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**HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ**

21<sup>st</sup> December 2007

Sir Callum McCarthy  
Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London  
E14 5HS

Dear Callum

#### **FINANCIAL STABILITY**

Thank you for your letter of 26 November. We met on 28 November to discuss your letter and subsequently discussed this with the Bank of England Governor on 10 December. I note that your assessments of the market conditions facing us are broadly similar.

Following the Governor's letter of 11 December, and as we discussed earlier this week when we met with the Governor, I welcome the joint announcement this week, made with the other major central banks, along with the arrangements that the Bank of England put in place earlier this week. These steps should help to ensure that there is sufficient liquidity in the money markets over the year-end period and in the early months of 2008, which is likely to present particular difficulties for a wide range of banks and other financial institutions and in turn the system as a whole. I am pleased to see that the money markets have reacted favourably to these announcements.

We have been working together to help individual institutions facing stress as well as attempting to minimise the risks of other institutions getting into similar situations and presenting risks to the system. The FSA, in many cases working closely with the Bank, is continuing to work closely with the most affected institutions. I am grateful for the work being done to put in place contingency arrangements. And the Treasury and the DMO are supporting the Bank in these efforts by making sure that it has sufficient instruments and resources.

However, despite all of these steps, I remain very concerned about the outlook for the next few months.

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It is clear from discussions with the major financial institutions that they do not expect these market conditions to dissipate quickly. In particular, they remain affected by the continued problems in the securitisation markets and are worried by the lack of inter-bank lending taking place and the prices being charged. We are, of course, also all involved in work on Northern Rock that may have implications for confidence in the broader financial market situation.

I would therefore be grateful for further advice on two points:

- first, on what further steps, if necessary, could be taken to re-establish confidence in the markets, either by the UK alone or on a coordinated basis with other major countries. I would be particularly interested in your views on the prospects for working with industry – both the banking sector and investors – to establish new, higher standards to bring confidence to new issues of mortgage-backed securities, given the lack of confidence about these products – including worries about the integrity of the processes behind them. Such steps might be the precursor to changes in the regulation or organisation of these markets in the future;
- second, on further contingency planning with financial institutions. In particular, how the authorities could press financial institutions more effectively to be better prepared for handling sudden pressures – in short, learning lessons from Northern Rock's experience. This could for example, be done through a generic statement that might provide the cover for working more closely with individual firms.

*Lewis Neal*

**ALISTAIR DARLING**

*(pp Approved by the Chancellor and  
signed in his absence)*