



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

20th February 2008

Dr Vincent Cable MP
House of Commons
London
SW1A 0AA

Dr Vince,
Northern Rock

Thank you for your letter of earlier today regarding the Granite trust.

Firstly, Granite is a special purpose vehicle - a trust - whose sole purpose has been to provide Northern Rock with a cost effective form of financing for its business. Northern Rock sold mortgages to Granite and used the proceeds to fund its business. The Granite vehicle funded the purchases of these mortgages by issuing bonds in the capital markets. This kind of structure is a common feature for many high street banks and building societies. No new mortgage assets have been transferred to Granite since the Bank of England started providing ongoing financial support to Northern Rock.

2. Secondly, as the Chief Secretary to the Treasury made clear during the Second Reading of the Banking Bill, Granite is an independent legal entity owned by its shareholders. Northern Rock owns no shares in Granite. Granite and only Granite is liable to its bondholders under any scenario. The Government has not provided any guarantee arrangements to Granite bondholders. There would be no benefit to the taxpayer in seeking to bring Granite into public ownership and the existence of Granite is no barrier to the onward sale of Northern Rock.

3. Thirdly, contrary to some suggestions, FSA advises that Northern Rock's mortgage book is of good quality and its assets exceed its liabilities. The Government's loan and guarantee arrangements are secured against Northern Rock's balance sheet, which includes high quality mortgage assets. Granite and its bondholders have no access to these assets.

4. Fourthly, it is a matter for the new management team to assess their commercial relationship with Granite going forwards, and to decide whether



they wish to maintain the arrangement or let it run off in an orderly way to be replaced by alternative funding sources. This decision would ultimately have no impact on the taxpayers' exposure.

5. Fifthly, Granite is a privately owned company. Her Majesty's Revenue and Customs (HMRC) has a legal obligation to maintain taxpayer confidentiality. You will therefore appreciate that I am unable to offer comment on the tax affairs of named individuals or organisations. However, I appreciate the House has sought further details of Granite's structure and these are set out in the attached technical note.

6. The full prospectuses relating to Granite that you have requested are publicly available and are on Northern Rock's website. Contractual documentation described in detail in the prospectuses is available from the Granite bond trustees.

The attached technical note addresses the detailed points you raise.

I am placing a copy of this letter in the Libraries of both Houses.

Yours sincerely

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ALISTAIR DARLING

TECHNICAL NOTE

Operation of the Granite structure

Northern Rock sells mortgages to Granite, the proceeds from which it uses to fund its' business. The Granite vehicle funds the purchases of these mortgages by issuing bonds in the capital markets. This is a common structure, used by many high-street banks and building societies.

Granite is a trust. As is usual with structures of this kind, Northern Rock retains a proportion of ongoing payments from the mortgages it sells to Granite. This proportion will vary. It is currently around 7% of the repayments on the mortgage assets.

Northern Rock receives full value for the sale of mortgages to Granite through the payment of cash when the mortgages are sold to Granite, and through Northern Rock's continued interest in the Granite trust.

Assets

Northern Rock has sold around half of its mortgage assets to Granite between 1999 and September 2007. There remain high quality assets on Northern Rock's balance sheet, as well as Granite's. The FSA continue to advise that Northern Rock's mortgage book is of good quality.

It will only be necessary to top Granite up with further mortgages in two scenarios: firstly, when new Granite bonds are issued. However, Granite has not issued any new bonds since September 2007. And secondly, to increase or maintain the size of Northern Rock's proportion of the trust and the cash distributions it receives. In both cases Northern Rock receives value for the sale of mortgages into Granite.

It is a commercial decision for Northern Rock whether to provide new mortgage assets to the Granite financing vehicle or whether to allow the vehicle to run-off in an orderly way.

In other words, again as is common in structures of this kind, the Granite bondholders have no access to the assets held by Northern Rock.

No new mortgage assets have been transferred to the Granite vehicle since the Bank of England started providing financial support to Northern Rock.

Taxpayer's exposure continues to be secured against Northern Rock's assets, including high quality mortgage assets.

Granite would not prevent the onward sale of the company into the private sector and any proceeds from that sale would not be directed at Granite or its bondholders. The taxpayer would benefit from all the upside of any onward sale of the company, with or without Granite.

Charitable trust

The Granite charitable trust is the trust which owns the shares in the holding company of the Granite structure.

The shares in Granite Finance Holdings Limited are held for the benefit of charities under a trust arrangement. The named charity is Down's Syndrome North East Association (UK) and other charities which the company can select. This charitable trust is completely separate to the trust and should not be confused with it.

The trust does not undertake any charitable activities because its property is limited to the shares it owns in Granite Finance Holdings Limited (this is £2 in nominal amount).

The reason why the shares are held for a charitable trust is so that the Granite vehicle is not owned by the seller of the mortgages (that is, Northern Rock) and can therefore be run separately from Northern Rock's business.

Clearly because the Granite vehicle is solely set up as a funding vehicle for Northern Rock, Northern Rock have determined it would not be appropriate for any other third party to own the shares in Granite Finance Holdings Limited. A charitable trust is a method of legally achieving the required result; although it should be noted that the trust need not be a charitable one.

Again, these structures are commonly used by major banks and building societies around the world.

Control of Granite

The contractual structure of Granite is such that it is effectively controlled by Northern Rock as it continues to service the mortgages in Granite and to provide cash management and other administrative services. This is absolutely

standard for a structure of this kind, and it is why Granite is consolidated on Northern Rock's group balance sheet. However, Northern Rock is not liable for the Granite bonds and bondholders have no access to Northern Rock's assets.