



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

20 January 2008

Callum McCarthy
Chairman
Financial Services Authority
Canary Wharf
LONDON
E14 5HS

Dear Callum

Northern Rock Plc

We spoke on 18 January 2008 with Mervyn on Northern Rock Plc.

We discussed the proposal I am considering, on behalf of the Tripartite Authorities, for how we take forward discussions with the Board of Northern Rock plc, and potential buyers, on a private sector restructuring of Northern Rock Plc and the other options we have if a private sector restructuring cannot be achieved.

In our telephone call, I set out that the Government's position was that a private sector solution (which included a whole or partial company sale or a Board-led plan) backed by the Goldman Sachs financing structure was the preferred outcome but if no proposal emerged that met the Tripartite Authorities' objectives, the only fallback was public ownership. This was in the context that the Goldman Sachs work had concluded that the financing required for a private sector solution could not be provided by the market without Government support. Your officials have been kept informed on the proposed way forward and the steps that we might take. Attached to this letter is a more detailed summary of the announcement that could be made.

You said you were content with the approach on the basis that we were highly confident that the Goldman Sachs financing structure could be delivered. Mervyn said he was content but highlighted the importance of maintaining the Tripartite's negotiating position between any announcement and its resolution. We also discussed the idea of requiring some form of deposit from bidders, which we will consider further.



I outlined our approach to handling the announcement if we decided to proceed. This would be to set out the proposal to the Northern Rock Plc Board after the markets had closed today. Following this, an announcement would be made prior to the markets opening on Monday and I would make a statement to the House later that day. In this discussion, we agreed that: the potential bidders should not be informed in advance of the announcement and; the announcement to the markets should be made at 7am on Monday.

We discussed whether Northern Rock Plc shares should be suspended following any announcement. You said that this should not happen but indicated that this would need to be reconsidered if the market trading in the shares became unruly.

I attach a draft copy of the proposed announcement, and am writing in similar terms to Mervyn.

Yours sincerely

AL

ALISTAIR DARLING

NORTHERN ROCK

HM Treasury, on behalf of the Tripartite Authorities, today announces the basis on which the Tripartite Authorities are taking forward discussions with the Board of Northern Rock, and with other interested parties, on the potential for a private sector solution for the entire company, with a view to ensuring that all existing loan facilities provided by the Bank of England are repaid in full, with interest, immediately following closing of any such transaction and any future financial exposure of HM Treasury meets the objectives of the Tripartite Authorities.

This announcement also provides further information about the contingency plans of the Tripartite Authorities should a private sector solution not be achievable on terms acceptable to the Bank of England and HM Treasury, as providers of financial support to the company, and the Financial Services Authority, as its regulator.

BACKGROUND

As explained on 11 October 2007, the Tripartite Authorities' objectives in relation to Northern Rock are to protect taxpayers, to promote financial stability and to protect consumers. The specific objectives of the Financial Services Authority are set out in Part I of the Financial Services and Markets Act 2000.

On 19 November 2007, HM Treasury, on behalf of the Tripartite Authorities, published a statement of principles setting out how the Tripartite Authorities, acting in their respective capacities, expected to approach proposals for the future of Northern Rock and its business, in particular considering the objectives against which the Tripartite Authorities expect to assess proposals made or received by Northern Rock.

EXISTING HM TREASURY GUARANTEE ARRANGEMENTS CONTINUE

The existing HM Treasury guarantee arrangements remain in place. Savers' money remains safe and secure.

FINANCING

Timetable and Process

The Tripartite Authorities are working closely with the company, and other interested parties, to develop a financing structure based on the outline terms described below that could be available to support a private sector solution, subject to the acceptability of detailed terms to the Tripartite Authorities, applying the principles published by HM Treasury on 19 November 2007.

HM Treasury and the Bank of England will have the right, at their complete discretion, to determine which, if any, of the proposals put forward by the company and other interested parties will receive their financial support. Any proposal would also need to satisfy the specific regulatory requirements of the Financial Services Authority. Accordingly, the Tripartite Authorities, acting in their respective capacities, will hold discussions with interested parties in relation to their proposals, in consultation with the Board of Northern Rock, where appropriate. Northern Rock has agreed to inform the Tripartite Authorities of any proposals made to it and make available relevant information about its group to interested parties.

The process of exploring this financing structure and determining whether there is a proposal for Northern Rock under private sector ownership that is acceptable to the Tripartite Authorities, acting in their respective capacities, will need to be completed in sufficient time to enable a

restructuring plan to be submitted to the European Commission by 17 March 2008 under European state aid rules. Accordingly, detailed proposals on which this plan can be based should be submitted as soon as possible and, in any event, must be received by the Tripartite Authorities by 4 February 2008.

A term sheet of the principal terms and conditions of the proposed financing structure will be provided to interested parties shortly.

HM Treasury and the Bank of England will make arrangements for the existing Bank of England facilities to be extended to 17 March 2008 to allow time to explore the proposed financing structure with Northern Rock and other interested parties.

Financing Structure: Background

In order to maximise the prospects of delivery of a financing solution that meets the objectives of the Tripartite Authorities in the current market conditions, the Tripartite Authorities in agreement with the Board of Northern Rock requested their retained financial advisers, Goldman Sachs, to evaluate options available for financing a restructuring of the company. The option they have proposed and which the Tripartite Authorities are willing to pursue with the Board of Northern Rock and other interested parties is described below.

It would be a condition of such financing structure that the net proceeds of the financing would be used immediately following closing of any transaction to repay in full amounts due under the existing Bank of England loan facilities, together with all accrued interest (including PIK interest).

Financing Structure: Principle Characteristics

Under the proposed financing structure, Northern Rock would sell a pool of its assets, consisting of residential mortgages, unsecured consumer loans and certain investment-grade securities, to a financing vehicle established for the purposes of the financing structure. The financing vehicle would fund the purchase of the asset pool by the issue of notes in the capital markets. The timely payment of principal and interest under the notes would be guaranteed by HM Treasury. HM Treasury's obligations under its note guarantee would be fully secured by a first priority interest in the asset pool. A fee would be payable by Northern Rock to HM Treasury for the provision of the note guarantee. All arrangement fees and expenses relating to the issue would also be paid by Northern Rock.

Each class of notes would bear a market interest rate which reflects the provision of the note guarantee by HM Treasury. The maturity date for the notes would be determined upon issue and would primarily be based upon assumed levels of principal repayments in the asset pool.

The asset pool would comprise assets having an appropriate value to support the issue of sufficient notes to make the payments to the Bank of England referred to above and to provide adequate liquidity for the company. Northern Rock would have the right to repurchase mortgages from the asset pool in certain circumstances, including where Northern Rock needs to substitute mortgage loans into the Granite master trust or its covered bond pool and it would otherwise have insufficient eligible mortgage loans to do so.

Because the value of the asset pool would exceed the initial purchase price paid by the financing vehicle, Northern Rock would retain a subordinate interest in the asset pool which would represent the difference between the asset pool and the notes in issue. This means that

any losses to the asset pool would first be borne by Northern Rock, protecting the taxpayer in the case of underperformance of the assets in the pool.

Principle Conditions

The Tripartite Authorities, acting in their respective capacities, have informed the Board of Northern Rock that they would be willing to explore with the Board, and with other interested parties, whether this financing structure can be made available in the context of a private sector solution put forward by such parties or by the company itself. This will involve a further assessment of whether any state aid which it involves could be approved by the European Commission. Any proposal would also need to satisfy the specific regulatory requirements of the Financial Services Authority. The Tripartite Authorities have informed the Board of Northern Rock that, in particular, the following principle conditions would need to be complied with in order to give adequate assurance that their stated objectives of protecting taxpayers, promoting financial stability and protecting consumers will be met:

- **Business Plan:** the successful proposal would need to be based on a robust and acceptable business plan that, in the context of the financial support proposed to be provided, satisfies both the stated objectives of the Tripartite Authorities and the requirements of European state aid legislation. This will require the plan to demonstrate that the company has sound prospects enabling it, in due course, to operate without Government support and acquire an appropriate standalone credit rating. The agreed plan would also need to provide for a fee to HM Treasury for its existing guarantee arrangements, increasing over time if such arrangements are continuing.
- **Protections:** for so long as HM Treasury's existing guarantee arrangements remain in place there would need to be appropriate protections that recognise the interests of HM Treasury as a provider of financial support to Northern Rock. In particular, the documentation would need to contain appropriate covenants in favour of HM Treasury to protect its interests during this period and support the delivery of the agreed business plan, including restrictions on dividends, prohibitions on change of control without HM Treasury consent and a range of other provisions appropriate for the provision of financial support of the kind contemplated. The documentation would also provide for HM Treasury to require Northern Rock to provide cash cover for HM Treasury's existing guarantee arrangements if certain events of default occurred.
- **Additional Capital:** the Tripartite Authorities would need to be satisfied that the company will have sufficient capital and liquidity to meet the requirements of the Financial Services Authority under a range of downside scenarios applied to the business plan, plus a significant buffer to protect taxpayers' interests (to be determined according to the requirements of the business plan). This capital would need to be committed as soon as reasonably practicable and in any event within 45 days of submission of the restructuring plan to the European Commission and would be in a form such as an underwriting commitment to subscribe for new Northern Rock ordinary shares or a completed issue of debt securities that would be convertible into such shares at closing which would be released or repaid (as the case may be) if the transaction were not completed for a reason outside the control of Northern Rock or its shareholders.
- **Management and Ownership:** any proposal must provide for ownership of the company and fulfilment of its management roles by suitable persons, having regard to the respective interests of the Tripartite Authorities.

- **Equity Participation:** as additional consideration for the provision of support from HM Treasury, HM Treasury would require an appropriate share in potential upside equity returns of the company. The details of such equity participation would be agreed as a condition to the financing structure. It is envisaged that such participation would be available until after the period that HM Treasury's guarantee arrangements remain outstanding.
- **State Aid:** implementation of the financing structure would require the submission by HM Treasury to the European Commission of an appropriate restructuring plan and the authorisation by the Commission of any state aid which it involves. The company and other relevant interested parties would be expected to assist HM Treasury with the preparation of such a plan. Implementation of the financing structure would follow receipt of the necessary state aid authorisation.

General

The financing structure is not an offer or commitment of any kind by the Tripartite Authorities or Goldman Sachs or a representation or undertaking by the Tripartite Authorities or Goldman Sachs that the financing structure can be implemented. The Tripartite Authorities and Goldman Sachs reserve the right to withdraw from the process of exploring or implementing the financing structure or any other proposal for Northern Rock at any time.

CONTINGENCY PLANNING

In order to ensure that their stated objectives are met, the Tripartite Authorities have continued to plan for the full range of possible outcomes to the strategic review of Northern Rock.

The preference of the Tripartite Authorities, acting in their respective capacities, is to reach agreement on a private sector solution which meets the objectives and conditions set out above. However, if no private sector solution is proposed which the Bank of England and HM Treasury, as providers of financial support to the company, and the Financial Services Authority, as its regulator, consider they can agree in light of their objectives of protecting taxpayers, promoting financial stability and protecting consumers, the Government would bring forward legislation which would empower HM Treasury, by order, to take Northern Rock into temporary public ownership. It is envisaged that any such power would be used to transfer Northern Rock's share capital, including its preference shares, into public ownership. It is anticipated that the remaining Tier 1 and Tier 2 capital instruments would continue in their existing ownership as listed securities. Holders of these capital instruments would remain at risk of first loss ahead of the Bank of England and HM Treasury as providers of secured financial support to the company. The Tripartite Authorities consider that a temporary period of public ownership would best serve their stated objectives if a private sector solution could not be agreed on terms acceptable to the Tripartite Authorities, acting in their respective capacities. The Tripartite Authorities do not consider that an administration of Northern Rock would meet these objectives.

All of the Government's guarantee arrangements would remain in place and accordingly savers' money would remain absolutely safe. Savers and borrowers would not be affected by the company being taken into public ownership. Northern Rock would continue to operate and provide services to customers as normal. Branches, call centres, postal and internet banking would all remain open and accessible, as usual.

In the event of Northern Rock being brought into temporary public ownership, it would be managed on arms' length terms, as a commercial entity, by a newly appointed experienced and professional management team.

The legislation brought forward would provide for the assessment by an independent valuer of compensation payable to any holder of securities transferred to HM Treasury. The principles for assessing compensation, which would be set out in the legislation brought forward, would reflect the principle that the Government should not be required to compensate shareholders for value which is dependent on taxpayers' support and the fact that public sector ownership would be an alternative to an administration of the company. Accordingly, the compensation would be assessed by the valuer on the basis, among other things, that all financial assistance to Northern Rock from the Bank of England or HM Treasury (including HM Treasury's existing guarantee arrangements) had been withdrawn and no other financial assistance (apart from Bank of England assistance on its usual terms through standing facilities or open market operations) were made available by them to Northern Rock.

Any decision or announcement to take Northern Rock into temporary public ownership would also address the future of the Northern Rock Foundation.

The preference of the Tripartite Authorities, acting in their respective capacities, is to reach agreement on a private sector solution which meets the objectives and conditions set out above. However, if no private sector solution is proposed which meets these objectives and conditions, the Government would bring forward legislation which would empower HM Treasury, by order, to take Northern Rock into temporary public ownership.

Goldman Sachs International ("Goldman Sachs"), which is authorised and regulated in the United Kingdom by the Financial Services Authority, is acting as financial adviser to members of the Tripartite Authorities and no-one else in connection with the restructuring of Northern Rock and will not be responsible to anyone other than those members of the Tripartite Authorities for providing the protections afforded to clients of Goldman Sachs or for providing advice in relation to the restructuring of Northern Rock.