allegation was that a payment of £1,000 had been asked (but not paid) in respect of a transaction entered into by the Crown Agents in 1967. The solicitors reported that they found the allegation unsupported.

387. What we find remarkable in the light of the foregoing is that (a) Mr Wheatley was continued in a position where he had a discretion to make loans of any amount (he was theoretically subject to the Credit Committee’s ceilings on unsecured loans and to obtaining security on others, but our narrative has demonstrated how illusory were these checks, and they did not apply to loans to associated companies, such as SIS); and (b) although Sir Stephen thought he should be watched and Mr Challis thought he should be moved, there is no note on the confidential files of these facts. When Mr Eaton succeeded Mr Barley in July 1973 he learned nothing of the history.

## **XXV Summary and Conclusion**

388. We have now detailed the ‘circumstances’ which our terms of reference required us to inquire into, and we can look back and summarise what has happened. Our inquiry has been twofold, firstly into what the Crown Agents did (or did not do), and secondly into the efforts, largely unsuccessful, of different organs of government to detect and check the Crown Agents’ activities.

389. In outline we can say that the losses have been due to incompetence rather than to misconduct. The causes have been the actions (and inaction) of individuals, coupled with a defective system. The system was defective in (a) lack of accountability, (b) absence of expert procedures, (c) absence of managerial supervision, (d) bad accounting. Outside agencies contributed to the failure to prevent the losses.

390. What the Crown Agents did was between 1967 and 1974 inclusive to conduct on their own account a substantial secondary banking activity and in the course of conducting it to engage in investment and lending which was unwise both in character and in degree. They embarked upon this course without seeking independent advice and we find that they possessed neither the skills nor the organisation necessary for such an enterprise. Accountability was lacking. It was unfortunate that the operation developed at a time when it was believed that those deploying funds could hardly avoid making money, and there was thus engendered in the officials concerned an undeserved degree of self-confidence. When crisis came they were totally unprepared, their lack of real banking experience was exposed and they allowed themselves to be locked into situations engendering further losses.

391. We have no reason to doubt the genuineness of the desire to secure a reserve which was the main reason advanced for the origin of the own-account

activities. But there was another factor in this origin, the factor of realisation of the facts that the Crown Agents had large funds to deploy and that there were money-making opportunities open to those with large funds at their command. They had had for many years an embryo 'bank' in the shape of the principals' deposits taken by the Joint Consolidated Fund and the Joint Miscellaneous Fund, which they deployed in safe investments. Once the eyes of those concerned were opened to the opportunities presented by the management of these and other funds, they embraced the prospect with enthusiasm. One of the remarkable features of the story is the speed with which the enterprises developed. They started in the first quarter of 1967 and by 30 September 1968, when Sir Stephen Luke retired, the Finvest operation had reached the order of £50m, and investment in equities, secondary banks and property companies had started, together with investment in subsidiary companies and in Australian property development. Some of the wilder enterprises, such as unsuccessful speculation in silver and in mining shares, had already been carried out. Thereafter we have the impression that the mainspring of the own-account activities was not the securing of a reserve but the satisfaction of money-making for its own sake.

392. There was thus a substantial secondary banking enterprise in being at the time when Sir Claude Hayes succeeded to the Chairmanship of the Crown Agents. Mr Challis, who had played an important part in its inception, had been chosen to head the Finance Directorate. After Sir Stephen's departure Mr Challis was virtually supreme in his field. He had a newcomer as Chairman, and Boards which he could dominate—the Crown Agents' Board because none of his colleagues possessed the ability to challenge him, and the Four Millbank Investments' Board because its majority were his subordinates. Sir Claude told us that he had been assured by his predecessor 'that the one thing I need not worry about was finance. I was told that it was in perfectly good hands and that I could concentrate on other things'. At Crown Agents' Board meetings, he said, two of the members, Mr Morris and the Managing Director of Millbank Technical Services Ltd, Mr Roe, would argue with Mr Challis, 'but nonetheless his mind was so powerful that he won the arguments'. Mr Newman, the Crown Agents' Managing Director, told us, 'we were not welcome if we raised questions'. Mr Challis would consult his Chairman insofar as he thought it necessary or desirable and, not surprisingly, was successful in eliciting his support. Mr Newman said this of the FMI Board meetings:

'It was quite clear at those meetings that a lot went on between Mr Hayes and Mr Challis—discussions outside the meetings—and we were merely being informed . . . what was going on.'

Thus the responsibility for the way in which the own-account activities developed rests fairly and squarely on Mr Challis because he conducted them, and on Sir Claude Hayes because he knew, or ought to have known, what was going on.

#### **Mr Challis**

393. Mr Challis with his subordinates—and indeed with his equals and with all the Crown Agents' personnel save the Chairman—imposed his authority and brooked no interference, as witness his treatment of Mr Nowers (para 121) and Mr Blundell (para 273) and his contemptuous minute repelling Mr Morris's criticisms (para 161). Mr Challis would have us believe that he did not influence

the courses taken by the money market managers, and said to us more than once that he had not ever ordered that a loan be granted. We do not believe him. It may well be that he did not direct the day to day operations of the managers; there was no reason why he should. But we have no doubt that the major decisions were his and that, for example, the loans to Stern and the GCA Capital Corporation were made at his behest. It was upon Mr Challis that the lack of accountability worked its effects. His subordinates were accountable to him, but he was in practice accountable to no-one. In theory he was accountable to the Chairman, but the Chairman exerted no effective control over him, and joined forces with him to repel any accountability to external bodies. Lack of discipline undermines morale, and we are sure that the absence of constraints upon Mr Challis played a part in producing and perpetuating the characteristics we discuss below.

394. Much of the own-account activity was satisfactory and calls for no comment. But alongside the run-of-the-mill deposit operations there were transacted the schemes we have dealt with. And throughout we find that the characteristics of the Finance Directorate under Mr Challis included (i) unjustified risk-taking; (ii) a lack of regulation and control and an aversion from taking advice; (iii) secretiveness; (iv) a low standard of commercial ethics; (v) a haphazard choice of associates.

#### **Risks taken**

395. Mr Challis has been described to us as adventurous. The risks he ran stemmed from two causes; the nature of the investment and the extent of the involvement in them. We have been reminded by witnesses of the fact that the Crown Agents were not alone in suffering misfortune in 1974; the crisis of confidence of that year caused the collapse of many fringe banks, and the over-extended property companies inflicted losses upon the most cautious of the clearing banks as well as upon the Crown Agents. It is true that the Crown Agents were not alone in that time in imprudent financing, and probably many of the fringe banks that collapsed will be found to have suffered from features similar to those exhibited by the Crown Agents. But the prudent banks, though they lent to the Mr Sterns of the time, did so with a proper regard to security and in such proportions as to ensure that losses could be accepted without affecting their own solvency. With the Crown Agents on the contrary it was a case of two many eggs in too few baskets—particularly the baskets labelled English and Continental, Australia and Stern.

396. We were also pressed with the argument that some of the risks incurred were taken in order to enhance the service afforded to principals. To a limited extent this is true. A number of the associated companies had among their objects the improvement of the facilities on offer to overseas governments. Thus we accept the evidence that the investment in Mr Abraham's Television Recordings (para 31) included this motivation. But when this argument is used to explain investments such as that in overseas merchant banks it begins to lose credibility and indeed becomes one of the armoury of propaganda weapons so often used by the Crown Agents in their dealings with Whitehall. An extension of this argument is the assertion that all the financial operations were designed to secure expertise to offer to principals. Other propaganda weapons were the representation that the joint funds belonged to the principals (para 126) and the use made of the existence of the Equity Investment Advisory Panel (para 114).

### **Lack of management procedures**

397. One can understand the own-account operations starting in a small way and needing little by way of rules and regulations at the outset. But a time must come when a properly conducted business grapples with the problem of management and control. In relation to the Crown Agents' business this would involve the monitoring of performance, the accurate reporting of events, and the setting up of a regulatory framework. When Mr Challis became Director of Finance and when Sir Claude came fresh to the organisation, an opportunity was afforded for either or both to take stock, to identify the problem and to take appropriate measures. The opportunity was not taken. Mr Challis was not good at detail. Mr P Matthews, his colleague for a year at First National Finance Corporation, found his methods disappointing:

'He had a tremendous gift for dealing with a problem. I thought he had no gift at all for following it through and tying up the loose ends.'

This seems to be the reason why there was such a lack of sound management procedures within the Finance Directorate. There were the monthly reports to the Director showing the state of the money book, and monthly reports of a general nature to the Board but there were no banking rules—certainly no written banking rules; there were supposed to be unwritten rules, eg about the percentage of security which could be lent, but they were vague and often honoured in the breach. Above all there was no systematic management accounting. Thus it was that the Crown Agents fell into such errors as borrowing short and lending long, and lending on insufficient security and the like. The dislike of management procedures probably explains the fading away of the office of Controller (para 91) when it was set up in response to Urwick Orr's advice. And even when the Credit Committee was set up with such formality after the Vehicle & General losses, its scope was limited and its decisions were frequently disregarded (paras 247, 356).

### **Secretiveness**

398. The secrecy in which the Finance Directorate conducted its affairs was a manifestation of the ingrown spirit found within the Crown Agents at the time in question. It was a closed-in body, training up its personnel from youth and rarely recruiting from outside. We have commented upon the strange results of this policy at paras 42 and 43 above. Amongst other things it resulted in the ludicrous situation of this complex trading organisation having only one qualified accountant on its staff until November 1970. The uncertainty in the 1960s over the continued existence of the office intensified this inward-looking attitude, as did the 'you are on your own' theory (para 12). Under Sir Claude Hayes communication at other than top level with the Ministry was discouraged (para 367). In the Finance Directorate the prevailing atmosphere of secrecy had the result that no one but Mr Challis could comprehend the state of affairs as a whole, and he at no time shared the complete picture with the Chairman. With secrecy went a rooted disinclination to take advice unless forced to. The Urwick Orr report, commissioned by Sir Stephen Luke, was an exception, but after his time no advice was taken upon management, banking or investment, and Price Waterhouse were brought in to advise only when the accounting system was breaking down.

### **Low ethical standards**

399. Though they may have been uncertain of their exact status, the staff of the Crown Agents had no doubt that they were Crown servants. As such, one would expect their conduct to conform with the high standards consistent with their positions in the public service, as indeed Sir Claude pointed out (para 174). But, as we have seen, there were fallings-off from these high standards. Some were personal, such as the taking of the Gramco shares (para 198) and of the gifts bestowed by Mr Stern (para 262). Others were commercial, such as the secret underwriting commission (para 73), the support buying of shares (para 139), the elaborate device employed in window-dressing a balance sheet (para 140), the attitude to Exchange Control (para 127) and the Nation Life affair (para 249). In a class of its own, in our view, stands the bargain between Mr Challis and Mr Walker to avoid the payment of UK taxation both by the Crown Agents and by Mr Walker and Mr Greene (para 233). Mr Nowers spoke no less than the truth when he said (para 168) that the office had lost its sense of direction in the spiritual sense.

### **Haphazard associates**

400. A feature emerging from the history we have explored is how fortuitous was the Finance Directorate's choice of associates. Mr Abrahams meets Mr Wheatley by chance, and becomes the Crown Agents' estate agent; he introduces Mr Walker, who becomes their property consultant, and his firm becomes their property solicitors; Mr Walker introduces Mr Caplan, who becomes their valuer. No doubt the Crown Agents did not have to go out to look for business opportunities; when the news got around that they had large funds for investment they did not lack for applicants eager to do business with them especially as they became known in the City, according to evidence given to us, as 'an easy touch'. But it is a strange organisation which allows a junior official, as Mr Wheatley was at the time, to recruit its professional advisors, and to recruit them not from nationally known firms but from young men making their careers. Let us say at once that we have no reason to suppose that in the main the Crown Agents got other than proper advice from the gentlemen we have named. Mr Walker in particular, who bulks large in this story, not only gave sound advice, as to Australia and otherwise, but also saved the Crown Agents from losses upon their uninstructed plunge into the real property world (para 51). But the solicitors, Davies, Arnold and Cooper were responsible for losing some security in the Stern case by not registering charges in time (para 342) and should not have borrowed from the Crown Agents without the latter being separately advised (para 275).

### **The losses**

401. The losses which we have listed above at paragraph 373 may be classified as due to (i) unsecured lending to borrowers now unable to repay fully or at all; (ii) secured lending where the security has proved insufficient or defective; (iii) support lending in cases where rescue failed; (iv) equity investments in associated companies which have failed; (v) participation in property development and dealing. The equity investments form a small proportion of the whole because the Crown Agents injected money into their associates by way of loans rather than by shareholding. The lending is both in sterling and in other currencies. Sterling lending was the province of the Sterling Money Market

Manager, the late Mr Wheatley, whom we did not see for the reasons mentioned in para 3. Mr Wheatley seems often to have made advances upon what has proved to be insufficient security; some of the property valuations relied upon were unduly optimistic and in some cases an unduly high proportion of the valuation was advanced. The non-sterling lending was the province of Mr Blundell, and it is satisfactory to be able to note that despite his unpromising background as a banker (para 43) Mr Blundell succeeded in avoiding major investment errors. The large non-sterling loans to Wilstar (Stern), GCA Capital Corporation, and Tulone were cases where he was required to lend against his better judgement (paras 246, 273, 350), and he can hardly be blamed for the Israel British Bank loss (para 359). Within his personal responsibility come the losses on Galico Investments, Great South West Corporation and Republic Corporation. The first named was a syndicate loan, within a syndicate led by the Crown Agents' banking partners, Continental Illinois, and the other two were small losses incurred early on in his time in charge of the section (para 160). Mr Blundell comes well out of our investigation.

#### **Property speculation**

402. As to financing property, a bank or finance house has broadly two options, one to lend at proper rates on ample security, the other to lend with less security and less, or delayed, return on the loan, but as a quid pro quo to take 'a slice of the action' by holding a stake in the equity. The former is a banking operation, the latter an entrepreneurial operation. The former has little risk, the latter produces high profits in boom time and large losses in slumps. The 'adventurous' Mr Challis chose the latter course for major investments. It produced a £17m profit on the first English and Continental operation and other lesser sums elsewhere; and now has produced enormous losses.

403. The sharing and the amount of the E&C profits reaped by Mr Walker and Mr Greene has been criticised by Sir Matthew Stevenson and others (para 216). But if an undertaking is predominantly financed by loans from one lender, that lender becomes locked in to the situation and in adverse conditions may have to find more money in the hope of preserving his investment, and in such conditions it is no more than a recognition of the facts to give him a stake in the equity. Moreover if it is one lender's money that enables a concern to make profits it is sensible for the lender to have a share in those profits. What that share should be must be a matter for negotiation and bargaining. Partnerships between capital and expertise are not unknown in the property world, and we are satisfied that it is not uncommon for the partnership to be on a 50-50 basis. In E&C Mr Walker and Mr Greene contributed their expertise not only to policy decision making but also to the running of the companies. On the other hand at the outset their experience was limited and they had yet to make their reputation. In the case of the other major partnership venture, both Mr Fenston and Capital & Counties were well-known and were expected to enhance the enterprise by their reputation. It has been suggested that the bargain with the Fenston syndicate was disadvantageous to the Crown Agents in that the syndicate did little except set the situation up. We are not disposed to find fault with the 50% share in either case. What in our opinion was wrong with these transactions was the going into them in the first place, not the proportions of the split. In the Australian venture there was the added fault, as we see it, of the Crown Agents binding themselves to provide finance far into the future.



A body like the Crown Agents, it may be thought, should avoid speculative ventures; it is one thing to be involved in property as an income producing asset or to lend a proportion of a property company's needs against valid security, but it is another sort of transaction altogether to buy Bush House not for its revenue but to re-sell at a profit, or to bind oneself by contract to furnish great sums for re-developing urban sites in Australia for years ahead.

#### **The Crown Agent**

404. Sir Claude Hayes inherited the own-account dealings situation. He could not be expected to oversee in detail the operations of the Finance Directorate, and that directorate was one among many in the organisation he headed. But he had asserted at the outset that Finance was his personal concern (para 91 above), he had the opportunity through presiding at the Crown Agents and Four Millbank Investments Board meetings of amassing information about the Directorate's activities, and moreover as time went on warnings started coming in (paras 161–164). His minutes of February and May 1971 (paras 172–174) show his awareness of some of the Directorate's failings, and by August 1972 he was mentioning one of Mr Challis's major shortcomings to the Permanent Secretary—his readiness to do business inconsistent with the standing of the Crown Agents (para 317). Sir Claude would have known more if he had been more approachable to his subordinates, none of whom among our witnesses, save Mr Challis, found him other than forbidding. In particular if Mr Nowers had had a Chairman to whom he felt able to voice his apprehensions and who would have been able to assess the weight of the complaints, this history would have been very different (para 170). This attitude of his was one of the reasons why internal warnings decreased as time went on; other reasons were the apparent success of the Finance Directorate's operations and the apparent approval given by the Stevenson Committee to those operations. Sir Claude's unapproachability was also partly responsible for the remarkable delay in grappling with the Stern crisis (para 340).

405. An equally important feature of Sir Claude's outlook was his determination to assert and maintain a position of independence for himself, the Crown Agent, and for the Crown Agents' organisation in his charge. This led to a running battle with the Ministry from the time in 1969 when they discovered Finvest down to the day in September 1974 when he departed. As against government Mr Challis's actions were supported and justified and the attempts of the Ministry to obtain information or to impose some constraints were treated as sinister attacks on the independence of the Crown Agents' office. In a minute written on his last day in office and addressed to his successor, Sir Claude said:

'By 1968 the Crown Agents were still alive and kicking and beginning to be profitable. Treasury and ODM officials suddenly realised this and started a long process of getting direct control over the Crown Agents, including their operations, their assets, their reserves and their property.'

Sir Claude's partisanship blinded him to the Ministry's real motives in making their inquiries and led him into actively misinforming them upon such matters as the Crown Agents' involvement in the second E&C set-up (para 302). His antagonism, coupled with his vigour and ingenuity in argument, played its part

in protracting discussion and prolonging the status quo—and with it the own-account operations in their risky form.

406. One special feature of Sir Claude's conduct was his failure to replace Mr Challis when he left (para 324). This was because he thought it premature in view of the impending changes in structure. It was a serious error. It led to the Crown Agents being wholly unprepared for the change in the financial climate and wholly unequipped to deal with it. Had a new mind come to the direction of the Crown Agents' finances in November 1973 a great deal of money would have been saved. And had the out-of-depth Mr Hewins felt able to approach his Chairman at the start of the troubles, many further millions also could have been saved.

### **Corruption**

407. We have had evidence that rumours of corruption in the Finance Directorate have persisted in the City for many years. This is not surprising, because the manner of the Crown Agents doing business was often such as to invite suspicion. We have referred in paras 382–386 above to the various allegations made at different times against the late Mr Wheatley, the Sterling Money Market Manager. At the date of his death he was awaiting trial on criminal charges of corruption in regard to matters with which we cannot deal in a published report for the reasons mentioned in para 3. It is not for us to speculate whether Mr Wheatley entered into some of the loss-making transactions of his section for improper reasons. We can only report that, apart from the subject-matter of the criminal charges, we have found no evidence of corruption, nor has any witness come forward with any specific allegations.

408. We have however found, in the case of Mr Stern's Christmas gifts (para 262) instances of the Crown Agents staff accepting favours which might be thought to place them under an obligation to a person with whom they had to deal in their official capacity. These gifts were in our view unfortunate. The Crown Agents' staff handbook does not deal clearly with the topic, but it hardly needs a rule to expound the unwisdom of a Crown servant accepting gifts or favours from persons with whom he is doing business. The recent Report of the Royal Commission on Standards of Conduct in Public Life (Cmnd. 6524) recognised that minor gifts and hospitality are part of the normal courtesies of life but regarded them as 'always potentially dangerous'. The Royal Commission approved the DoE rules forbidding inter alia the acceptance of gifts other than simple tokens bearing the name of the organisation that gave them (Report, Cmnd 6524 paras 214, 217). Mr Challis is especially blame-worthy in the case of the Stern gifts in that he should have set an example to his staff. There is a conflict of evidence between him and Mr Hewins over whether he knew of the gift to the latter; we accept Mr Hewins' account and think that when consulted Mr Challis should have ordered the immediate return of the gift to Mr Stern, as well as returning his own.

### **External control**

409. Turning to the second strand of our Inquiry—the question of external checks—it is satisfactory to note that at the outset the alarm mechanisms worked efficiently. The inception of own-account dealing was recognised by the Exchequer and Audit Department in October 1969 as a departure which should be brought to the Treasury's attention (para 92); in February 1970 the other

auditor, the Director General of Overseas Audit Service, reported to the Ministry his misgivings over the operation of the JCF (para 102); and in May 1970 the Bank of England, having picked up items causing them concern, expressed that concern to the Treasury (para 107). The Treasury was the correct department to be approached by the Bank and the E&AD, but it was the Ministry of Overseas Development which would have to come to grips with the situation. The Ministry was at once informed of the E&AD's report, but unfortunately did not learn of the Bank's concern (para 109). The Treasury did convey their own interest and lent impetus to an investigation of the situation.

410. And investigation rather than action was the keynote of the ensuing transactions. What clearly bedevilled the matter was the uncertainty over the Crown Agents' status. The Crown Agents had outlived their original function, and no one knew quite how the transformed organisation fitted into the constitutional framework. If control of the Crown Agents was called for, it was logical to ask whether the power to control existed and to what it extended. This was initially a legal and constitutional question, and, if answered favourably to control, a second question opened out, namely how far it was prudent or politic to exert control. An examination of the problem at once threw up these questions, and unfortunately they were allowed to dominate thinking and obscured the initial practical problem, ie what to do about the own-account activities. With hindsight it can readily be seen that there was an urgent need to ascertain accurately what the Crown Agents were doing, to assess the validity of the reason given (the creation of the reserve), to evaluate the risks being run, and to restrain some if not all of the own-account operations. Without hindsight two officials at the Ministry perceived this; we have quoted sufficient of Mr Smith's and Mr Burr's minutes to illustrate the accuracy of their appreciation of the situation (eg paras 94-96, 104, 106, 298). Unfortunately the Permanent Secretary disagreed: he saw no reason to interfere, although he sanctioned inquiries into the Crown Agents' status (para 98). Thus there was lost the first and best opportunity of controlling or stopping the own-account activities. By early 1970 both the Ministry and the Treasury were thinking in terms of investigation of what the Crown Agents were and what they were doing generally, and when in April 1970 events prodded the Ministry into further action, it was towards inquiry that the officials' minds turned (para 104).

411. Once an inquiry was contemplated (1970) or decided upon (January 1971) action was postponed; it was further postponed until the Stevenson Committee reported (March 1972) and thereafter while its report was being considered. The more time passed, the more firmly established became the own-account operations and the more difficult it became to control them. These difficulties were enhanced by the approval conferred by the Stevenson report; the fact that this approval was conditional on re-structuring the Crown Agents so as to diminish the risks (para 210) lost its urgency under Sir Claude's reassurances (para 303). Not until August 1973 was action taken in the shape of the statement of principles then imposed (para 304). But even then nothing happened. No doubt the Ministry expected the Crown Agents to take action at once to observe the principles in the conduct of their affairs, eg imparting of information, reform of the quality of investment business. In fact Sir Claude Hayes did little about them. They were left to be put into practice by the new companies mentioned in the principles, and the process of setting up those

companies had hardly started when the government changed in March 1974 and further time became needed for the formulation of a new policy.

412. Once the decision had been taken to investigate first and act afterwards—a logical enough sequence—it is difficult to see how any chain of events other than those which took place could have been brought about. What however is plain is that the process could have been accelerated. We have the feeling that the setting up of investigative machinery and the consideration of the constitutional status of the Crown Agents were subjects more congenial to Government than the taking of financial control decisions. But while condemning the delay from October 1969, when the Ministry was first alerted, to August 1973, when the principles were laid down, and to October 1974, when management changed, we recognise that the Stevenson findings were bound to set matters back, that Sir Claude Hayes's vigorous and disingenuous defensive campaign was bound to protract matters, and that the Ministry were never able to obtain a full picture of the own-account scene, owing to the delay in the accounts and the way in which the Crown Agents furnished information which was sparse and sometimes misleading. In particular it is plain that a reason for the Ministry's failure to act on financial control at a critical point in time (end 1972) was their belief that the need for outside control had passed with Sir Claude Hayes's declaration that the Crown Agents intended to close down on further venture investment after collecting the POSSFUND profit (para 303). It was open to Sir Claude to use his authority to impose this new investment policy on his finance directorate. If he had done so many of the losses that we have recorded would not have been incurred. As our narrative has shown he did not do so and risk investment went ahead but was not disclosed to the Ministry.

413. In spite of repeated experiences of misinformation, or action promised and not taken, the Ministry maintained, almost to the end of his tenure of office, their belief that Sir Claude Hayes was to be trusted to carry out his undertakings to the Ministry. Although exasperated by his intransigence, the Ministry treated Sir Claude remarkably gently, as witness their anxiety to secure his agreement to the form of inquiry (para 190), their handling of the matter of the Gramco shares (para 183), their prolonging his term of office to secure his pension rights (para 365), and their patience with his opposition generally.

414. We think attention should be drawn to the handling of the crisis of 1974. The Crown Agents' optimistic statements (paras 338, 345) had for long concealed the parlous state of their finances, but at last on 13 May 1974 Mr Hewins's rough balance sheet was disclosed and it became apparent to the Ministry, the Treasury and the Bank of England that the Crown Agents were insolvent; yet the only action taken was the preparation of the statement of government guarantee, to be released if there was a 'run on the bank' (para 346). The organisation which had brought about this lamentable state of affairs was allowed to run on under the same management until Sir Claude retired. His retiring date had just been extended from 30 June 1974 to 30 September 1974. What could and should have been done has been discussed at para 364. In the end the own-account activities were not examined and disciplined until the expiry of the Chairman's term of office.

#### **The role of the auditors**

415. The Crown Agents' accounts, as audited and reported on by the Ex-

chequer and Audit Department, ought to have served, inter alia (a) as an annual public record of the own-account activities; (b) as a management tool for the use of the Crown Agents in the performance of those activities, and (c) as a means of providing the Treasury, the Ministry and the Bank of England with information and the opportunity to take any appropriate measures of control or otherwise. For various reasons the accounts failed to perform these functions.

416. In October 1969 when the E & AD identified the size and nature of the Finvest operation, and reported thereon to the Treasury and the Ministry, they passed to the proper quarter the question of what authority the Crown Agents had for own-account operations. We note that it might have been possible for the E & AD to make this report a year earlier when first told about Finvest (para 92) but we doubt whether this would have materially altered the course of events.

417. When in October 1971 the Treasury directed that the accounts should be so prepared 'as to conform to the standards of disclosure required by the Companies Acts where these are appropriate' (para 117), they were recognising that the accounts were those of a large and complex trading organisation. We think that in some respects the accounts, as audited by the E & AD fell short of those standards. The principal shortcoming was as regards delay. We have mentioned the inordinate delays at paras 280–291. The statutory requirement that the E & AD should make their examination 'with as little delay as possible' was lost sight of, and it was plain to us that no one in the Crown Agents, and few outside, felt a need for the accounts or an obligation to furnish them in good shape and in good time (paras 281–285). When at length each year's accounts came out they were next to useless as an informatory record because so seriously out of date. Some of the delay may have been due to inadequate audit staff allocated to the Crown Agents (para 283). More important in our view was the apparent lack of concern over the delay on the part of the E & AD higher directing staff, and the failure to report it as a departure from the accounting standards prescribed by the Treasury.

418. As to other audit shortcomings, our narrative has shown situations where the audit process might have, but did not, expose imprudence, irregularity, or even deception on the part of the Finance Directorate in the conduct of the own-account business. Examples are the absence of provision for losses, actual or potential (para 290) and the concealment of massive contingent liabilities incurred by the issue of comfort letters (paras 148–149). But the most significant impression that we gained of the part played by the E & AD in the rise and fall of the Crown Agents as bankers and investors was that they never recaptured the spirit of alertness and perceptive inquiry so clearly shown in Mr Long's report on Finvest to the Treasury in October 1969. We were told that the Treasury valued the E & AD audit especially because of the detailed private report made when needed. One of the great might-have-beens of our inquiry is the remedial action on the part of the government that would surely have followed if the Treasury had asked for, and the E & AD had used their audit scrutiny to supply, further information on the quantity and quality of own-account operations as these developed after 1969.

419. Finally, we must notice the apparent indifference of the E & AD to the failures of the Crown Agents' internal accounting system. The published

accounts may have lost their relevance through delay, but at least they were eventually completed and certified. It is not too much to say that internal accounts for effective management purposes were non-existent. Conditions may have been different in other branches of the Crown Agents which we have not examined: our scrutiny of the Finance Directorate has shown that in this field, higher management, from the Senior Crown Agent down, felt no need of such accounts, indeed preferred to be without them. The Crown Agent and his Finance Directorate must answer for the consequences in terms of failure to control the financial transactions that figure in our narrative. But a contributory factor lies in the apparent omission by the E & AD to perform for the Crown Agents the recognised auditor's function of advising management of defects and weaknesses of financial system, a matter they might also have included in their reports to the Treasury.

#### **The role of the Treasury**

420. We have drawn attention above to opportunities that were missed by the Treasury to use their responsibility for the Crown Agents' accounts to inform themselves and the Ministry about the state of the Crown Agents' own-account finances. We appreciate that the Treasury took the view that it was for the Ministry, as the Department of State responsible for the Crown Agents, to deal with the latter over the organisation of their affairs. Nevertheless we think that the Treasury, as custodian of the public purse, might have been expected to press harder for government action to control the Crown Agents, including action to reform their internal management, and to have been less acquiescent in the policy of confining action to the revision of the Crown Agents' constitution. It is ironical to observe that while the Ministry were to the end labouring under misapprehensions over the nature and extent of the own-account dealing, government did not utilise its auditing arm to secure accurate information. Not until Mr Cuckney commissioned Coopers & Lybrand in October 1974 was any accountancy investigation carried out.

#### **The role of the Bank of England**

421. The Bank of England is the national central bank. Although not a government department it is publicly owned. It possesses the practical skills and contacts enabling it to detect flaws in the financial world and to provide assistance in remedying them. These attributes are lacking in a government department such as the Ministry or, indeed, the Treasury. We appreciate that the Bank is independent of government, but it is government's major contact with the City, and we think it would not have been unreasonable for the Bank to have played a greater part in this affair than it did. It was astute to detect signs of trouble and its initial warnings were correctly passed to the Treasury. But after that it played a minor role. It would have preferred a different type of inquiry from the one mounted (para 189) and in consequence played little part on the Stevenson Committee's deliberations, whereas fuller information from it might well have modified that Committee's views (paras 218-9). Thereafter the Bank, although frequently consulted (paras 342, 346, 363) remained on the sidelines (para 310). It is unfortunate that it was not invited to take a larger part in the post-Stevenson deliberations. The Bank's inquiries by direct contact with the Crown Agents were limited to the pre-Stevenson period.

**In conclusion**

422. The sums granted out of public funds to the Crown Agents will either be lost to the taxpayer, or if repaid out of the future profits of the Crown Agents will be a clog on their competitive position. These unfortunate results flow from (i) an unwise decision to operate as financiers on own-account, (ii) the folly and euphoria with which some of the operations were conducted, compounded by lack of expertise and neglect of accounting systems and professional safeguard controls and (iii) the failure of government to inform itself of the developments, to appreciate the risks and to grasp the need for quick action. Against this sombre finding it is satisfactory to be able to note that no criticism has been made to us of the Finance Directorate's handling of principals' portfolios and that, judging by their continued success in their traditional procurement role, the Crown Agents' orthodox activities have not suffered from the publicity accorded to the subject matter of our inquiry.

423. In conclusion we wish to reiterate that we have received complete co-operation from the present staff of the Crown Agents and from the various government departments with which we have dealt. Our research has been conducted with great competence by a team of accountants put at our disposal by Whinney Murray & Co and led by Mr Michael Taylor-Jones ACA and Mr George Elwes ACA. Mr Taylor-Jones has also been our painstaking and efficient Secretary and has earned our especial gratitude by his industry and skill.

E S FAY  
EDMUND COMPTON  
P GODFREY

M K TAYLOR-JONES, *Secretary*

10 August 1977

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## CROWN AGENTS BOARD

**Field of Investment**

When the Office was subject to the jurisdiction of the Secretary of State for the Colonies our permitted field of investment was defined by the Secretary of State but we eventually achieved the position that the range of securities in which we were permitted to invest was a good deal wider than the then current Trustee Acts.

Since the Colonial Office abandoned their responsibility for the Crown Agents, we have proceeded on the assumption that:—

- (a) As regards our independent principals, we would invest their funds in whatever securities they authorised us to purchase.
- (b) As regards Colonial funds, we would invest in the range of securities last authorised by the Secretary of State for the Colonies plus any other securities which have been authorised by the latest Trustee Act, 1961.

The Secretary of State stipulated that colonial funds must never be put at risk by the office acting for other principals and there is no difficulty in following this ruling.

It is suggested, however, that funds under the direct control of the Crown Agents viz. the Office Funds, the Joint Funds and the MIF should be invested at the discretion of the Crown Agents.

It is proposed that investments should be made in the following categories:—

- (a) Securities specified in the first schedule to the Trustee Investments Act, 1961 and Authorised Investments as defined in the Four Millbank Unit Trust Fund deed.
- (b) Loans to finance houses which are wholly owned by clearing banks or are owned by clearing banks in association with other banks.
- (c) Loans to the London offices of US banks, being members of the American Reserve Bank system.
- (d) Loans to Water Companies whose debentures or stock are or would be trustee securities.
- (e) Loans to the Commonwealth Development Corporation.
- (f) Loans to financial institutions against adequate collateral security.

The Joint Funds are already invested in the securities listed above under (a), (b), (c) and (f). We have not hitherto invested in any loans specified under (d) and (e) above, although, for the reasons mentioned in Mr Challis's minute of the 10 March, which was considered at the Board meeting on 16 March, the security offered by these two types of investment can be regarded as sound in every way as those covered by our existing field of investment.

March 1966



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## OFFICE RESERVES

**A Purposes for which the Office requires reserves**

1. To meet admitted claims arising from
  - (a) professional liability, negligence, errors and omissions
  - (b) uninsured risks.
2. To draw upon in the event of
  - (a) current or potential budgetary deficits due to cyclical fluctuations in the present level of business
  - (b) assets of the Office Reserve Fund being inadequate to meet the Office's liabilities
  - (c) a contraction in business.
3. To provide for capital expenditure and to finance any major projects designed to further the work of the Office.

**B Assessment of the size of reserves required**

For: A1(a) £500,000

or

A1(b) if it proves feasible to take out insurance policies, with the Crown Agents accepting claims of under £10,000 then £50,000 to cover, say five 'incidents' in any one year.

For: A2(a) This state of affairs would normally be corrected by budgetary action but there will undoubtedly be circumstances when the measures to be taken may require some time to become effective, eg appropriate advance notice to Principals about adjustment of charges and the eventual impact of economies.

It would be prudent to allow £200,000 to bridge the interim period.

For: A2(b) This situation would arise if future quinquennial or interim valuations of the Pension Scheme revealed that the Scheme was in deficit and it were not possible to make good the deficit solely by increasing the Office annual percentage contribution (the Scheme would also show a deficiency if it were not possible to maintain the present rate of contributions at 25 per cent).

To meet this contingency past experience of actuarial valuations would suggest a figure of £400,000.

For: A2(c) Under this heading the following situations have been assumed for the purpose of assessing the reserves required:—

- (i) A fairly modest contraction in business due to specific causes resulting in a fall in revenue of £500,000 per annum. The assessment of reserves required in such an eventuality is not easy. Firstly it would have to be determined without doubt whether the recession was temporary or permanent. Allowing for a period of two years at least for the situation to become clear then

if it were proved to be a temporary recession approximately £950,000 would be required

or

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if it were proved to be a permanent recession an additional two years should be allowed for staff transfers and overhead adjustments requiring an additional £700,000.

(ii) *A Close-down of the Office*

The Office could not of course close down overnight nor could its activities cease abruptly or even entirely. The major problem would be the orderly disposition of established staff coupled with the phasing out of current business. Given maximum co-operation of both Treasury and ODM it would probably take three years before staff transfers were completed. In addition there would be the problem of senior staff aged, say, fifty years and above whose transferability might be difficult, if not impossible. In such circumstances abolition of office payments and pensions may have to be provided for about 300 out of about 950 established staff. Capitalised on the basis of average abolition of office payments per head of £4,000, average pension per annum until sixty years of age of £1,200, and the continuation of the 25% pensions contribution for each such officer until sixty years, the amount required would be approximately £5,750,000.

Also, in such circumstances, in respect of those established officers who were transferred, provision would have to be made to meet in full the Crown Agents' obligation for their pension rights up to the date of transfer. Without an actuarial valuation to determine the present value of future benefits payable in respect of service with the Crown Agents of those officers who were transferred before reaching the age of sixty years, it is not possible to say what amount would need to be added to the invested assets allocated to the Pension Scheme to cover any shortfall. In my estimation £300,000 would probably be adequate.

*Summary*

In the most favourable circumstances postulating A1(a) or (b) and A2(a).

Reserves needed would be £250,000 to £700,000.

In the circumstances postulated by A1(a) or (b), A2(a), A2(b) and A2(c)(i)

Reserves needed would be £2,750,000.

In circumstances postulated A1(a) or (b), A2(b) and A2(c)(ii).

Reserves needed would be £6,950,000.

My conclusions are that we should aim at building up a minimum of, say, £3m by the end of 1971 and continue until a figure of £7m is reached

**C Measures to achieve these objectives**

By the end of 1967 the Contingencies Reserve should have risen to £1.2m. The first objective requires another £1.8m. This can only be found by raising revenue by an additional £400,000 a year and to set our sights at this figure is a practicable proposi-

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tion. The balance would largely be derived from rising income from the growing reserve.

The subsequent objective introduces some additional factors. Of the additional £4m required, only £1.5m need be in fresh 'cash'. Reserves set up for special purposes, eg Office Buildings Renewals, Office Equipment, Marine Insurance Reserve, now totalling, say, £550,000, would no longer be required and this sum, together with the market value of freehold and leasehold property estimated at £2m would provide the balance of £2.5m. On the assumption that we can continue to collect additional revenue of £400,000 a year from 1971 onwards, we should achieve the ultimate objective by 1975.

**D Policy for investment of the Reserve**

The reserves should be in the form of easily realisable securities. I would suggest:—

A minimum of £500,000 in 'shorts'

£2,500,000 in securities maturing within a period of ten years

And the balance in longer dated securities.

With a general proviso that the spread of maturities should be flexible according to the view taken of the market at any time.

It will be noted that the above calculations make no provision under head A3. The extent of any provisions under this head must necessarily depend on policy decisions. It may, however, be found appropriate to divert part of the longer dated end of the invested reserves to finance selected projects depending on the nature and period of the commitment entered into.

K.W.B.

15.3.67

## 'F' DEPARTMENT

*Notes on***Finvest****F.D. Overseas Banks Settlement Unit Suspense A/C****Revenue from Equity Portfolio Management****T.V.R. Ltd and T.A.L. Ltd****Finvest***The Sources of Money Invested*

Subsidiaries of London clearing banks

London branches of Continental, American and international banks

Various financial institutions, eg industrial pension funds, insurance companies, bank nominees

*How and Where Investment is Undertaken*

Money is placed short term (for periods up to a year) with institutions described in 'The Sources . . .' above in the form of:—

Bank deposits—including the inter-bank market

Loans to finance houses (those wholly or majority owned subsidiaries of the London clearing banks)

Loans to UK local authorities

Loans to selected merchant banks

(Moneys placed with the above institutions are lent without collateral security.)

Investments are made in:—

British Government short dated securities (approx. £10,500,000 at present)

UK Equities (approx. £500,000 at present)

Australian Equities (approx. £900,000 at present)

*Who Operates Investments and What Higher Supervision is Applied*

Banking Division (Mr Wheatley I/C) and appropriate managers of the Investment Division (Mr Mitchell and Mr Lucas). Supervision exercised by Head of Department and Director of Finance.

*Whether a Clear Distinction can be made between Surpluses which can be 'creamed off' and 'paper' Profits*

Such a distinction could be made but in practice it has not been done—the Fund has been revalued monthly and the excess of assets over liabilities represents the total profit to date both realised and unrealised. Cash is kept at a minimum, say £100,000, to meet interest payments to depositors.

*Whether the accounting and reserve arrangements can be put on a similar footing to the new M.I.F. Scheme*

FINVEST is hardly comparable with the M.I.F. The former must be operated on a continuous basis since liabilities cannot be applied specifically to a particular year. It would, however, be feasible to set up a special reserve in the Office Reserve Fund against losses.

*To what extent Office Funds may be at risk*

Technically, to the extent of total liabilities, ie amounts deposited by the institutions described in 'The Sources . . .' above, which can be of the order of up to £50m. On the other hand the risk can only be assessed in the light of the financial strength of the banks etc with whom money is placed ('How and Where . . .' above). We are probably at greater risk on our equity investments; failure to realise profits (or incurring a loss even) depends on the expertise applied to the markets concerned, especially the market in Australian mining shares.

*Performance*

At 30 June 1968, excess of assets over liabilities in FINVEST amounted to £664,000.

**F.D. Overseas Banks Settlement Unit Suspense Account**

This unit is concerned entirely with operations in foreign currencies and securities.

*Sources of Foreign Currencies*

- 1 Drawings in \$US from World Bank loans under Case 1 (reimbursement) procedure.

(Equivalent amounts in sterling (at parity rate of exchange) are credited to recipient governments' loan accounts with CAA; sterling amounts so credited are financed by borrowings at interest from the London money market).

- 2 Foreign currencies remitted by principals for management by CAA or in settlement of particular obligations and commitments.

*Method of Operation*

- 1 Foreign currencies so acquired are utilised in a number of ways:—
  - (i) Maintenance of currency deposits with various banks throughout Europe and in the USA (principally Continental Illinois)
  - (ii) Investment in European and US bonds and equities. Special features here include the setting up of a unit trust run on CA's behalf by the Deutschebank specialising in commodity shares and the arrangement recently concluded with Kuhn Loeb and Continental Illinois to manage an American portfolio of between \$1m and \$2m.

The whole operation is conducted in a flexible way taking a view of the financial situation and investment prospects in the major financial centres. Currency deposits are switched from one centre to another and investments likewise.

*Performance*

At 30 June 1968 the unit's operations over a period of nine months showed a book profit of £378,000 (including £83,000 profit arising from devaluation).

**Revenue from Equity Portfolio Management**

Present revenue is approximately £50,000 pa with prospects of rising to, say, £70,000 pa.

**T.V.R Ltd and T.A.L. Ltd**

No return on the equity investment in T.V.R. Ltd and T.A.L. Ltd this year is expected.

K.W.B.  
Director of Finance  
13.8.68

## URWICK, ORR &amp; PARTNERS LTD

## Report No. Special

**D. Control**

The primary duty for carrying out the policies of the Board lies with the executive managers responsible for Operating functions. Control is the process whereby the effectiveness of action taken, within the framework of policies, can be measured. In practice to measure effectiveness it is always necessary to have information and for the most part this will be precise numerical information. It is the duty of the control function to supply this information.

The function goes beyond the passive provision of information however. Figures are notoriously capable of diverse interpretations. It is necessary to ensure that the information provided is relevant and that the correct interpretation is placed on it. This is a vital part of the function, and is the reason why this is a professional function and is usually done by an accountant. It must be stressed however that this is not the traditional function of accountancy as such and to emphasise this we shall use the title Controller to designate the person responsible for this function.

The ultimate duty of acting upon the information supplied rests with the executive managers. The Controller however by his skill in presenting and interpreting his information will often point the way clearly for the managers. It follows from this that he must be in the centre of things, well informed about the policies of the Board and the lines of possible future developments. While he must always be ready with information about costs and must ensure that his colleagues see clearly all the financial implications of their proposals he must not act as a purely repressive influence and must comprehend and sympathise with their plans for development and expansion. We have expanded somewhat on the nature of this function because it has been a neglected activity in your organisation. This is understandable in view of the considerable element of guaranteed income which, with only occasional setbacks, characterised the finances of the Crown Agents in the Colonial era and of the stress placed on the absence of the profit motive in your operations. The position is now very different and you must now take urgent steps to develop your information system.

This information system will have many facets but three essential requirements are:—

- (i) Regular reporting on profitability—probably at monthly intervals—showing results for individual services.
- (ii) Budget comparisons.
- (iii) Analysis of turnover by type of service and by Principal.

In general the Board should use the Controller to assemble and co-ordinate all the information they require. The mass of general information contained in Departmental Reports should be routed to the Controller who would be responsible for reducing it for systematic presentation and relating the numerical part of it to the general budgetary scheme

We have included Office Services as part of Control. It does not require separate executive representation at Board level. There is no absolute logic in associating Office Services with the Control function but it contains a large body of staff of a miscellaneous character apt to be taken for granted and the qualities desirable for the Head of Control Department are those which should also ensure an economical approach to this function.

## COPY OF LETTER FROM SIR STEPHEN LUKE TO SIR GEOFFREY WILSON

5th September, 1968.

You asked me to write to you about the constitutional status of the Crown Agents' Office and its relationship with the Ministry of Overseas Development.

2. The historical origins of this Office are to be found in the agencies established in London in the eighteenth century by individual Colonial Governments for the purpose of purchasing their stores and investing their funds. In 1833 the British Government intervened to amalgamate the remaining agencies into one organisation. The Office was thus created by administrative act; it was not given, and has never had, any form of legal status. It is not a British Government department, nor are its staff civil servants; they are, however, by a Treasury definition in 1909, 'servants of the Crown' and their salaries and conditions of service conform to those of the UK Civil Service. The Office is a public service dependent entirely on its earnings; the accepted criterion for determining its charges is, however, that they shall be maintained at a level sufficient only to cover administrative costs and to maintain an adequate working balance and a reserve for contingencies. Our accounts are audited by the Comptroller and Auditor-General.

3. Ministerial responsibility for the Office was transferred from the Secretary of State for the Colonies to the Minister for Technical Co-operation in 1961. Up to that point the Office could be fairly regarded as part of the machinery of Colonial Government and, as such, the Colonial Office maintained fairly close control over its policy and administration. The Secretary of State appointed the Crown Agents and they were required to obtain his approval for their establishment of staff, for their scales of charges, and for their investment and other basic policies. In short, the Office functioned as a sort of subordinate department of the Colonial Office—with results which, even in those days, were often far from happy. The transfer of responsibility for the Office to the newly-created Department of Technical Co-operation coincided with—indeed was caused by—the changed constitutional status of the Crown Agents' Principals. By 1961, many of these had already achieved, or were on the way to achieving, full constitutional independence, and it was clearly no longer appropriate that the Crown Agents whose business was now largely conducted on behalf of independent Commonwealth or foreign Governments or authorities should remain under Colonial Office control.

4. Our relationship with D.T.C./O.D.M. has been quite different in character from that with the Colonial Office—far less formal and far more helpful. Andrew Cohen had been my colleague and friend for so many years that it seemed natural to substitute an informal working relationship for a rigid situation. The Office had ceased to enjoy the protected existence of a government department; it was now faced, over the full range of its operations, by the full blast of competition, and its prospects of survival depended on its capacity to match that competition with comparable efficiency, flexibility and speed of action. In such conditions control by civil servants remote from our day-to-day operations was no longer feasible and might prove positively damaging. Andrew Cohen therefore let go the reins; on the other hand, I kept him fully and regularly informed of the progress of our affairs, I gave him advance notice of our major plans and intentions, I sought his formal approval where this seemed necessary, and I consulted him informally on major questions of policy. All this will be evident from your files. What you will not find—or, at least, I have been unable to find—is any definition of the way in which the Minister now exercises his ultimate responsibility over this Office.

5. You were, I think, inclined to wonder whether this state of affairs was satisfactory from your Minister's point of view. I am ready to come over to discuss this question with you and Claude Hayes at any time. Perhaps, however, I may make one preliminary point. As I see it, the Senior Crown Agent/Chairman has a dual responsibility: to the Minister, for the efficiency and integrity of his Office, and for the prudent management of its finances; and to his Principals, for the proper fulfilment of their instructions. There are, of course, areas of doubt where the distinction is blurred by political or other factors (eg in the purchase of arms or the management of funds), but broadly speaking it must be recognised that our continued acceptability to overseas Governments depends on their knowledge that we conduct their affairs, not only with efficiency, but also in confidence and without external interference.

6. When first I came to this Office, nine years ago, I do not think that anyone had attempted to estimate what its future was likely to be. For some time, indeed, I suspected that I had been appointed to preside gracefully over its dissolution. In 1961/2 we came close to bankruptcy; in those years, with our backs to the wall, we were forced to get rid of one-fifth of our staff. I learned then, through a lengthy period of painful anxiety, that our prospects of survival depended almost entirely on our own exertions—apart from absorbing our redundant staff there was no help that Her Majesty's Government could effectively give us (nor, for that matter, much evidence that it cared whether we survived or not). In the new circumstances, we worked out our own philosophy. We believed that this organisation, with its experience, its expertise, its world-wide contacts and its *esprit de corps* could continue to provide an extensive range of services beneficial to the countries of the developing world. But we recognised that it was not enough to provide a disinterested and impartial public service; we must also be commercially competitive. Our situation compelled us, like any commercial or industrial concern, to seek to maximise our efficiency and flexibility; we could not afford to stagnate; if we failed to expand we should inevitably contract.

7. We therefore set out to rebuild our fortunes. We changed our image by modernising our publicity and public relations; we re-organised our management structure; we overhauled our machine; we expanded the range of our services; we developed our overseas representation; we sought opportunities for work in new geographical areas. By a combination of good luck and our own exertions we were rewarded. Year by year, from 1963, our level of business and financial situation steadily improved; our reserves have now reached a level that frees us from undue anxiety about the impact of unforeseen contingencies or temporary fluctuations of business. The modest affluence that we now enjoy gives us greater scope for manoeuvre. We can afford to improve our machinery—for instance by extending our net-work of overseas representatives (we now have offices in Washington, Tokyo, Kuala Lumpur, Lagos, Nairobi, Bahrein and Sydney) or by the purchase of a computer. We similarly have the resources to provide a wider range of more sophisticated services—whether through the creation within the Office of new machinery such as the Department of Advisory Services; or through our new wholly-owned subsidiary, Millbank Technical Services Ltd; or through our participation in external merchant banking and television concerns. Over the past two or three years we have acquired a new confidence that we have successfully weathered the transition, that we can now discern the sort of institution that this is going to be in the years ahead, and that the foundations we have laid provide a sound basis for future growth.

8. We have, moreover, been encouraged by a growing recognition of our value to the United Kingdom. Our *raison d'être* is and must remain the provision of services to the developing world and, as such, we must buy in the best markets. Nevertheless, we export annually some £50–60 millions worth of British goods, and it is obvious that



our continued existence has preserved many traditional trade links that might otherwise have snapped. Indeed, the more we can extend our operations into new areas, such as Saudi Arabia or Latin America, the better for British exports, since foreign Governments use us only for buying in this country. Moreover, we make a contribution, through the fees we earn, of some £3–4 millions annually in the UK invisible exports. And, finally, it seems possible that, before long, we shall be handling a number of major projects for the Defence Sales Organisation of the Ministry of Defence—that the British Government will have itself become one of our Principals.

9. This letter has come to look like a retiring Senior Crown Agents' *Apologia Pro Vita Sua*, but I thought it useful to give you this historical resumé as background information for our proposed discussion. It explains, at least, my personal predilection for the existing relationship between this Office and your department, and the difficulty I find in suggesting means of giving greater precision to it. But, of course, a definition of sorts is possible. Counsel provided us with something like this several years ago when we had it in mind to have the Office incorporated by Royal Charter. After prolonged discussions we abandoned this project because it would have involved depriving the staff of their much-prized status as 'servants of the Crown', but the enclosed draft shows you what we had in mind at the time.

10. Finally, I should perhaps mention that the practical difficulties inherent in the ambiguities of our status have recently been emphasised by a report on our management structure that we recently commissioned from Urwick, Orr. These eminent consultants, working within the rigid terms of reference necessarily imposed on them, saw no reason to dissent from the policies that we have been pursuing; what they did say was that our objective of maximum competitive efficiency could be achieved only by a massive decentralisation of responsibility within the Office combined with a far more scientific system of information and control. We must be prepared to take larger risks, and to fuss less about mistakes and errors of judgement. We are all agreed that the consultants' advice must be taken. I do not regard it as inconsistent with the maintenance of our existing relationship, but it is perhaps a factor that we must take into account when we come to our discussion.

I am sending a copy of this letter to Claude Hayes.

(Sgd.) S E V LUKE

G M Wilson, Esq, CMG,  
Ministry of Overseas Development

FINANCE DEPARTMENT  
Proposed Objectives for 1969

**(1) Finvest—General & UK Money Market**

At the end of 1968, the general FINVEST dealing account stood at about £48 million.

*We plan*

to raise this amount to £100 million within three months and to £200 million six months thereafter. The extent to which this can be achieved will depend on the tightness or otherwise of money. The expanded account would be used for greater UK money market dealing and for feeding the increased requirements of some of the other operations listed below.

*Income Target*

£500,000.

**(2) Finvest—UK Fixed Interest**

*We plan*

to commence jobbing for FINVEST in gilts. The profits to be made are difficult to estimate because there can frequently be periods when few opportunities for jobbing in gilts present themselves but, given the facilities for increased charting, we could well reach the following target.

*Income Target*

£50,000.

**(3) Finvest—UK Equities**

Activities commenced in January, 1968, with a ceiling of  $\frac{1}{4}$  million, later raised to  $\frac{1}{2}$  million. The year ended in a net profit (ie realised profits less cost of borrowing and unrealised losses) of £38,000.

*We plan*

- (i) to raise the ceiling to £1 million
- (ii) to devote up to an additional  $\frac{1}{2}$  million to option dealings and discretionary trading accounts in selected sectors with individual brokers.

*Income Target*

(i) £120,000

(ii) £25,000 initially.

**(4) Finvest—Overseas Markets**

During 1968 we commenced receiving foreign currencies from Principals for deposit abroad. At the end of the year, these deposits totalled the equivalent of \$10 million but the operation is, of course, limited by the requirements of Principals.

*We plan*

to institute a foreign money market operation on our own account by borrowing foreign currencies and by taking positions in currencies deposited by our principals, building up to a first ceiling of \$100 million over a few months.

*Income Target*

£50,000.

**(5) Investment Research**

We are becoming increasingly conscious of our lack of adequate investment research facilities which are an integral part of any professional organisation connected with the financial and investment world. Such facilities are obviously desirable and, in fact, essential to the successful outcome of the previous proposals, particularly numbers (3) and (4), and to improving our services to Principals.

*We plan*

to institute investment research units, starting in a small way, with, immediately, a threefold objective.

- (a) To conduct original reviews of all 200 companies from which our major UK equity portfolio is selected and of each section contained in the FT Index.
- (b) To assess the reviews and advice from our brokers.
- (c) To analyse the overall performances of overseas markets.

**(6) Property**

The full yield from investment in real property can be relatively slow but considerable appreciation can accrue in the long term. Furthermore it provides a hedge against inflation and devaluation and the security provided is sound. Property development provides a shorter term operation where the returns can be high.

CAA investment in property is already typified by Abbey Orchard Street, St Nicholas House, etc and we are now committed to participation in property development in Sydney, Australia with other projects there to be considered.

*We plan*

to intensify investigation into this form of investment on a world-wide basis.

*Income Target*

Difficult to assess at this stage. However, No. 4 Abbey Orchard Street acquired for £1.65 million in April, 1967, was recently valued by valuers of the highest repute at £2.29 million

**(7) CAA Loans to Principals**

Attached as Appendix A, I present a paper detailing proposals for instituting a scheme for C.A.A. loans to Principals.

*Income Target*

£150,000.

**(8) Banking Division**

At present, suppliers' invoices against contracts placed by C.A.A. are paid daily and, subject to minor mechanical precautions relating to the despatch of the stores for shipment, as soon as they are received. This arrangement goes against all normal commercial practice.

*We plan*

to devise a system whereby invoices would be *debited to Principals' accounts* daily as at present but *payment to suppliers* would be delayed until a set day in each month. Such an arrangement would equate with commercial practice and provide a build-up of funds each month to be used for our own purposes. At a conservative estimate, FINVEST would be allowed the use and the income on £2 million a year.

*Income Estimate*

£150,000.

**(9) Conclusion**

The above proposals represent a total income target of just over *£1 million plus* the income and security to be earned from property investment and development.

In Appendix B the costs of the extra staff required are estimated at £75,000.

Finally, if these entire proposals are approved there will remain an accommodation problem to be resolved.

D.W.F.C.

Head of 'F' Department

16.1.1969

Mr Clark

STERLING INDUSTRIAL SECURITIES LIMITED

You will know that for some months past, we have had discussions with Mr Sidney Finley, and Mr Sidney Davidson concerning the acquisition of Red Dragon Securities Limited, and possible participation by the Crown Agents in the Banking operation to be established therefrom. You will see from 37 on this file that the capital of Red Dragon has now been acquired by another interested party, you will also note from 37 on this file that Red Dragon have already reimbursed Sidney Davidson with the sum of £5,000 in reimbursement of the expenses of investigating that company, and setting up the projected acquisition of its capital. After all expenses have been met, any sum remaining from this £5,000 will be divided equally between Finley, Davidson and the Crown Agents, and it is expected that the Crown Agents will receive £3/400 from this operation. Such reimbursement will be suitable for the time which we have expended in this matter.

Finley and Davidson intend to press on with the formation of Sterling Industrial Securities Limited, as a Banking operation whether or not the Crown Agents wish to participate, but they would certainly welcome the participation by the Crown Agents to the extent of one third of the projected share capital. It is anticipated that the share capital will be 500,000 shares of £1 each of which 100,000 will be issued and fully paid in the first instance. To this end, Solicitors (Messrs Berwyn and Company) have been instructed to draw up a new memorandum and articles of association for Sterling, and are presently engaged in this operation.

I would see the business of any new Banking operation of this kind falling into the following categories:—

1. Acceptance Credits
2. Block Discounting
3. Commercial Bills
4. Bridging Finance
5. Short Term Property Mortgages
6. Property Development
7. Commercial Lending
8. Acquisition of Equity Interests
9. Bank Guarantees
10. Deposit Accounts
11. Current Accounts

There are also other marginal activities such as the financing of import deposit receipts to which consideration should be given.

I would suggest that participation in an operation of this nature with people such as Finley and Davidson who are definitely profit orientated could be advantageous to the Crown Agents, and an initial subscription of approximately £33,000 would not be unduly large. The proposed board of directors would consist of Finley, Davidson and myself.

Would it now be possible please for approval to be given for the Crown Agents participation in this venture. If further discussions upon this subject are required, I can arrange a suitable meeting with Finley and Davidson.

B.R.W.

F.3

14th April 1969

## COPY OF LETTER FROM SIR CLAUDE HAYES TO MR M G SMITH

11 July 1969.

You wrote to me on 8 July about the press announcement of our interest in First National Finance Corporation. On the general questions you raise I agree that the Minister should be given advance notice of any new venture which we have in mind such as those you mention, ie Sassoons, Crown Communications, Associated Railway Consultants. I think, in fact, that the Ministry was consulted on all three, and also on another company (Television Recordings Limited) in which again we have a considerable shareholding and take part in management. I agree also that we should notify the Ministry of such ventures if they are sufficiently important a part of our activities, whether or not they involve clearance with the Treasury or the Bank of England, as Sassoons did. Indeed, it is well understood that we should do this.

Our stake in the First National Finance Corporation is not, however, in this field of business ventures or the kind in which the Crown Agents have an active role to play. Our investment is about £700,000, which is less than 1% of our total investment portfolio. It carries no further financial liability or obligation. This investment is in fact a straightforward investment on behalf of our Principals and only one of a great many, several of which are bigger in cash terms than this one. I think that it may have struck your notice particularly because it happened to get into the press as a result of our appointing one of our staff to the Board. This, however, does not imply that we are going to take an active part in the management of this Corporation. As our stake in the equity is 5% however we thought it desirable to have one of our staff on the Board so that we could keep an eye on the Corporation's activities. It is also, in my opinion, an extremely valuable element in the training of members of our Finance Department to get an insight into this kind of commercial activity. I need hardly say that Wheatley will not receive any personal emoluments; our rules are that any emoluments for any official participation of this kind are paid to the Crown Agents.

The answer to your last question is therefore that F.C.N.C. was not intended to have any relation to our existing pattern of services, in fact its business is all in the UK and consists mainly of hire purchase, industrial leasing and property development. Its Chairman is Lord De L'Isle and Dudley.

Perhaps I could add, in case you are not aware of it, that our investments generally, and certainly an investment of this kind and size, are supervised and advised upon by our Investment Advisory Panel, which consists of three eminent city financial men.

I repeat that I certainly have every intention of consulting the Ministry on any active venture of a novel kind which we might make, in particular we may have one shortly in the Caribbean, but there are too many loose ends at present to put it to you.

(Sgd) C J Hayes

M G Smith Esq,  
Ministry of Overseas Development.

## 1 THE MINISTRY RECORD

**Note of Meeting in Sir Geoffrey Wilson's Room  
at 2.30 p.m. on Friday, 24 April 1970**

Present: Sir Geoffrey Wilson  
Mr R B M King  
Mr M G Smith  
Mr E C Burr  
Mr C J Hayes } Crown Agents  
Mr A H Challis }

1. Sir Geoffrey Wilson referred to previous informal conversations with Mr Hayes about the Crown Agents. He himself had taken the view that while the position of the Crown Agents might be thought anomalous it was as well to let it continue provided that public attention was not called to it. However the Crown Agents activities were spreading and they seemed constantly to appear in the news; the article in the 'Sunday Times' of 19 April which the Minister had seen was the latest example. It seemed necessary to take the previous discussions further.

2. The Minister was responsible for the appointment and presumably the dismissal of the Crown Agents but financial responsibility was not covered in any documents. The Crown Agents acted on behalf of overseas principals but had no operational nexus with HMG in the UK; their only receipts from HMG were for services rendered. The Ministry did not nowadays approve the Crown Agents' charges. They sent copies of their accounts to the Ministry before they were published. He accepted that the fact that the accounts were audited by Exchequer and Audit Department was evidence that little could go wrong in this field.

3. He asked Mr Hayes how he saw things developing in future and in particular how he saw the Crown Agents' operating as a principal affecting the Minister's position.

4. Mr Hayes admitted that there had been some failure to keep Sir Geoffrey informed. He regarded the 'Sunday Times' article as personally motivated and it was agreed that the article as such need not enter into the discussions. The Crown Agents were doing what they had always done. They had not changed their general direction. Looking back it had appeared in 1962 that HMG was not interested in the Crown Agents who had to look after themselves. They decided to enlarge the area of their business for Colonies which had become independent but financially they had been through a severe crisis and had to promote business in order to retrieve their position. By 1967-68 they had built it up again both with traditional business and in new directions, including purely financial transactions. These were the only parts which were profitable; the Crown Agents were, and still are, losing money on procurement. In 1967 they had decided that the finance business should subsidise the procurement and recruitment business and build up a substantial reserve. This had not been needed in Colonial days because of HMG's implicit underwriting of the Colonial Governments but a need for it had emerged as the Colonies became independent, both for working capital because their principals did not keep money on deposit here (the Crown Agents had indeed recently provided an overdraft of £1m to Ceylon which was half their reserve) and because there was a risk that countries might repudiate obligations which the Crown Agents had incurred on their behalf. Although the Crown Agents were only agents it might be in the general interest of their clients for them to meet such obligations.

5. In 1967 they had aimed at accumulating a reserve of £5m over 7 years. This had been discussed informally in ODM and they had set about it. They did not make enough money on their brokerage, etc margins to accumulate funds and they had therefore traded in securities both on behalf of their principals who included Governments and central banks with a little bit in addition which could be money which the Crown Agents had borrowed or accepted on deposit from outside institutions. They did not consider whether particular investments or parts of investments were on their own behalf or on behalf of their principals; everything they did was ultimately for the benefit of their principals.

6. There was some discussion as to the ownership of the reserves and Mr Hayes said that this was not clear. The Crown Agents held them but there were differing opinions as to whether in the last resort they would revert to the Crown or to the overseas principals. Mr Hayes thought their principals would expect a distribution based on the old practice of Crown Agents making such a distribution of profits from time to time.

7. There was similar discussion about debts or obligations incurred by the Crown Agents. Mr Challis did not think that the principals would be held liable for these but that it might be found that the Crown had to carry any such debts. Sir Geoffrey Wilson suggested that disposal of reserves and meeting debts ought to run together.

8. Mr Hayes and Mr Challis pointed out that in their investment and money market transactions they incurred risks only commensurate with maintaining the right degree of liquidity and that there was no real risk. In First National Finance Corporation for instance they held only 8% or 9% as a portfolio investment on behalf of their depositors.

9. Some of their operations were at their discretion on behalf of their principals and other principals gave them instructions: in some cases they acted as principals. Any principal could see from the Crown Agents' accounts the state of the reserve. They thought that they would lose business if they increased their fees. The present book value of the reserve was over £3m.

10. Sir Geoffrey Wilson and Mr King agreed that it was prudent for the Crown Agents to build up a reserve but Mr King raised the question whether the Crown Agents were the right type of organisation for the job they were doing. Their function had changed with the process of independence so that they themselves were now a quasi-independent organisation. Final responsibility needed to be defined. If the Minister was responsible for the appointment of the Crown Agents it was impossible to avoid the conclusion of the residual responsibility falling on her.

11. Mr Hayes questioned whether a different organisation was needed. He thought that things could be left as they were and the Crown Agents to get on with their job. The alternatives appeared to the meeting to be either a commercial organisation or a body linked in some way with HMG. In 1964 the question of incorporating the Crown Agents by Royal Charter had been examined. It was suggested on the one hand that the main reason why those discussions broke down was the position of the Crown Agents' staff; on the other hand Mr Hayes suggested that it might have been because of the difficulty on defining the Crown Agents' functions a difficulty which he thought remained. It was pointed out that the Crown Agents themselves had no legal personality. Mr Smith said that the Crown Agents performed functions and had an 'image' which we did not wish to lose. He suggested that some form of constitution perhaps similar to that of the statutory corporations but which recognised them as an emanation of the Crown might be considered. Mr Hayes and Mr Challis did not think this would be possible. Mr Smith remarked that the Treasury were taking an interest in the



question of ultimate financial responsibility and this implied the question of general responsibility. HMG itself had no direct interest except in so far as the Crown Agents operated on behalf of the few remaining dependencies.

12. Sir Geoffrey Wilson recognised the merit of what Mr Hayes had said and that might be the ultimate answer. However times and personnel changed and the constant news items provoked discussion. Mr Hayes said it was their policy to make their activities known. Sir Geoffrey Wilson mentioned the possibility of a Working Party including the Ministry, the Crown Agents, the Treasury and the Civil Service Department, to look into the question but Mr Hayes questioned the inclusion of either the Treasury or the Civil Service Department. So far as taxation was concerned they gained no advantage from their position as Crown Agents and they were fully open to the Inland Revenue, although they might obtain some advantage in the markets merely because they were the Crown Agents. Even if they did the proceeds merely accrued to their reserves.

13. It was agreed that the Ministry would consider further what, if any, talks should take place with the Crown Agents about their constitution and operations and it was suggested that the Crown Agents also should consider this. The Crown Agents undertook to provide a statement of the bodies in which they had an interest, such as would involve them in the management.

E C Burr  
5 May 1970

## 2 SIR CLAUDE HAYES'S RECORD

### Record of Meeting

Mr Challis and I went to a meeting with Sir Geoffrey Wilson, Mr R B M King, Mr M G Smith and Mr E C Burr, at the Ministry of Overseas Development on Friday 24 April. The purpose of the meeting was to discuss the constitutional position of the Crown Agents.

2. It was obvious that the cause of the meeting was the 'Sunday Times' article on 19 April referring to the Crown Agents financial operations 'in their own right' and to some extent a previous press notice of our involvement in Tradewinds.

3. Mr M G Smith was particularly resentful about the Tradewinds investment without his being aware of it. We explained that this was a very minor investment in terms of cash and that it was a very useful investment in terms of air freight to our West African Principals.

4. We explained that the Crown Agents are not carrying out financial operations 'in their own right'. I gave the history of the decision reached in 1967 that we should look to our Finance Department to expand its activities in order to build up a reserve of £5 million over seven years. I pointed out that the reason for this decision was that we were told in 1963, or thereabouts, that we were 'on our own' and that HMG no longer had any financial responsibility whatsoever for us (except, perhaps, in respect of specific commitments on behalf of remaining dependencies). It was therefore essential that the Office should build up a reserve sufficient to provide working capital and a fall-back reserve, and £5 million was small in relation to trading activities of £80 million a year. We said that since the sole purpose of our financial activities was to build up a reserve which was in turn solely in the interests of our Principals, these activities were clearly in the interests of our principals, and the Crown Agents could not be said

to be trading 'in their own right'. It was true, nonetheless, that in addition to investing our Principals' money we were operating inter-bank in the name of the Crown Agents as a whole and not specifically on behalf of Principals. This was because the fee or turn on the ordinary investment transactions of Principals' money would not build up the reserve we needed.

5. Sir G Wilson said that in the light of recent press reports there had been consideration by the Treasury of our position and the Treasury had come to the conclusion that HMG had a residual responsibility for the Crown Agents, for instance in the sense that if the Crown Agents incurred deficits which they could not meet or went out of business leaving debts, HMG would in practice have to assume responsibility. I said that this was not what we had been told seven years ago and that if this is now the Treasury's view it transforms the situation since it reduces the pressing need to have an adequate reserve against remote calamities (though it does not remove the need for an adequate working capital and sensible liquid reserve). Sir G Wilson said that in view of this presumption of an ultimate Exchequer responsibility, it was felt in Whitehall that we ought to have Whitehall discussions on the Crown Agents' position. These would involve the Treasury and the Civil Service Department as well as the ODM. Such discussions might lead to a conclusion that the Crown Agents should become independent and commercial, or that they should reconsider the question of some public constitution such as a Royal Charter, but more probably that things should be left as they are. When I said that this had been the conclusion of previous discussions, Sir G Wilson said that perhaps it was as well to have such discussions every five years or so. I said that (since it was obvious that the decision to have discussions had already been taken) we should much prefer informal discussions among a few people who knew the situation and that we were in no position to write lengthy committee papers informing from scratch people who had no background knowledge of the Crown Agents and their work. Sir G Wilson said that he had in mind asking Mr Philip Rogers from the Civil Service Department.

6. In the course of these discussions Sir G Wilson and Mr Maurice Smith repeatedly raised the question of 'freedom from tax'. We made it quite clear that the Crown Agents were and could not be free of tax. We said that all our activities were known to the Inland Revenue who conducted regular thorough investigations of them. We also said that our two subsidiary companies submitted accounts like any other registered company and were subject to income tax deducted from their dividends and to Corporation Tax on any profits. We explained that where we were exempted from tax as a public fund on dividends received for the common funds, these dividends had to be claimed in each case from Inland Revenue who investigated every case before refunding them. I hope, therefore, that we have made it clear that the tax question is one between the Crown Agents and Inland Revenue and no responsibility of the ODM or the Treasury.

7. I undertook to send to the ODM a list of the investments which we have made directly for the benefit of our activities for Principals and in which we have assumed some management participation. I pointed out that the ODM have been consulted about the major investments such as Sassoons and TVR and that the working arrangement between my predecessor and Sir A Cohen was that minor investments would not be the subject of consultation. This covered the Caribbean Bank and Tradewinds.

(C J Hayes)  
27 April 1970

cc Mr Morris  
Mr Challis

## MINUTE BY SIR GEOFFREY WILSON TO THE MINISTER

## Crown Agents

For some months now, we and the Crown Agents have been trying to get an agreed statement about their history, constitution (such as it is) and activities on the basis of which you could decide whether you would like to make any changes and, if so, what. Mainly owing to absences abroad, this agreed statement has been delayed and will not be ready before I leave. I have, however, seen a fairly final version of it and this note represents the advice I should give you if I were still here when the final version appears.

2. The problem is that you appoint the Chairman and the other Crown Agents (only one at the moment) but, having made the appointments, you have little or no control over their subsequent activities, mainly for the reason that some 95% of their work is performed as agents for overseas principals and a comparatively small part is performed for HMG or for the remaining colonies. Yet, whatever the precise legal position may be, I have no doubt at all that if they were to get into financial difficulties, HMG would have a moral obligation to bail them out and if they did anything silly, either politically or financially, you could be seriously embarrassed. The question therefore is whether anything can or should be done to relieve you of this potential embarrassment or, at any rate, to minimise the risk.

3. A good many proposals have been put forward for regularising the legal position, eg an Act of Parliament, a Royal Charter, Letters Patent under the Chartered Companies Act, Order in Council, or Incorporation under the Companies Act. Any of these might produce a tidier and more logical system than we have at present, but there are great difficulties in the way of all of them, and none of them, with the possible exception of Incorporation under the Companies Act, goes to the root of the problem, ie who appoints them. So long as you appoint the Chairman and the other members, it seems to me that you are bound to have a measure of responsibility for their actions, no matter what the precise legal position may be. The crux of the matter therefore is (a) who appoints them and (b) if you do, is there any tolerable way of minimising your liability?

4. In theory it would no doubt be possible to hive the Crown Agents off entirely and to set them up as a wholly independent commercial concern, although I am far from clear how this would be done, eg who would be the shareholders, who would appoint the Chairman and other members of the Board, and would the existing overseas principals be willing to entrust these functions to a commercial undertaking divorced from HMG. I do not believe that matters have reached a stage where we should contemplate anything of this kind. I therefore think that you (or, rather, the Foreign Secretary) should continue to make the appointment. Some people think that you might minimise the risk by exercising more control than at present over the activities of the Crown Agents. I do not myself believe that this is either possible or desirable. We do not have the competence or commercial expertise to supervise their activities in any meaningful sense. In any case, having appointed presumably competent people to run the thing, I think we should let them get on with the job without looking over their shoulder to see if they are doing it in a responsible way. On the other hand, I do think that, if they want to do something unusual, or which they think might be potentially embarrassing to you, they should ask you beforehand whether you have any objection. This would, of course, leave it to them to make the running, but this is how I think it ought to be. With this safeguard, I think the extent to which you are at risk is quite minimal. The Crown Agents have conducted their affairs sensibly and

efficiently in the new circumstances of the last ten years and, in my view, there is no reason for any change.

5. If, however, you feel that the present arrangements leave you too much at risk, you might perhaps consider setting up a small committee, composed of eg a High Court Judge, a Merchant Banker and a retired Civil Servant (eg Sir Richard Powell or Sir Alexander Johnston) to consider the present set up. I think the terms of reference of any such committee should be to consider whether there are any good reasons for changing the present arrangements and, if so, how, and that they should be discouraged from volunteering some quite new way of arranging this business.

6. The Civil Service Department, the Treasury and the other wing of the FCO are concerned in this and their views should be sought in due course.

21 December 1970

## COPY OF LETTER FROM MR P W NOWERS TO SIR STEPHEN LUKE

13 August 1971

Some weeks ago you came to see me about the 1970 accounts and you then pressed some concern at the way the Office has become involved in many ventures and about the losses which have already been sustained. There are many of us in the Crown Agents who share your concern and it occurred to me that you, as an elder statesman whose views still command respect, might be able to exert some influence towards a return to sanity.

The seriousness of the position not only of the Finvest operation but of the JCF will be apparent from this statement of the approximate state of surplus/deficit at 31.12.70, a position which I do not think has been explained in so many words to the Chairman or Mr Morris.

	Office £000	Finvest £000	JCF £000	JMF £000
Surplus of assets over liabilities at book values ... ..	3,818	640	212	234
Less unrealised losses on investments ... ..	—	2,895	1,649	2
Surplus/deficit at market values ...	+3,818	—2,255	—1,437	+232

The net of those figures gives the true reserves of just £358,000 against the risks of the following situations:—

Unsecured overdrafts to Principals.

Unrealised losses on unquoted shares.

Guarantees on loans.

Possible loss of borrowed money advanced to associates—

eg Sterling Industrial Securities and English and Continental Properties.

Any deficit or significant exceptional losses arising out of our traditional operations.

All that has happened seems to me to be evidence that the Office has lost its sense of direction in, for want of better description, a spiritual sense. From money being needed as reserves against the hazards of our traditional activities we are becoming geared to money-making as an end in itself. You must have noticed the increasing proportion of time at Board meetings given to commercial activities. While the Departments concerned with services to Principals are being screwed down more firmly to their budgets there appears to be no control and a bottomless well of finance for the financial sector to call on whilst they appear to have first call on the most promising staff—to the detriment again of our services. Our annual accounts, from being an account of our stewardship to our Principals showing what we have earned and what we have spent, have to shift their emphasis to showing our asset-strength. The guest list for the Summer reception showed nearly half the visitors to be from the financial sphere and only just over half from all other activities.

Our position is a difficult one. We have to try to combine an almost dedicated standard of service externally with highly commercial standards of internal organisation and financial control. The evidence of our continuing levels of business confounds the cynics who say that nobody wants or needs us any more but I feel we must make a positive choice as to the future direction of our activities. Either we must return to the concentration of our main energies on services to Principals or we must abandon

the pretence, turn ourselves into Crown Agents Limited and try to be successful at that. At present we are tending to neglect the one and to fail at the other.

You will recall that the Finvest operation was started with the object of raising over a short term of years the reserves which the Office needs but which seem unlikely to arise from surpluses on our traditional activities. Initially the operations were limited to on-lending in the money market and the continuing success of this activity is shown by the following records:—

	Annual surplus £000	Cumulative surplus £000
Closing months of 1967 ... ..	50	50
1968 ... ..	385	435
1969 ... ..	566	1,001
1970 ... ..	785	1,786
First half of 1971 ... ..	786	2,572

Against the accumulated surplus must be set two large losses. The £1 million loans on Vehicle and General arose from a bad error of judgement and suitable precautions could for practical purposes prevent any repetition. The Mersey Docks affair (probable loss £½ million) caught many other institutions as well as the Crown Agents and must be seen as a once in a century occurrence although it carries the lesson of not taking anything for granted. After these losses there is still a surplus of £1 million and on the record of 1971 so far this could be added to at the rate of £1½ million per year.

Unfortunately other ventures were undertaken, some of them involving a large element on speculation. When the realised profits and losses of these activities are taken into account the record is very different as this statement shows:

	Money market annual surplus £000	Other activities realised annual surplus/deficit £000	Cumulative overall surplus/deficit £000
Closing months of 1967 ... ..	50	—	+58
1968 ... ..	385	—	+435
1969 ... ..	566	—578	+423
1970 ... ..	785	—145	+1,063
First half of 1971 ... ..	786	—624	+1,225
Less provision for loss on Vehicle and General and Mersey Docks			1,500
<i>Deficit on Finvest from the start of operations to 30.6.71</i>			<u>275</u>

In addition to the realised losses and the known unrealised losses there are a number of situations of potential loss which may or may not eventually be resolved without losses being actually realised, whilst the Office is at risk in enormous sums. A presentable balance sheet for 1970 covering all activities can be produced only by the device of writing up the value of our office buildings and resorting to other measures of concealment which Towse and I view with the strongest distaste.

I realise that I have dealt very much with the losses and on things that have gone wrong. There have, of course, been some successes and some of the situations of potential loss may well be resolved satisfactorily but it is fair to say, I think that the successes have been fairly few in number although those few have been, fortunately, highly successful.

With hindsight it is easy to see that had we limited our activities to the money market we should now be £1 million on the way to accumulating the reserves we need, even after providing for the V & G and Mersey Docks losses. The losses incurred by other activities, losses which are continuing in some cases, must be written off as the price of experience but they will be total loss only if we fail to learn from them. The lessons seem to me to be clear enough.

To my mind the first essential is not to embark on any further adventures whatever except where our traditional activities would be positively assisted and no element of risk would be involved. Enough of our ventures have proved to be losers or to offer so little prospect of profit as to demonstrate that even the most glittering swans can prove to be geese.

Secondly, I think every single venture should be given a really hard-headed appraisal with a policy of disengaging ourselves, accepting losses if necessary to avoid the accumulation of further losses, from all but those which are demonstrably successful. Above all, this operation must eliminate the huge areas of risk to which the Office is exposed (eg loans of £20 million to English and Continental Properties). I recognise that disengagement might be difficult where principals are involved as partners in a venture.

To complete the rescue operation we should, over a period and as profitably as possible, ease ourselves out of speculative equity investment and other speculative activities which overall have cost us dear. We have been badly advised—and in some instances used quite unscrupulously I am sure—by brokers and we should no longer expose ourselves to such hazards.

With the whole operation fined down to basically the money market and a few carefully selected profitable ventures the Office could settle down to the steady accrual of a minimum of £1 million per annum with the prospect of considerably more. The £7 million of reserves required would be built up over four or five years without loss, without risk and at a considerable saving in costs.

I had drafted out most of this letter before the exposé appeared in the 'Guardian'. My first reaction to that article was that events had overtaken me but on reflection it seems that there is an even more urgent need for prompt action to put our house in order.

Yours sincerely

(P W Nowers)

Sir Stephen Luke KCMG  
E D Sassoon Banking Co Ltd  
Winchester House  
100 Old Broad Street  
London EC2

## Annex E to the Stevenson Report

## 'HARD-CORE' \*LENDING FROM CROWN AGENTS BANKING FUNDS

at

†July 1971 ‡31 December 1971

	£'000	£'000
4 Millbank Investments Ltd ... ..	8,750	9,404
English and Continental Property Co Ltd ... ..	23,000	15,300
First National Finance Corporation Ltd ... ..	15,000	12,300
Abbey Orchard Property Investments (Australia) Ltd ...	2,400	6,171
Sterling Industrial Securities Ltd ... ..	3,000	4,000
E D Sassoon Banking Co Ltd ... ..	2,750	2,500
Singapore International Merchant Bankers Ltd ...	—	190
Caribbean Bank Ltd ... ..	95	95
Crown Continental Merchant Bank (Jamaica) Ltd ...	600	920
<b>Total ... ..</b>	<b>55,595</b>	<b>50,880</b>

\* CA consider that the genuine 'hard-core' should be stated as £30-£40m; see paragraph 6.32.

† July 1971 was a period of maximum exposure; see paragraph 6.31.

‡ Figures for 31 December 1971 are provisional.



## ENGLISH &amp; CONTINENTAL PROPERTY CO LTD

## Approximate Balance Sheet at 31.1.1973

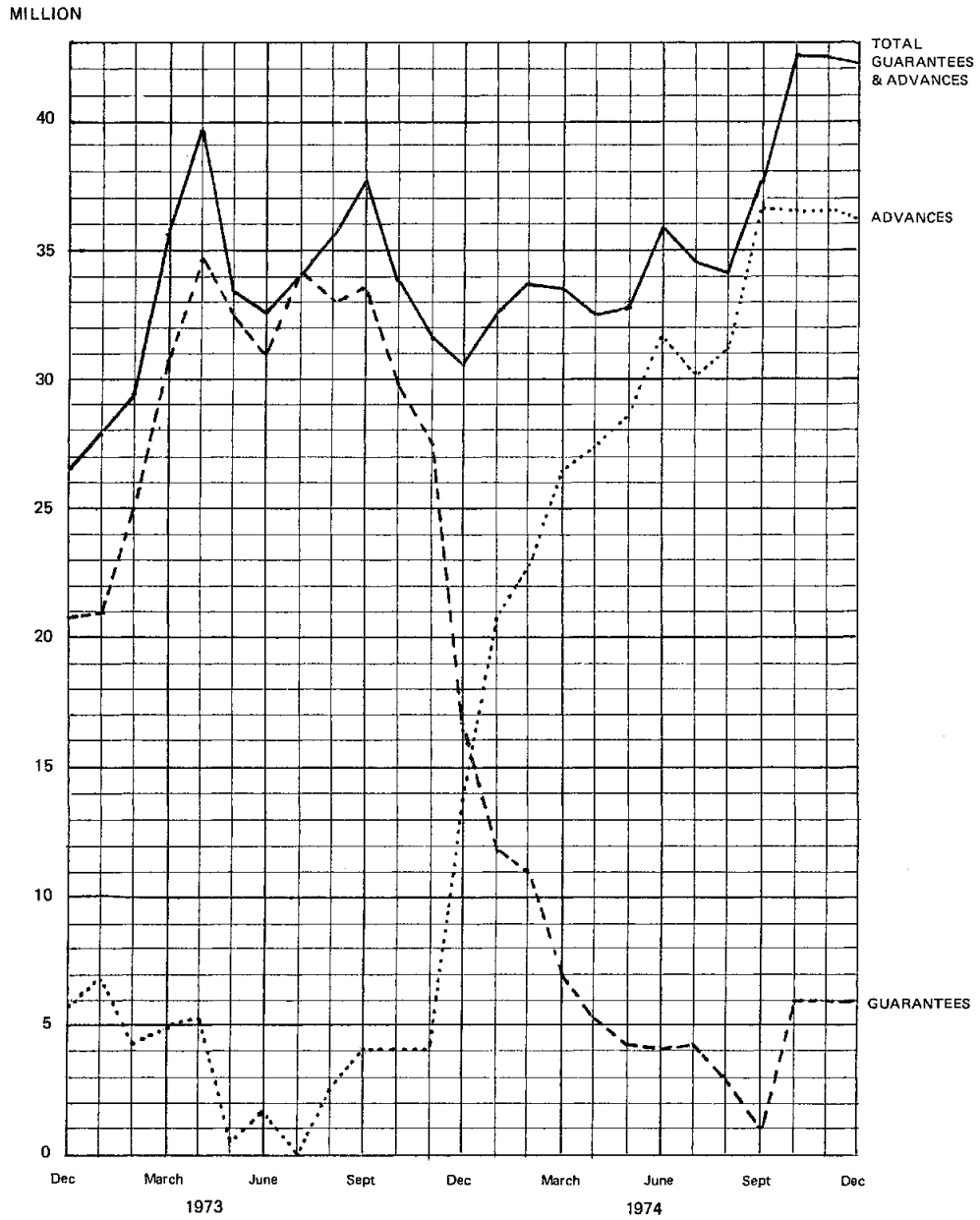
	£m
<b>Sources of Finance</b>	
Crown Agents' direct advances ... ..	7.0
Third party loans supported by Crown Agents' comfort letters	21.0
Other liabilities ... ..	0.5
Share capital and reserves ... ..	1.2
	<u>29.7</u>
<b>Application</b>	
Advances to—	
E & C Homes ... ..	16.7
Other E & C companies ... ..	0.9
	<u>17.6</u>
Expenditure on new developments—	
Cutler Street ... ..	3.0
Westinghouse ... ..	0.4
Manchester Central Square ... ..	1.3
Others ... ..	3.8
	<u>8.5</u>
Quoted investments ... ..	1.7
Other assets ... ..	1.9
	<u>29.7</u>

## NOTES—

- Assets and liabilities taken over by POSSFUND but which by agreement between the parties remained in ECP's books during 1973 are excluded.
- Contractual commitments existing at 31.1.1973 to complete the following purchases are not included—

	£m
Cutler Street ... ..	10
Manchester Central Square ...	3
Westinghouse ... ..	3
	<u>16</u>

GUARANTEES & ADVANCES TO ENGLISH & CONTINENTAL COMPANIES: JANUARY 1973-DECEMBER 1974



Mr Wheatley

STERN FAMILY HOLDINGS

We are aware that Mr Stern would like us to participate in a triangular arrangement involving Stern Family Holdings, Nation Life and CAA, whereby we would take in money from Nation Life and simultaneously lend it to SFH with, of course, a reasonable turn on the money.

We think the amount in question is likely to be *about* £5m and the term 10 years. There are legal and technical reasons to prevent a straight back to back transaction, and therefore the leg which involved our lending to SFH would represent unsecured lending in our terms. As SFH are already up to their present ceiling for unsecured borrowing from us, I have consulted the Director and after making the best appraisal of Mr Stern and his operation which we could, he and I are of the opinion that if Mr Stern cared to give his personal guarantee of the money so lent, in due legal form, we could accept it and do the business.

Accordingly, I shall be glad if you will discuss this with him at lunch today, and if he is minded to fall in with our idea we should please tell him that as a matter of formal business we shall need to have legal approval of the guarantee document and it will need to make appropriate provision for the contingency of his decease. At the same time, we should do what we could to smooth the path and seek to avoid a protracted business with Lawyers.

Let us see what he thinks about this.

(N Hewins)

13.3.73.

NH/MK

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STATUS, STRUCTURE AND RESPONSIBILITY OF THE CROWN AGENTS  
MAIN PRINCIPLES

1. The appointments of the Chairman and any other Crown Agents are made by the Secretary of State (or by the Minister on his authority) for such periods and on such terms and conditions as he may determine.
2. Appointments as above involve the Crown Agents being subject to the direction of the Secretary of State (or the Minister for Overseas Development acting on his behalf), but Ministers will not normally propose to be concerned with particular transactions between the Crown Agents and a Principal.
3. The Crown Agents will keep in close touch with the Minister on major matters affecting the nature and scope of their activities whether or not these involve the Crown Agents in consultation with other Government Departments.
4. Financial business on the Crown Agents own account will in general be conducted on the basis of the trustee analogy, but other investments which are prudent and consistent with the name and standing of the Crown Agents would not be excluded. It is intended that the Crown Agents shall be guided in these matters by non-executive Directors of the Crown Agents' wholly owned investment company appointed after consultation with the Secretary of State.
5. The Crown Agents will maintain a prudent level of reserves and shall not distribute their assets except with the consent of the Secretary of State. Further, 4 Millbank and other premises used by the Crown Agents for their business shall not be disposed of without the prior consent of the Secretary of State.
6. The Crown Agents will not enjoy the benefit of exemption from taxation. This will have no effect on any taxation exemption which overseas governments and authorities may have in regard to income from services, and proceeds from investments, managed for them by the Crown Agents.
7. Directly employed staff of the Crown Agents whose terms and conditions of service have been analogous to those of the Civil Service will continue to be treated on this basis, and similar arrangements will apply to future such staff. The grading of posts at director level and above is a matter for specific agreement with the Minister.

## FINANCIAL SUMMARIES, 1966-1974

**Introductory Note**

We have prepared the following tables:—

1. Assets and liabilities
2. Lending to major borrowers
3. Own-account property investment
4. Diversion of banking funds to long term investment
5. Profits and losses

These tables show on a consolidated basis the assets and liabilities and the results of the funds and the subsidiary companies under the Crown Agents' immediate control, viz, the Office Fund, including Finvest, the JCF, JMF, Millbank Technical Services Ltd, Four Millbank Investments Ltd and Four Millbank Securities Ltd (the company which took over the long term assets of FMI in 1974).

With the exception noted below the tables are based on the audited accounts of the separate funds and companies, or, where available, the consolidated accounts. We have made such adjustments as we considered necessary to put the tables on a reasonably consistent footing from year to year. No audited accounts of the Crown Agents' overseas investments were available for 1966 or 1967 or for Finvest for 1967 and unaudited figures have been used. The amounts involved are (£m):—

				1966	1967
Finvest	...	...	...	—	21·0
Overseas investments	...			0·3	2·3



Table 1—Assets and Liabilities—1966-1974

		£ million										
At 31 December		1966	1967	1968	1969	1970	1971	1972	1973	1974		
		Notes										
<b>ASSETS</b>												
Banking assets												
Liquid assets and advances to major banks	...	1	168.8	156.7	83.9	134.2	154.7	238.1	217.6	185.8	445.4	
Advances to principals	...		14.8	13.6	9.8	8.0	5.2	9.8	14.7	16.1	18.0	
Advances to secondary banks, property companies and others	...	2	24.7	16.1	66.6	100.0	199.1	114.7	128.3	187.7	150.1	
			208.3	186.4	160.3	242.2	359.0	362.6	360.6	389.6	613.5	
Provision for losses and doubtful debts	...									8.6	86.5	
										381.0	527.0	
Investments, mainly at valuation												
Quoted	...		0.3	2.8	11.3	20.8	18.6	22.3	32.3	23.6	3.4	
Associates and other unquoted	...		—	1.0	1.1	1.2	5.0	7.3	9.6	15.1	7.9	
			0.3	3.8	12.4	22.0	23.6	29.6	41.9	38.7	11.3	
Own-account property investment	...	3	—	—	—	4.5	18.4	31.2	46.3	61.4	86.4	
Provisions for losses	...		—	—	—	—	—	—	—	—	31.6	
			—	—	—	2.0	6.1	6.3	9.4	27.5	54.8	
Property in own occupation, at valuation	...		208.6	190.2	174.7	270.7	407.1	429.7	458.2	508.6	613.8	
<b>LIABILITIES</b>												
Principals' deposits	...		202.7	163.9	118.5	201.6	303.1	299.9	252.5	287.3	485.8	
Borrowed on money market	...		—	23.0	47.5	64.3	99.8	111.1	174.3	151.7	81.5	
Other current liabilities	...	4	2.7	0.4	3.8	0.3	0.5	9.3	14.1	33.1	61.2	
			205.4	187.3	169.8	266.2	403.4	420.3	440.9	472.1	628.5	
RESERVES ATTRIBUTABLE TO THE CROWN AGENTS			3.2	2.9	4.9	4.5	3.7	9.4	17.3	36.5	(14.7)	

## NOTES:

- 1 Liquid assets include cash balances and money at call and short notice with major institutions, UK Government stocks, Treasury bills, certificates of deposit and local authority bonds.
- 2 With advances to secondary banks and property companies are also included commercial loans, personal loans, loans for North Sea oil exploration and investments in assets leased under hire purchase agreements. The history of advances to certain individual borrowers dealt with in the report is summarised in table 2.
- 3 Own-account property investment includes both direct investment and investment by shareholdings and loans in English & Continental and in the Australian property companies. Fuller details are shown in table 3.
- 4 Other current liabilities include deposits received by MTS from Principals in respect of major contracts as follows: 1971 £4.9m, 1972 £7.2m, 1973 £8.9m, 1974 £52.0m.









Table 4—Diversion of banking funds to long term investment

	£ million										
	At 31 December										
	1966	1967	1968	1969	1970	1971	1972	1973	1974		
Liabilities, per table 1 ... ..	205.4	187.3	169.8	266.2	403.4	420.3	440.9	472.1	628.5		
Banking assets, per table 1 ... ..	208.3	186.4	160.3	242.2	359.0	362.6	360.6	381.0	527.0		
Banking funds diverted to long term investment ... ..	sufficient assets		9.5	24.0	44.4	57.7	80.3	91.1	101.5		

Table 5—Profits and losses 1967-74

	£ million										
	1967	1968	1969	1970	1971	1972	1973	1974			
<b>NET INCOME FROM TRADITIONAL SERVICES</b>											
Financial ... ..	0.6	0.3	0.4	0.4	0.4	0.2	—	0.1			
Procurement, advisory and other ... ..	(0.6)	(0.8)	(0.6)	(0.5)	(0.1)	(0.5)	0.1	(0.5)			
	—	—	(0.5)	(0.2)	(0.1)	—	(0.3)	0.1			
<b>OWN-ACCOUNT FINANCIAL OPERATIONS</b>											
Net profit realised ... ..	(0.9)	—	0.2	(0.3)	1.5	3.2	19.6	(0.6)			
Less provision for tax ... ..					(0.9)	(0.2)	(5.9)	(0.6)			
	0.3	0.2	(0.4)	(0.1)	0.6	3.0	13.7	(1.2)			
Revaluation of investments ... ..	—	—	—	(0.1)	3.5	0.2	0.4	—			
Provision for losses ... ..	—	—	—	(4.8)	1.6	0.5	(13.8)	(124.6)			
Foreign exchange differences ... ..	—	0.3	—	0.1	(0.3)	4.1	2.1	(3.0)			
	(0.6)	0.5	(0.2)	(5.1)	5.4	7.8	2.4	(128.8)			
<b>NON-TRADING ITEMS</b>											
Revaluation of property in own occupation ... ..	—	—	2.0	—	4.4	—	0.4	16.7			
Government grant ... ..	—	—	—	—	—	—	—	85.0			
	(0.6)	0.5	(0.2)	(5.1)	5.4	7.8	2.4	(128.8)			
<b>SURPLUS/(DEFICIT) FOR YEAR</b>	(0.6)	2.0	(0.4)	(0.8)	5.7	7.9	19.2	(51.2)			
Balance from previous year ... ..	3.2	2.9	4.9	4.5	3.7	9.4	17.3	36.5			
Appropriation of MIF reserve ... ..	0.3	—	—	—	—	—	—	—			
<b>RESERVES/(DEFICIENCY) AT 31 DECEMBER...</b>	2.9	4.9	4.5	3.7	9.4	17.3	36.5	(14.7)			

## NOTES:

- 1 Bracketed figures represent losses, charges against income or deficits; plain figures are surpluses or credits to income.
- 2 The income of traditional surpluses is fees, mainly charged to principals but in the case of financial services it includes management fees charged to the Joint Funds and to Finvest.
- 3 The net profit realised from the own-account financial operations includes investment income, interest received and profits on investments, less interest paid and losses on investments.
- 4 The £19.6m surplus for 1973 includes £17m on the sale of E&C to POSSFUND. The tax charge of £5.9m mainly relates to this profit.





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