

Northern Rock plc
Annual Report and
Accounts 2008

northern
rock

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CHAIRMAN'S STATEMENT

Northern Rock was taken into temporary public ownership on 22 February 2008 and a business plan (the "Plan") was developed that was designed to support the Government's stated objectives of protecting UK taxpayers, maintaining financial stability and protecting consumers. The Plan contained a number of key targets, including repayment of the Government loan by the end of 2010, release of the Government guarantee arrangements (subject to FSA requirements) during 2011, and the creation of a smaller, profitable bank capable of returning to private ownership in due course. It was approved by HM Treasury on 31 March 2008.

The Plan was built upon four strategic priorities:

- Repayment of the loan facilities provided by the Government;
- Alignment of the organisation and operations of Northern Rock to reflect the new commercial strategy;
- Building a stand-alone funding and capital position; and
- Strengthening the risk and control environment.

Against a challenging economic backdrop, Northern Rock has made strong progress against these objectives during 2008. In particular, and primarily through an effective programme of accelerating mortgage redemptions, the Company has been able to reduce the Government loan well ahead of the Plan. At the end of 2008, the net amount outstanding to the Government stood at £8.9 billion, a reduction of £18.0 billion from the start of the year.

The organisation has been restructured and realigned, to create a smaller, viable and more sustainable business. Northern Rock completed its formal redundancy consultation process in August 2008 and now employs around 4,500 staff. As a result of the restructuring, around 1,300 staff were made redundant, 500 of which were on a voluntary basis. Engagement with Unite and other employee representatives was constructive throughout the process. The Company worked hard to minimise the number of compulsory redundancies and has continued to work closely with the regional development agency, One NorthEast, to ensure effective outplacement support is in place to assist those leaving the Company.

We have taken a number of steps to strengthen significantly the management team during 2008. Gary Hoffman joined the Company as Chief Executive on 1 October 2008. He leads a substantially reconstituted executive team with some key new external appointments. These have added considerable expertise to the Northern Rock organisation, particularly in the areas of Risk, Human Resources, Planning and Debt Management.

GOVERNANCE

The Board of Northern Rock has been restructured and strengthened during 2008. Full details of Board changes are included in the Corporate Governance Report on pages 6 to 10 of this report.

Appointments made following the decision by HM Treasury to take the business into temporary public ownership have been designed to bring valuable additional experience to the Board and will provide considerable benefit to the Company. I should like to thank all those who served as a Director in 2008 for their valuable assistance through this transitional period.

Ann Godbehere, Chief Financial Officer, stepped down from the Board on 31 January 2009, having taken up her appointment when the Company was placed into temporary public ownership in February 2008. With Ann's input we have accomplished some key stages in the delivery of the Plan, and I take this opportunity to thank Ann for her substantial contribution to the Company during her time with us.

The Company continues to take very seriously its responsibilities to the wider community. Since 1997 we have supported The Northern Rock Foundation which in turn supports community and charitable causes in the North East of England and Cumbria. In 2008, the Foundation received £15 million and in line with the commitments made, we will donate a further £15 million per annum in 2009 and 2010.

FUTURE STRATEGY

The external economic environment has deteriorated markedly since the Plan was agreed in March 2008. The global banking crisis worsened, particularly in the second half of 2008 and we are now seeing the broader impact on the economy. There has been a further contraction in liquidity in the market, lending conditions have continued to tighten and the UK housing market has declined more rapidly than previously forecast. These conditions have had a resultant impact on our business, including a full year loss before tax of £1.4 billion, largely as a result of loan loss impairment charges of £0.9 billion and write-downs of treasury assets totalling £0.3 billion.

In response to the changes in the external environment, we embarked in the autumn of 2008 on a review of the Plan. This has now been completed, in close consultation with the Government, and a number of revisions to the Company's strategy were announced in February 2009. In essence, the Company is now well placed to support an increase in mortgage lending capacity in the market and will offer up to £14 billion of new mortgage lending over the next two years, based partly on a funding facility to be provided by the Government. At the same time, the Company has begun to slow down its mortgage redemption programme.

To facilitate the increased lending, a legal and capital restructuring of Northern Rock will be undertaken to maximise capital efficiency and value for the taxpayer, and to facilitate the return of the Company to private ownership in due course.

Northern Rock has seen enormous change during 2008. The Company is now in a much stronger state and is beginning its journey back to private ownership. The achievements of the last year, which have been considerable, could not have been possible without the extraordinary commitment and dedication of the Northern Rock staff. Their performance and commitment to customer service have been outstanding, and I offer my thanks to all the Company's employees.

Ron Sandler
Chairman

2 March 2009

CHIEF EXECUTIVE'S REPORT

2008 has been a challenging year for Northern Rock but I am pleased to report that the Company has made good progress against its business objectives.

PROGRESS AGAINST PLAN

The initial priority of the March 2008 business plan (the "Plan") was rapid repayment of the Government loan. The Company has been successful in reducing the Government loan well ahead of the Plan, mainly through a programme of targeted and proactive mortgage redemptions. At 31 December 2008, the net balance outstanding to the Government stood at £8.9 billion, a reduction of £18 billion since the start of the year.

Northern Rock does, however, remain significantly loss making. While this was always envisaged in the Plan, the reported loss for 2008 has been exacerbated further by the rapid deterioration in the external environment, with a combination of rising arrears and falling house prices leading to an increased loan impairment charge.

One of the major commitments in the Plan was to strengthen the risk and control environment in the business. Good progress has been made in this area with the creation of a much stronger, independent, risk function, responsible for monitoring the application of risk measures and targets, in line with the risk appetite of the business.

New governance structures have been put in place to improve the oversight and control of the business, and ensure decisions are taken at the appropriate level, in line with clear authorities.

I joined the Company on 1 October 2008 and am pleased to lead a new Executive team where we have been able to attract a number of high calibre individuals.

PLAN REVIEW

The financial world has changed since the Plan was put in place. The Company has been working closely with the Government in reviewing its business plan to reflect the changing environment. This review has now been concluded.

Reflecting changed priorities and in order to support Government policy to increase mortgage lending capacity in the market, the Company has slowed down the rate of its mortgage redemptions.

In addition, the Board has now agreed that Northern Rock will launch a programme of additional new lending. Funding to support new lending will be partly provided by an increase in the Government loan to Northern Rock, with an extended repayment schedule.

To facilitate the new lending activity, and maximise capital efficiency and value for the taxpayer, there will be a legal and capital restructuring of the Company, with the additional capital requirement expected to be within the £3 billion previously announced.

A detailed planning exercise is now being undertaken by the Company and further announcements will be made in due course as plans are finalised. These changes are unlikely to have any significant impact on staffing levels, and the focus on new lending will exploit the capacity and skills within the organisation.

OPERATIONAL PERFORMANCE

While Northern Rock has been through a significant period of transition and restructuring during 2008, it has remained operationally strong at all times. My colleagues have maintained the highest levels of customer service throughout this period and I wish to pay tribute to them for their dedication and professionalism.

We remain a major employer in the North East.

OUR CUSTOMERS

As our business and our industry changes, we are always mindful of our customers' needs. All decisions in the business are made with consideration of the impact they may have on our customers, whether saver or borrower. It is our intention to treat customers fairly in all our dealings. We conduct extensive customer research in support of this aim, and we also make a commitment to our customers to continually seek to improve what we have to offer them.

I would personally like to thank all of our customers for their ongoing support, during what has been a very turbulent period.

LENDING

Gross residential mortgage lending for the year was £2.9 billion, much lower than in previous years, but in line with our business plan objective to maintain a presence in the residential lending market while reducing the size of our balance sheet.

Reflecting our revised business plan, and to support Government policy, Northern Rock will offer up to £14 billion of new mortgage lending over the next two years. This will include a range of mortgage products covering home purchase, including first-time buyers, and remortgaging. This will be responsible new mortgage lending that will be competitively priced to deliver a commercial return.

The new lending proposition means that the Company's existing mortgage customers will not be actively encouraged to leave when their mortgage deal matures and they will have more choice.

FUNDING

Progress has been made in rebuilding the Company's retail deposit base, with retail balances growing to £19.6 billion at the end of the year, an increase of £9.2 billion. Rebalancing the funding mix of Northern Rock is an essential element of the Plan, with our branch network and direct sources (postal, online and telephone) all playing an important part in 2008.

The rate of retail savings inflows increased markedly during September, as a consequence of the turmoil in financial markets. In response, the Company took a number of actions to ensure that it complied with its self imposed Competitive Framework, thus underpinning its commitment that it will not take unfair advantage of Government support while in receipt of State aid.

As part of the Plan, we envisaged a managed contraction in the Company's securitisation vehicle, Granite. In November the Company confirmed that Granite had gone into pass-through, following a Non-Asset Trigger event. While this does change the order in which note holders are repaid, and potentially the timing of repayment, we continue to plan a managed reduction in the total amounts outstanding under this programme.

CHIEF EXECUTIVE'S REPORT (continued)

Non-retail funding balances continue to reduce as the balance sheet contracts as planned. In July, Northern Rock resumed new wholesale funding albeit on a modest scale, reflecting market conditions and the Company's intention to achieve a more balanced mix of retail and non-retail funding.

CREDIT QUALITY

The deterioration in economic and market conditions has resulted in increasing arrears for Northern Rock, and the sector as a whole.

At the end of December 2008, residential arrears over three months were 2.92% – this rate reflects a combination of rising arrears cases and the rapid shrinkage in the Company's loan book during the year.

One of the major contributors to this has been the Together product, with arrears over 3 months on the secured element of the Together book increasing to 4.53% at 31 December 2008. This, along with the unsecured element of Together, has been a key driver of the loan loss impairment charge in the year.

At Northern Rock, we have taken significant steps to strengthen our debt management function, with an emphasis on working with customers who are experiencing mortgage payment difficulties to try and agree an appropriate debt management solution, so that customers can remain in their homes wherever possible.

We continue to develop and extend our own mortgage rescue solutions as well as supporting Government and industry initiatives in this area.

We have committed formally to not take possession of an owner-occupied property for at least six months after the customer first falls into arrears. In practice, in those cases where enforced repossession does occur, we have worked with customers on average for a period of 15 months from when they first fall into arrears.

The number of properties in possession at 31 December was 3,620, compared to 4,201 reported at the end of September, reflecting the actions we have taken in this area. Unfortunately, given the external economic backdrop it is likely that repossessions will continue to be a feature of the market over the coming year, but our aim is to work closely with customers and to keep the level of enforced possessions to a minimum.

OUTLOOK

The outlook for the UK economy remains highly uncertain. Our new business plan has been developed to enable Northern Rock to play its full part in initiatives to support mortgage lending and the broader economy. As we slow mortgage redemptions down, we will increase our new lending activities. This is good news for customers of Northern Rock and consumers generally, who will benefit from an increase in mortgage availability.

Northern Rock has achieved a great deal over the last year, in very difficult circumstances. I believe we have now put the foundations in place to allow the business to look forward to the next phase of its development.

Gary Hoffman
Chief Executive

2 March 2009

THE BOARD

During 2008, the number of meetings attended by each Director was as follows:

	Board	Audit	Nominations	Remuneration	Risk
Number of meetings held in 2008	38	7	7	5	7
Chairman					
R A Sandler CBE (Appointed Executive Chairman 22 February 2008, became Non-Executive Chairman 1 October 2008)	16/16		7/7	3/4	
B K Sanderson CBE (Retired 22 February 2008)	22/22			1/1	
Non – Executive Directors					
L P Adams	37/38	1/1		5/5	7/7
M K Atkinson (Appointed 5 August 2008)	4/6	1/1			1/3
J R Coates (Appointed 5 August 2008)	6/6	1/1			3/3
R J Davies (Appointed 10 October 2008)	5/5		1/1	1/1	
J F Devaney	36/38	4/4		4/5	5/7
Sir Ian Gibson CBE (Retired 22 February 2008)	20/22			1/1	
S A M Hester (Appointed 22 February 2008; retired 1 October 2008)	9/11		6/6	3/3	
S T Laffin (Retired 31 December 2008)	37/38	7/7		1/1	7/7
M J Queen (Retired 1 May 2008)	26/28	4/4		1/1	
P J Remnant (Appointed 22 February 2008)	15/16	6/6	7/7		
T W Scholar (Appointed 22 February 2008)	14/16	5/6			6/7
P A Thompson (Appointed 25 January 2008; retired 22 February 2008)	16/16				
Executive Directors					
A F Godbehere (Appointed 22 February 2008; retired 31 January 2009)	16/16				
G A Hoffman (Appointed 1 October 2008)	5/5				
D A Jones (Retired 22 February 2008)	22/22				
A M Kuipers (Retired 7 September 2008)	31/32				

THE BOARD (continued)

During 2008 the Chairman of each Committee was as follows :

The Audit and Risk Committees were chaired by Mr Queen until his retirement on 1 May 2008. Mr Laffin succeeded as Chairman of the Audit Committee, and Mr Adams became Chairman of the Risk Committee, both with effect from 1 May 2008. Following Mr Laffin's retirement on 31 December 2008, Mr Atkinson became Chairman of the Audit Committee.

Sir Ian Gibson was Chairman of the Remuneration Committee until his retirement on 22 February 2008, and was succeeded by Mr Hester. Mr Hester retired on 1 October 2008 and was succeeded as Chairman of the Remuneration Committee by Mr Devaney.

The Nominations Committee was chaired by Mr Sanderson until his retirement on 22 February 2008, and was succeeded by Mr Sandler.

The current membership of the Committees is set out on pages 8 and 9.

CORPORATE GOVERNANCE

On 22 February 2008, the Company's shares were delisted following their transfer to the Treasury Solicitor as nominee for Her Majesty's Treasury. As a result, the full requirements of the UKLA's Listing Rules and the Combined Code on Corporate Governance, no longer apply to the Company.

This corporate governance section summarises:

- the composition of the Board at the date of this report; and
- the governance regime in place at the date of this report.

The Operating and Financial Review on pages 20 to 33 also addresses certain governance matters.

COMPOSITION OF THE BOARD

The Directors in office at the date of this report are:

R A Sandler CBE – Non-Executive Chairman

Ron Sandler was appointed as Non-Executive Chairman on 1 October 2008 having previously joined the Board as Executive Chairman on 22 February 2008. He is also Chairman of the Nominations Committee and a member of the Remuneration Committee. He was Chief Executive of Lloyd's of London from 1995 to 1999, and subsequently was Chief Operating Officer of NatWest Group. He is Chairman of Paternoster Ltd and Ironshore Inc.

L P Adams – Non Executive Director

Laurie Adams was appointed to the Board as a Non-Executive Director on 29 November 2007. He is Chairman of the Risk Committee and a member of the Remuneration Committee. Mr Adams is a Non-Executive Director of Sibluc Holdings Limited (formerly Haven Europe Ltd) and Novae Group plc. He was formerly Managing Director and Global Head of Legal and Compliance of the Investment Banking Wholesale Division at ABN Amro Bank.

M K Atkinson – Non-Executive Director

Kent Atkinson was appointed to the Board as a Non-Executive Director on 5 August 2008. Mr Atkinson is Chairman of the Audit Committee and a member of the Risk Committee. Mr Atkinson was previously Group Finance Director of Lloyds TSB plc, and subsequently a Non-Executive Director. Mr Atkinson is the Senior Independent Director of Coca-Cola HBC SA. He is a Non-Executive Director of Standard Life plc, Gemalto NV and Millicom International Cellular SA. He was the Senior Independent Director of Cookson Group plc and Telent plc (previously Marconi Corporation plc).

J R Coates – Non-Executive Director

Richard Coates was appointed to the Board as a Non-Executive Director on 5 August 2008. He is a member of the Audit and Risk Committees. Mr Coates was Managing Director of Baseline Capital Limited from 2003 to 2008, a specialist mortgage data analysis and modelling organisation. For the previous 30 years he was at KPMG UK, rising through various appointments to become Senior

Partner, UK Head of Financial Services. He is a Non-Executive Director for Police Mutual Assurance Society Limited.

R J Davies – Non-Executive Director

Bob Davies was appointed to the Board as a Non-Executive Director on 10 October 2008. He is a member of the Nominations and Remuneration Committees. Mr Davies was Chairman of the CBI in the North East until December 2008 and is a Non-Executive Director of Barratt Developments plc. He was Chairman of Biffa plc, from 2006 to 2008 and Chief Executive of Arriva plc from 1998 to May 2006. Mr Davies was formerly a Non-Executive Director of British Energy Group plc and Northern Business Forum Limited.

J F Devaney – Non-Executive Director

John Devaney was appointed to the Board as a Non-Executive Director on 26 November 2007. Mr Devaney is Chairman of the Remuneration Committee and a member of the Risk Committee. He is Chairman of NATS Holdings Ltd, and was formerly Chairman of Telent plc (previously Marconi Corporation plc).

G A Hoffman – Chief Executive

Gary Hoffman, Chief Executive Officer, was appointed to the Board on 1 October 2008. Previously Group Vice-Chairman and Executive Director of Barclays plc, he joined Barclays in 1982 as a graduate in economics from Cambridge University. He is a Non-Executive Director of Visa Europe and Trinity Mirror plc and is a Trustee of the Charities Aid Foundation. He is also Vice-Chairman of Coventry City Football Club.

P J Remnant – Non-Executive Director

Philip Remnant was appointed to the Board as a Non-Executive Director on 22 February 2008. He is a member of the Audit and Nominations Committees. He is Chairman of the Shareholder Executive and is a Senior Adviser of Credit Suisse's investment banking division in Europe. Previously, he was a Vice Chairman of Credit Suisse First Boston in Europe and was Director General of the Takeover Panel between 2001 and 2003. He formerly held senior investment banking positions with BZW and Kleinwort Benson.

T W Scholar – Non-Executive Director

Tom Scholar was appointed to the Board as a Non-Executive Director on 22 February 2008. He is a member of the Audit and Risk Committees. He was appointed Managing Director (International & Finance) at HM Treasury in January 2008. Prior to that, he was Chief of Staff and Principal Private Secretary to the Prime Minister. From 2001 to 2007 he was an Executive Director of the International Monetary Fund and the World Bank, and Minister (Economic) at the British Embassy in Washington, DC. From 1997 to 2001 he was Principal Private Secretary to the Chancellor of the Exchequer.

CORPORATE GOVERNANCE (continued)

GOVERNANCE STRUCTURE

OVERVIEW

Since the commencement of a period of temporary public ownership on 22 February 2008, the governance of the Company has been regulated principally by a framework document (the “Framework Document”) agreed between the Company and its shareholder, Her Majesty’s Treasury (“HMT”). This sets out the structure of how the day-to-day shareholder relationship between the Company and HMT will work in practice, and may be revised from time to time where required by HMT as circumstances change.

The ongoing relationship between the Company and HMT as shareholder, HMT and the Bank of England as debt provider and debt servicer and the Financial Services Authority as regulator will be underpinned by the Tripartite Authorities’ stated objectives: to protect taxpayers, to promote financial stability, and to protect consumers.

BASIC PRINCIPLES

The basic relationship between the Company and HMT as shareholder operates according to the following principles under which HMT as shareholder:

- appoints the Chairman of the Board and appoints two Non-Executive Directors in consultation with the Chairman;
- must give its consent for the appointment of other members of the Board proposed to be appointed by the Nominations Committee and agrees the terms on which the Directors are appointed and incentivised;
- determines the high level objectives that the Plan is designed to achieve and agrees the Plan with the Board;
- must agree any subsequent updates to the Plan;
- reviews with the Board from time to time the Company’s strategic options;
- requires that the Board is accountable to it for delivering the agreed Plan;

- gives the Board the freedom to take the actions necessary to deliver the Plan;
- monitors the Company’s performance to satisfy itself that the Plan is on track; and
- must give its consent for certain significant actions.

IMPLEMENTATION OF BASIC PRINCIPLES

BOARD STRUCTURE AND GOVERNANCE

In accordance with the Framework Document, the Company operates a corporate governance structure which, so far as practicable and in light of the other provisions of the Framework Document, or as otherwise may be agreed with HMT as shareholder, takes appropriate account of best practice for a company listed on the Official List, including the Combined Code on Corporate Governance (the “Combined Code”).

The Board will continue to operate the following main committees:

- Audit Committee;
- Risk Committee;
- Remuneration Committee; and
- Nominations Committee.

The work of these committees is described below.

During 2008, the Board has comprehensively reviewed and updated its corporate governance processes in the light of ownership and structural changes. The revised processes are set out in a detailed Board Governance Manual.

BOARD APPOINTMENTS AND MONITORING

It is a key principle of the Framework Document that HMT as shareholder and the Chairman should share a common view about Board composition (including size, balance of experience and background) and succession. To achieve this:

- the Chairman and either the Chancellor of the Exchequer or a senior official nominated by the Chancellor of the Exchequer (the “Nominated Official”)

will regularly review Board composition and succession in the light of performance and the requirements of the Plan;

- two Non-Executive Directors nominated by HMT as shareholder (the “Shareholder Directors”), have been appointed to the Board. These two Non-Executive Directors are currently Mr Remnant and Mr Scholar. The Company acknowledges that the Shareholder Directors liaise with and report to representatives of HMT as shareholder from time to time in relation to the business of the Company and decisions made or to be made by the Board in order to assist with the exercise of their powers and duties as directors of the Company;
- the Chairman will discuss with the Nominated Official any impending changes to Board membership;
- the Nominated Official will meet with the Chairman of the Nominations Committee as necessary to discuss any proposed Board changes before they become subject to the formal appointment/consent procedure outlined above;
- the Company’s Articles of Association require that each Director stands for re-election at least every three years and that Directors appointed by the Board should be subject to election at the first opportunity after their appointment. The Directors to retire by rotation will be those in office longest since their previous re-election. The Shareholder Directors are expressly exempted by the Company’s Articles of Association from having to retire by rotation. Non-Executive Directors are appointed for a specified term (normally two years, for new or renewed letters of appointment entered into after 31 December 2008) subject to re-election in accordance with the above procedures;
- the Board will ensure that suitably rigorous appraisals are made of the effectiveness of the Chairman and

CORPORATE GOVERNANCE (continued)

Board. In view of the number of significant changes in Board composition and structure during the course of 2008, it was not considered appropriate to review and appraise the effectiveness of the Chairman and the Board, over this period. A suitable exercise will take place during 2009; and

- the shareholder has certain monitoring and information access rights, and its consent must be obtained for certain material transactions.

THE BOARD

The Board met 38 times during 2008 and the details of attendance at the Board and Committee meetings are given on page 4. Where Directors were absent from Board or Committee meetings, on each occasion the Board or respective Committee was satisfied with the apologies that were offered.

The Board is responsible for:

- developing and recommending a Plan to deliver the objectives of the Tripartite Authorities, including a proposed business strategy and funding plan consistent with the aims of temporary public ownership. The Plan will be updated as required and will be subject to review by and the approval of HMT as shareholder; and
- delivering the Plan. Subject to the Framework Document and the Company's Memorandum and Articles of Association, final decisions on running the Company rest with the Board in accordance with the Directors' fiduciary responsibilities. HMT as shareholder is committed to giving the Board the freedom to act to deliver the agreed Plan. Thus, save as provided in the Framework Document, HMT as shareholder will not interfere in day-to-day operational and commercial matters.

The Board has a written schedule of matters reserved for its determination. Reserved matters include corporate governance arrangements and the relationship with HMT; responsibility for

overall management of the Company's long-term objectives and commercial strategy; financial reporting and controls; setting an appropriate risk appetite and maintaining a sound system of internal control and risk management; and the approval of half yearly, interim management statements and the Annual Report and Accounts.

BALANCE OF EXECUTIVE AND NON-EXECUTIVE DIRECTORS

More than half of the Board comprises Non-Executive Directors, all of whom have experience in a range of commercial or banking activities.

BOARD COMMITTEES

In accordance with the requirements in the Framework Document the Board has established a number of Committees. The Chairman and membership of each Committee are set out in each section below.

Each Committee has detailed terms of reference clearly setting out its remit and authority.

The following paragraphs set out details of the Committees and the particular work that they undertake.

AUDIT COMMITTEE

The Audit Committee currently comprises Messrs Atkinson (Chairman), Coates, Remnant and Scholar.

The Committee considers and, where appropriate, advises the Board on all matters relating to regulatory, prudential and accounting requirements that may affect the Company. It reports to the Board on both financial and non-financial controls and monitors the integrity of the financial statements of the Company and any formal announcements relating to the Company's financial performance. An important aspect of its role is to ensure that an objective and professional relationship is maintained with the external auditors.

The Audit Committee has responsibility for recommending the appointment, re-appointment and removal of the external auditors.

The Audit Committee reviews the scope and results of the annual external audit, its cost effectiveness, and the independence and objectivity of the external auditors. It also reviews the nature and extent of any non-audit services provided by the external auditors. The external auditors may attend all meetings of the Audit Committee and they have direct access to the Committee and its Chairman at all times.

The Managing Director Internal Audit provides further assurance that the significant risks identified by the business are properly managed. The Managing Director Internal Audit also has direct access to the Audit Committee and its Chairman. The Committee regularly receives reports of reviews conducted throughout the Company by the Internal Audit and Compliance functions.

The Audit Committee met seven times in 2008. In March 2008, the Audit Committee reviewed and confirmed the effectiveness of the external auditors. The external auditors were consequently re-appointed at the 2008 Annual General Meeting until the conclusion of the next Annual General Meeting.

RISK COMMITTEE

The Risk Committee currently comprises Messrs Adams (Chairman), Atkinson, Coates, Devaney and Scholar.

The main role of the Risk Committee is to review, on behalf of the Board, the key risks inherent in the business, the systems of control necessary to manage such risks, and to present its findings to the Board.

This responsibility requires the Risk Committee to keep under review the effectiveness of the Company's Risk management frameworks and systems of internal control, which includes financial, operational, compliance and risk management controls and to foster a culture that emphasises and demonstrates the benefits of a risk-based approach to internal control and management of the Company. The Risk Committee fulfils this remit by reinforcing management's risk management awareness and making

CORPORATE GOVERNANCE (continued)

appropriate recommendations to the Board on all significant matters relating to the Company's risk appetite, strategy and policies.

During 2008, the Risk Committee has specifically reviewed and re-defined the risk appetite for Board approval, examined each of the core Risk Management frameworks within the business to make sure these remain effective in the light of the changing environment, and received more developed and focused risk reporting – which included extended risk review sessions facilitated by the business risk function.

It is also primarily responsible for considering any major findings of the Financial Services Authority and management's response to any risk management review undertaken by Internal Audit or the external auditors.

To assist the Board in discharging its responsibilities for the setting of risk policy, the Risk Committee periodically reviews the Company's credit risk, interest rate risk, liquidity risk and operational risk exposures in relation to the Board's risk appetite and the Company's capital adequacy.

As part of the implementation of the International Convergence of Capital Measurement and Capital Standards: Revised Framework (commonly known as Basel II), the Committee has responsibility for monitoring the performance of the Company's Basel credit rating systems and reviewing reports prepared by the Company's Basel designated committees.

The Risk Committee also ensures that the public disclosure of information regarding the Company's risk management policies and key risk exposures is in accordance with statutory requirements and financial reporting standards.

The Risk Committee met seven times during 2008.

NOMINATIONS COMMITTEE

The Nominations Committee currently comprises Messrs Sandler (Chairman), Davies and Remnant.

Subject to compliance with the requirements of the Framework Document (as set out above), the Committee monitors and reviews the membership of, and succession to, the Board of Directors and the Committee makes recommendations to the Board in this regard. One of its functions is to identify potential Executive and Non-Executive Directors taking into account the requirement for the members of the Board to have an appropriate range of skills and experience.

The Committee met seven times during 2008.

REMUNERATION COMMITTEE

The Remuneration Committee currently comprises Messrs Devaney (Chairman), Adams, Davies and Sandler.

Subject to compliance with the requirements of the Framework Document (as set out above), the Committee is responsible for considering and advising the Board on the remuneration policy for Executive Directors and the Chairman, and for determining their remuneration packages. In discharging its responsibilities, the Remuneration Committee takes professional advice from within and outside the Company.

It is the Board's responsibility to determine the remuneration policy for Non-Executive Directors within the limits set out in the Articles of Association. The Remuneration Committee also determines the level of remuneration for the Company's Executive Committee Directors (comprising management at the level immediately below the Board).

The Committee met five times during 2008.

EXECUTIVE COMMITTEE

The Board has delegated authority to the Executive Committee to oversee the prudent day to day management of the Company's affairs. The Committee currently comprises Mr Hoffman (Chief Executive), Mr Jones (Acting Chief Financial Officer), Ms Belsham (Director of Transition Management), Mr Hunkin (Chief Risk

Officer), Mr Mooney (Retail Banking Director), Mr Smelt (HR Director), Mr Tate (Debt Management Director) and Mrs Thompson (Chief Operating Officer).

The Committee considers, in the first instance, all reports made to the Board and Board Committees, except in relation to matters reserved to the Board for its own determination. The function of the Committee and its sub-committees, together with a description of the role and responsibilities of the Committee members, is set out in the Executive Governance Manual, which was approved by the Board in November 2008 following its comprehensive review of governance processes and day to day management of the Company. The Board has also adopted a Delegated Authorities Manual which specifies the level of authority to be exercised by the Executive Committee and various individuals.

The following sub-committees (reporting to the Executive Committee) have been established:

- Retail Products and Limits Committee;
- Retail Credit Risk Committee;
- Operational Risk and Compliance Committee;
- Assets and Liabilities Committee;
- Capital and Liquidity Management Committee; and
- Major Projects Committee.

RELATIONSHIP BETWEEN THE CHAIRMAN AND THE CHIEF EXECUTIVE

A clear division of responsibility exists between the Chairman, who is responsible for running the Board, and the Chief Executive who has responsibility for running the business. This division is set out in writing and has been agreed by the Board.

INDUCTION AND TRAINING

It is the Company's policy that every Director should receive appropriate training when appointed to the Board, and subsequently as necessary. The Company's induction process is designed to ensure that

CORPORATE GOVERNANCE (continued)

every new Director understands their responsibilities as a Director of the Company. The Board Governance Manual supports this process. Where appropriate, the process also enables Directors to build an understanding of the Company, its business and the market in which it operates.

To enable the Board to function effectively, all Directors have full and timely access to all information which may be relevant to the discharge of their duties and obligations. The Company also arranges additional, specific training or support for any Director who requests it. The Chairman ensures that all Directors are properly briefed on issues to be discussed at Board meetings. All Directors are able to obtain further advice or seek clarity on issues raised at Board meetings from within the Company or from external professional sources. All Directors have access to the advice and services of the Company Secretary who is responsible for ensuring that Board procedures and applicable rules and regulations are observed.

Where necessary, Directors are able to take independent professional advice at the Company's expense.

INTERNAL CONTROL AND RISK MANAGEMENT

A description of the Company's approach to all aspects of financial and other risk management and the related use of derivatives is set out in notes 17 and 40 to the Accounts. Material risk exposures must be maintained within the Board approved risk appetite and are subject to Board policy statements which further define specific exposure limits and controls, appropriate to each of the risks concerned.

The Board of Directors is responsible for the Company's system of risk management, regulatory compliance and internal control. The systems are designed to ensure that the key risks taken by the Company in the conduct of its business are identified and evaluated so that appropriate controls are put in place to manage those risks. Such systems are designed to manage rather than eliminate the risk of failure to achieve

business objectives and can only provide reasonable, but not absolute, assurance against material misstatement or loss.

The Board of Directors is not aware of any significant failures in internal control that arose in the business of the Company during 2008 that have not been identified and dealt with in accordance with the internal control procedures of the Company.

The Company's Internal Audit function provides a degree of assurance as to the operation and validity of the system of internal control and planned corrective actions are independently monitored for timely completion.

DIRECTORS' REMUNERATION REPORT

SUMMARY

Since the commencement of a period of temporary public ownership on 22 February 2008, the full requirements of the Directors' Remuneration Report Regulations (the "Regulations") and the Combined Code on Corporate Governance (the "Combined Code") do not apply to the Company. However, the Company has voluntarily complied with the Regulations in most key respects. The Directors' Remuneration Report also sets out how the principles of the Combined Code relating to Executive Director remuneration have been applied by the Company during 2008.

COMPLIANCE

The Company complied with the provisions of the Combined Code relating to Directors' remuneration throughout 2008, save that the service contracts of Mr Sandler (for his service as Executive Chairman) and Ms Godbehere were approved by HM Treasury in connection with the Company's entry into temporary public ownership. Both of these service contracts have now terminated.

THE REMUNERATION COMMITTEE

During 2008, the Remuneration Committee (the "Committee") consisted entirely of Non-Executive Directors save that (as permitted by the Combined Code) the Chairman of the Company, Mr Sandler, has served as a member of the Committee since 22 February 2008, and continues to do so; his predecessor as Chairman, Mr Sanderson, also served as a member of the Committee until his retirement from the Board on 22 February 2008.

Until 22 February 2008, the Committee comprised Sir Ian Gibson (Chairman), Mr Queen, Mr Adams, Mr Devaney, Mr Laffin, Mr Sanderson and Mr Thompson (who joined the Committee on 25 January 2008). Between 22 February 2008 and 1 October 2008, the Committee comprised Mr Hester (Chairman), Mr Adams, Mr Devaney and Mr Sandler. Since 1 October 2008, the Committee has comprised Mr Devaney (Chairman), Mr Sandler, Mr Adams and Mr Davies (who joined the Committee on 10 October 2008).

The Committee operates within agreed terms of reference. The Committee has responsibility for making recommendations to the Board of Directors (the "Board") on the Company's general policy relating to executive remuneration. It also determines, on behalf of the Board, specific remuneration packages for the Chairman, the Executive Directors and the Executive Committee, being the level of management immediately below the Board. Neither the Chairman nor the Chief Executive are present when their own remuneration is under consideration.

The Committee met on five occasions during 2008.

The Committee is empowered to take advice from both inside and outside the Company on a range of matters, including the scale and composition of the total remuneration package payable in comparable financial institutions to people with similar qualifications, skills and experience, and the amounts payable to Directors on termination.

The following persons and advisors provided advice or services that materially assisted the Committee in its consideration of Executive Directors' remuneration matters during 2008:

- Internal support was provided to the Committee by the Company Secretary and the Human Resources Director;
- Mercer Limited, who are the consulting actuaries to the Company, advised on various pension issues relating to Directors; and
- Freshfields Bruckhaus Deringer LLP advised the Company on various remuneration and service contract matters and on compliance with the Regulations. They are the Company's principal legal advisors.

REMUNERATION POLICY FOR EXECUTIVE DIRECTORS

By virtue of The Northern Rock plc Transfer Order 2008 (the "Transfer Order"), which was made pursuant to the Banking (Special Provisions) Act 2008,

with effect from 22 February 2008 all shares in the Company were transferred to the Treasury Solicitor, as nominee of HM Treasury, and consequently the Company entered into a period of temporary public ownership.

As announced on 23 February 2009, the Board is developing a revised business plan. The Committee will develop a revised remuneration policy that is closely aligned to achievement of the objectives of the revised plan.

REMUNERATION PACKAGES DURING 2008

The Executive Directors' remuneration packages comprise basic salary, pension benefits and certain other benefits in kind.

No cash bonuses have been awarded to any Executive Director in respect of 2008.

No short term or long term incentive arrangements are currently in place for 2009 or future years. However, the Committee anticipates that long term incentive arrangements will be an element of its revised remuneration policy.

BASIC SALARY

The Committee's objective is that Executive Directors' basic salaries should be paid at an appropriately competitive level.

No salary increases took effect on either 1 January 2008 or 1 January 2009, the normal review date.

Relevant salary information is as follows:

- Mr Sandler served as Executive Chairman between 22 February 2008 and 1 October 2008, at a salary of £90,000 per month. Mr Sandler has served as Non-Executive Chairman with effect from 1 October 2008, and is entitled to a fee of £350,000 per annum in respect of this role.
- Mr Kuipers served as Chief Executive Officer until 7 September 2008, at a salary of £560,000 per annum.
- Mr Hoffman succeeded to the role of Chief Executive Officer on 1 October 2008. His salary is £700,000 per annum.

DIRECTORS' REMUNERATION REPORT (continued)

- Ms Godbehere served as Chief Financial Officer between 22 February 2008 and her retirement from the Board on 31 January 2009, at a salary of £75,000 per month. This salary continued until she left the Company on 28 February 2009.

PENSION BENEFITS

Of those Directors in service as at 31 December 2008, the Company does not provide pension arrangements for Mr Sandler or Ms Godbehere. The Company pays an amount equal to 40% of Mr Hoffman's annual salary towards pension arrangements maintained by him. Two Executive Directors who retired from the Board in 2008 participated in final salary pension arrangements, as set out on page 16.

LEGAL ADVICE IN RELATION TO DUTIES

Following commencement of the strategic review in September 2007, the Board authorised the Directors in office at that time to take personal legal advice at the Company's expense in relation to their duties as Directors. This advice continued during 2008 and has extended to certain Directors who have joined the Board since September 2007. To the extent that the receipt of this advice constitutes a taxable benefit for such Directors, the Company would also discharge the associated tax liability.

POLICY ON EXECUTIVE DIRECTORS' SERVICE CONTRACTS

It is the policy of the Company that Executive Directors' service contracts should be terminable by the Company on 12 months' notice given at any time, and that each Executive Director should be permitted to terminate his employment by giving 6 months' notice. Although the service contracts entered into with certain Executive Directors in 2008 (as described below) did not fully comply with this policy, it is the Committee's intention that future service contracts entered into by the Company should do so. The service contracts entered into during 2008 were, however, compliant with the Combined Code, which permits an initial term in

excess of one year where this is necessary to recruit a new Director.

Mr Hoffman serves the Company under a service contract dated 23 July 2008 (effective 1 October 2008) which is terminable by either party on 12 months' notice given at any time after 1 October 2009. Mr Hoffman's contract may be terminated immediately by the Company on payment of an amount equal to the salary only (excluding other benefits) that he would have received during his notice period. If Mr Hoffman's contract is terminated before 1 October 2009, the payment in lieu of notice would relate to the balance of notice period to 1 October 2010. The termination amount would be paid in monthly instalments, and such instalments would be reduced by an amount equal to the monthly remuneration derived by Mr Hoffman from other activities commencing during the notice period. In addition, Mr Hoffman would on termination, be entitled to any outstanding instalments of the payments to which he is entitled as compensation for the loss of entitlements under long term incentive arrangements with his previous employer (as set out in the footnote to the Directors' Individual Remuneration table on page 15).

Ms Godbehere served the Company under a service contract dated 22 February 2008 which was expressed to be terminable by either party on one month's notice given at any time after 22 August 2008.

Ms Godbehere's service contract terminated (without payment of compensation) when she left the Company on 28 February 2009 following her retirement from the Board on 31 January 2009.

Mr Sandler served the Company as Executive Chairman under a service contract dated 22 February 2008 which was expressed to be terminable by either party on three months' notice, which, if served by the Company, would expire on or after 22 February 2009.

In connection with Mr Sandler's transition to Non-Executive Chairman (which occurred on 1 October 2008), the service contract terminated (without payment of compensation). Mr Sandler's arrangements

in respect of his service as Non-Executive Chairman are described below.

The service contracts of Mr Sandler and Ms Godbehere were expressed to be terminable by the Company on payment in lieu of notice of an amount equal to the salary only (and not other benefits) that they would have received during their notice period.

TERMINATION ARRANGEMENTS FOR FORMER DIRECTORS

Mr Kuipers served the Company as Chief Executive Officer under a service contract dated 14 January 2008 (previous contract dated 5 January 2005). His employment terminated, and he retired as a Director, on 7 September 2008. His service contract was expressed to be terminable by the Company on 12 months' notice or by way of payment in lieu of notice equal to 12 months' salary and certain benefits as described below. Under a settlement agreement dated 5 September 2008, Mr Kuipers became entitled to a termination payment of £707,939 to be paid in monthly instalments. This amount is made up of £560,000 as payment in lieu of 12 months' salary, plus an amount of £147,939 in respect of the annual cost of pension and certain other benefits specified in his service contract (but excluding any amount in respect of bonus). Such instalments as are outstanding will be reduced in the event that Mr Kuipers commences alternative employment at a basic annual salary of at least £20,000. In such case, the monthly amount payable will be reduced by such sum as is equal to 50% of 1/12th of the basic salary in excess of £20,000 which he may receive from such alternative employment.

The Company agreed to contribute £5,000 plus VAT towards Mr Kuipers' legal fees. Mr Kuipers retains his private medical insurance benefit until 31 December 2009. Mr Kuipers was entitled to an immediate pension in accordance with the rules of the Northern Rock Pension Scheme, subject to actuarial reduction for early receipt.

The following information, relating to Directors who retired from the Board prior

DIRECTORS' REMUNERATION REPORT (continued)

to the date of publication of the Company's 2007 Directors' Remuneration Report on 29 March 2008, updates the information provided in that Directors' Remuneration Report:

- (a) Mr Sanderson, who served the Company under a letter of appointment dated 19 October 2007, retired as the Chairman of the Company and as a Director on 22 February 2008. Mr Sanderson's appointment was for a fixed term of two years which had been due to expire on 19 October 2009. Mr Sanderson's annual fee was £315,000 and he was entitled to a further £85,000 towards the costs of his London office accommodation and the cost of his personal assistant subject to him providing the Company with reasonable evidence in relation to those costs (the "Additional Payment"). His letter of appointment was expressed to be terminable by the Company at any time but, on termination prior to 19 October 2009, Mr Sanderson was entitled to the balance of his fees and the Additional Payment in respect of the period to 19 October 2009. Pursuant to a settlement agreement dated 23 December 2008, Mr Sanderson became entitled to a payment of £315,000 (representing one year's fee only); this has been paid to him. He would have been entitled to a further £210,000 (representing the balancing eight months' fees). However, at Mr Sanderson's suggestion, the Company agreed to contribute the £210,000 to The Northern Rock Foundation. No compensatory amount was paid in respect of the Additional Payment. The Company agreed to contribute £20,500 plus VAT towards Mr Sanderson's legal fees;
- (b) Mr Applegarth, who retired as a Director on termination of his employment on 12 December 2007, received monthly instalments pursuant to a settlement agreement dated 12 December 2007. Although such

instalments were expressed to be reduced in the event that Mr Applegarth commenced alternative employment or the provision of services at a basic salary or fee of at least £20,000 per annum prior to 16 November 2008, Mr Applegarth did not commence such alternative activities so that the instalments did not fall to be reduced. A total of £731,629 was paid to Mr Applegarth pursuant to these termination arrangements, plus an amount of £108,675 in respect of the annual cost of pension and other benefits specified in his service contract (but excluding any amount in respect of bonus);

- (c) Mr Baker, who retired as a Director on 16 November 2007, continued in service as an employee on his previous terms and conditions (that is, at a salary of £530,000 and potential bonuses) until retirement from the Company on 2 May 2008. On leaving the Company, he became entitled to an immediate pension, subject to actuarial reduction for early receipt, under the Northern Rock Pension Scheme. Mr Baker waived his contractual entitlement that, as he had attained 55 on retirement, his pension should not be subject to actuarial reduction. No termination payment was made to Mr Baker on his retirement; and
- (d) Mr Thompson, who was appointed as a Non-Executive Director on 25 January 2008, retired on 22 February 2008. On retirement from the Board, Mr Thompson was, in accordance with the terms of his letter of appointment dated 17 January 2008 (details of which are set out below), paid £100,000, representing the balance of his fees to 31 December 2008.

POLICY ON EXTERNAL NON-EXECUTIVE DIRECTORSHIPS HELD BY EXECUTIVE DIRECTORS

Executive Directors are permitted to hold one external non-executive directorship unrelated to the Company's business,

provided that the time commitment is not material. Executive Directors are permitted to retain any fees arising from such a non-executive directorship.

Mr Sandler, Ms Godbehere and Mr Hoffman have been permitted to retain all non-executive directorships held by them at the date of their appointment to the Board, and the fees therefrom.

REMUNERATION OF THE CHAIRMAN AND NON-EXECUTIVE DIRECTORS

The fees for the Chairman and Non-Executive Directors described below were set at levels sufficient to attract the calibre of Non-Executive Director needed to assist the Company during and following its strategic review.

The Chairman and the Non-Executive Directors are entitled to fees from the Company and it is the Company's policy that they do not participate in bonus, incentive or pension schemes.

Mr Sandler commenced his appointment as Non-Executive Chairman on 1 October 2008 (upon relinquishing his Executive Chairman role), and serves the Company under a letter of appointment dated 4 December 2008. Under the terms of Mr Sandler's letter of appointment, he is entitled to an annual fee of £350,000. Mr Sandler's appointment as Non-Executive Chairman will terminate on the earliest of 30 September 2011, the date on which the Company is returned to the private sector, or upon the expiration of four months' written notice of termination from Mr Sandler or the Company.

The standard annual fee structure that has been put in place for Non-Executive Directors with effect from 22 February 2008 is as follows:

Non-Executive Director's Basic Fee	£60,000
Additional Fee for Membership of a Board Committee	£5,000
Additional Fee for Chairman of a Board Committee	£15,000

DIRECTORS' REMUNERATION REPORT (continued)

With effect from 1 January 2009, the Additional Fee for the Chairman of the Risk Committee is £20,000.

The following paragraphs set out details of the letters of appointment and fee arrangements of Non-Executive Directors who remained in service on 31 December 2008:

(a) The following individuals were appointed as Non-Executive Directors of the Company by letters of appointment dated between 16 November 2007 and 22 February 2008:

- (i) Mr Adams – 23 November 2007;
- (ii) Mr Devaney – 16 November 2007; and
- (iii) Mr Laffin – 16 November 2007.

The letters of appointment for these Non-Executive Directors were for a fixed term, which expired on 31 December 2008 (the "Termination Date"). If their appointment had been terminated prior to the Termination Date (other than for a material breach of duties by the Director of the terms of the letter of appointment), then the letters of appointment provided for them to receive the balance of their fees payable up to the Termination Date. They were entitled to a basic fee of £90,000 per annum and a further £10,000 per annum for each Committee membership. Mr Laffin retired from the Board on the Termination Date and, in accordance with these provisions, did not receive a termination payment. The appointments of Mr Adams and Mr Devaney were renewed with effect from the Termination Date, and their revised letters of appointment are described below.

(b) On 22 February 2008, the Shareholder Directors, Mr Remnant and Mr Scholar, were appointed as Non-Executive Directors of the Company by initial letters of appointment dated 22 February 2008. Mr Scholar has waived his entitlement to fees.

(c) Since 22 February 2008 the following individuals were appointed as Non-Executive Directors of the Company by letters of appointment dated as follows:

- (i) Mr Atkinson – 1 August 2008;
- (ii) Mr Coates – 1 August 2008; and
- (iii) Mr Davies – 10 October 2008.

The letters of appointment for these Non-Executive Directors were for a fixed term of 12 months. If their appointment is terminated prior to the date that their appointments are due to expire, they are not entitled to any compensation or fees.

The Board has determined that standard letters of appointment should apply in relation to the renewed appointment of any of the Non Executive Directors referred to above (except the Shareholder Directors) and the appointment of any further Non Executive Directors. These letters of appointment will be for a fixed term of two years, subject to termination by either party on three months' notice at any time or, if the Company anticipates that it will cease to be in public ownership, by the Company providing notice at any time that it considers appropriate, so that the appointment terminates on the day that the Company is returned to the private sector. The renewed letters of appointment of Mr Adams and Mr Devaney (both dated 22 December 2008, becoming effective on 1 January 2009) reflect this new policy.

The following paragraphs set out details of the letters of appointment, fee arrangements and any termination payments relating to individuals who served as Non-Executive Directors during 2008, but retired before 31 December 2008:

(a) Mr Thompson retired from the Board on 22 February 2008 and, as described above, was paid the balance of his fees to 31 December 2008 in accordance with the terms of his letter of appointment dated 17 January 2008.

(b) The following Directors, who retired from the Board on the date stated after their name, did not receive a termination payment on retirement:

- (i) Sir Ian Gibson (retired 22 February 2008; letter of appointment dated 24 December 2007);
- (ii) Mr Queen (retired 1 May 2008; letter of appointment dated 24 December 2007);
- (iii) Mr Hester (retired 1 October 2008; letter of appointment dated 22 February 2008); and
- (iv) Mr Laffin (retired 31 December 2008; letter of appointment dated 16 November 2007).

DIRECTORS' REMUNERATION REPORT (continued)

FINAL SALARY PENSION ARRANGEMENTS

During 2008, two Executive Directors (both of whom retired from the Board during the year) accrued retirement benefits under a defined benefit pension scheme, (2007 – 6 Executive Directors).

DIRECTORS' INTERESTS IN SHARES

As a result of The Northern Rock plc Transfer Order 2008 on 22 February 2008 all of the Ordinary shares were transferred to the Treasury Solicitor as the Treasury's nominee and contingent interests lapsed.

The following Directors (excluding Directors who were appointed to the Board on or after 22 February 2008) held a beneficial interest in the Company's Ordinary shares in the period up to 22 February 2008:

	At		Contingent Interests	
	22 Feb 08	31 Dec 07 (or date of appointment)	22 Feb 08	31 Dec 07 (or date of appointment)
Non Executive Directors				
B K Sanderson (retired 22 February 2008)	–	–	–	–
L P Adams (appointed 29 November 2007)	–	–	–	–
J F Devaney (appointed 26 November 2007)	–	–	–	–
Sir Ian Gibson (retired 22 February 2008)	15,000	15,000	–	–
S T Laffin (retired 31 December 2008)	–	–	–	–
M J Queen (retired 1 May 2008)	16,000	16,000	–	–
P A Thompson (appointed 17 January 2008; retired 22 February 2008)	–	–	–	–
Executive Directors				
D A Jones (retired 22 February 2008)	73,323	94,393	132,285	132,285
A M Kuipers (retired 7 September 2008)	138,423	174,663	207,951	207,951

EMPLOYEE SHARE SCHEMES

Rights under the Northern Rock employee share schemes were extinguished on 22 February 2008 as a result of The Northern Rock plc Transfer Order 2008. Details of the Ordinary shares over which Mr Jones and Mr Kuipers (who retired from the Board on 22 February 2008 and 7 September 2008 respectively) had conditional rights under each relevant scheme as at 22 February 2008 were set out in full in the 2007 Directors' Remuneration Report, and are aggregated in the column headed "Contingent Interests" in the table above. No other Directors in office during 2008 participated in those schemes.

J F Devaney
Remuneration Committee Chairman
2 March 2009

CORPORATE SOCIAL RESPONSIBILITY REPORT

INTRODUCTION

Corporate Social Responsibility ("CSR") reporting is broken down into a number of interconnecting areas and a summary of our key activities within each area is presented in this report.

GOVERNANCE AND ACCOUNTABILITY

GOVERNANCE

Details of Northern Rock's Board of Directors and governance structures are detailed in the Corporate Governance Report on pages 6 to 10.

ACCOUNTABILITY

NORTHERN ROCK FINANCIAL PERFORMANCE

Northern Rock has committed to provide regular and transparent reporting against its Business Plan. The Company releases detailed financial statements for the half year and full year. These detailed releases are supported by quarterly trading updates.

BUSINESS ETHICS AND HUMAN RIGHTS

GROUP TREASURY

Where appropriate, treasury dealing takes place in accordance with the rules and guidance in the Financial Services Authority (FSA) Handbook. Any treasury dealing outside the scope of the FSA regulation, such as money market deposits and foreign exchange, is covered by the Non Investment Products Code (NIPs Code). This is a voluntary code (endorsed by the FSA) that lays down what is generally considered to be good market practice. As well as market practice covering dealing and settlement processes, it also covers other areas such as marketing and incentives, entertaining and gifts, gambling and drug and alcohol abuse.

The Group compliance and treasury control and compliance teams conduct periodic reviews to assess how our policies, procedures and practices compare to FSA regulations and best practice in the NIPs Code.

NORTHERN ROCK PENSION SCHEME

In October 2007, the Trustees adopted a risk-averse investment strategy as a result of the circumstances the Company was in at that time. As a result, no quoted equities are currently being held as fund investments in respect of the defined benefit section of the Scheme. In due course, however, it is possible that an allocation to higher-risk assets, including quoted equities, will again be made. It is likely that such an investment would again be made via pooled funds.

BETTER PAYMENT PRACTICE AND THE LATE PAYMENT OF COMMERCIAL DEBTS (INTEREST) ACT 1998, AS AMENDED BY THE LATE PAYMENT OF DEBT REGULATIONS 2002

The Company recognises the importance of making creditor payments on time, thereby ensuring that our suppliers do not encounter unnecessary cash-flow problems as a result of late payments being made.

Ensuring that the Provisions of the Act have been fully communicated and implemented also ensures that Northern Rock will not incur risks to reputation as a result of non-compliance. A look ahead date on payment run parameters ensures late payments are kept to a minimum. The only invoices not meeting the agreed payment date should be those subject to query or dispute.

Creditor days are included in the Directors Report.

MARKETPLACE

COMPETITIVE FRAMEWORK

The Company is determined to ensure that it does not take unfair advantage of Government support during the period of temporary public ownership. Therefore a self-imposed framework of principles and commitments has been established:

OUR PRINCIPLES

- We will not promote our Government guarantee arrangements in any market.
- We will not sustain a prolonged presence as a market leader in the marketplace or in any product category.

- We will maintain market shares below historical levels while in receipt of State aid.
- We will strive to differentiate ourselves on the basis of service and innovation.
- We will at all times treat our customers fairly.
- We will regularly review our competitive offering and performance to ensure adherence to the framework.

OUR COMMITMENTS

- We will not explicitly refer to Government ownership in marketing literature.
- We will not allow our share of retail deposit balances to exceed 1.5% in the UK and 0.8% in Ireland (well below our historic levels of 1.9% in the UK and 1.3% in Ireland).
- We will limit our share of gross new mortgage origination to no more than 2.5% in any calendar year.
- We will not rank within the top 3 in any one of the defined 15 Moneyfacts retail deposit categories during 2008.

During the year, the Company has actively managed its product range to maintain balances within the parameters of the Competitive Framework.

OUR CUSTOMERS

Customers are of paramount importance to Northern Rock. Whether customers have invested or borrowed, our aim is to offer products and services in an open, honest and fair way.

As our business and our industry changes, we are increasingly mindful of customer needs. Commercial decisions are considered in the context of how they will impact upon customers. We are also seeking to ensure that our business plan supports the relationship we have with customers.

We also recognise that the general economic environment means that increasing numbers of customers will require additional support and assistance – particularly where they have a current

CORPORATE SOCIAL RESPONSIBILITY REPORT (continued)

account overdraft facility, or are struggling to meet their mortgage repayments. We actively seek to identify the most constructive way forward, with a view to providing whatever support we can offer.

ENGAGEMENT

CUSTOMER RESEARCH

Northern Rock's Customer Research programme enables us to objectively monitor our service levels and the extent to which we are meeting our customers' needs. Using an external consultancy, we are able to establish our customers' attitudes across a range of product areas and customer types.

The programme has naturally evolved to reflect our changing business priorities. Throughout 2008, we have actively monitored customer reaction to developments within our business and the wider financial services market, enabling us to tailor our approach to customer service accordingly.

Throughout 2008, we have spoken to mortgage customers where we have not offered them a new product deal, as part of our active mortgage redemption programme. Feedback from those customers has helped us to track borrower attitudes to our proposition as it evolved, tailor staff training requirements accordingly, and monitor the effectiveness of our service delivery.

Data continues to be gathered to monitor our customers' overall satisfaction levels. Given the current economic climate it is pleasing to note that satisfaction levels still generally exceed 80%.

An additional barometer of customer satisfaction is advocacy, since customers will usually only recommend a product or company if they are completely satisfied. Again, it is encouraging that over 75% of customers in our latest surveys are prepared to recommend Northern Rock to friends and family.

We know from research and feedback that most customers experience a good level of service from Northern Rock. However, it is our commitment to customers that means we will continually seek to improve what we have to offer.

WORKPLACE

HR RESTRUCTURING

As a result of the escalating credit crisis, Northern Rock being taken into temporary public ownership in 2008 and development of the subsequent business plan, it became necessary to restructure the Company.

KEY OBJECTIVES OF RESTRUCTURING EXERCISE

It was important for Northern Rock to ensure that:

- All staff made redundant in the Company were dealt with in a professional manner and had appropriate support to help them with their future careers.
- The restructuring was undertaken with due regard to our operating platform to ensure service provisions to our customers remained unaffected both during and post restructuring.
- The right mix of people remained in the organisation with the necessary skills and capabilities required to deliver the ongoing business plan.
- The Company worked with Unite to support those staff who were leaving the Company and those rebuilding the Company post restructure.

KEY OUTCOMES OF RESTRUCTURING

- At the start of consultation exercise, it was envisaged that a number of redundancies would be necessary. During this exercise Northern Rock actively sought opportunities to minimise the number of compulsory redundancies.
- The option of voluntary redundancy was offered wherever possible, cognisant of the need to retain a suitably skilled and experienced workforce post restructuring. However, as certain areas of the business ceased to trade, the use of compulsory redundancy was unavoidable in certain situations.
- Through effective consultation with Unite and other employee representatives, the number of

redundancies was limited to 1,300, of which approximately 500 were voluntary.

- A number of new roles were identified as part of the restructuring exercise, with approximately 600 staff redeployed to alternative roles within the Company, avoiding a greater number of redundancies.
- Establishment of a high quality outplacement programme in conjunction with One NorthEast.

STAFF ENGAGEMENT SURVEY

A corporate engagement survey of staff was undertaken in the last quarter of 2008. Over 2,600 staff provided their views on motivation and morale and what it was like to work at Northern Rock within the newly restructured Company. This has given us great insight and helped us to identify where we have the opportunity to improve.

The survey analysis showed some positive themes emerging but, as expected following the amount of change the Company has experienced in a relatively short time, there were also some things that we need to take a much closer look at and seek to improve, with the help of staff.

- It was extremely satisfying to note that over 80% of respondents felt satisfied, or very satisfied, to still work at Northern Rock and a similar proportion thought it was a good place to work. We believe that reflects the very positive attitude and pride in the Company that our staff hold.
- Over 90% of respondents recognised how important and central the customer is to Northern Rock's business.
- The importance of increased training and development was also recognised in the responses which may reflect the amount of change experienced over 2008 and the number of people who have changed roles. There was also a desire to receive more recognition for the work undertaken and to be able to build a career with the Company.
- Overall there was a high satisfaction level with communications. Over 80%

CORPORATE SOCIAL RESPONSIBILITY REPORT (continued)

were satisfied or very satisfied, but there was also a clear desire for more direct two-way contact and interaction with both direct line management and senior management.

In the first quarter of 2009, each operational function will also develop, with their Human Resources business partner, an action plan of things that can be realistically improved and, equally as important, the things that we are doing well and need to keep doing.

TRAINING

Northern Rock's training function was restructured in 2008, and a revised training programme will be rolled out during 2009.

HEALTH AND SAFETY

ACCIDENT REPORTING

In 2008 there were 7 RIDDOR reportable accidents. Compared to national data for RIDDOR reportable accident rates within the business and finance sector, this number is below the national average.

SICKNESS ABSENCE

During 2008, there was a total of 61,648 days lost due to all types of sickness absence. 27.7% of this sickness absence was attributable to factors that may be associated with work. This represents a decrease from 33.5% in 2007.

ENVIRONMENT

The key environmental impacts arising from our corporate operations have been identified as the use of energy, carbon dioxide emissions, waste, water use, corporate transport and staff transport to work. Where practical we are also committed to ensuring that environmental awareness and best practice form an integral part of our decision making process.

ENERGY

The Company is committed to controlling the environmental impact from its use of energy and is demonstrated by its re-accreditation to Energy Efficiency Scheme, operated by The Carbon Trust.

This is an area where we seek continuous improvement and towards the end of 2008 "smart meters" have been ordered for all of our sites. This will improve our ability to manage consumption.

CARBON DIOXIDE

Following the amendments to DEFRA Reporting Guidelines, the Company can now only use grid average for CO₂ calculations. This has meant that our output of CO₂ per employee in 2008 was 3.02 tonnes against 0.524 tonnes in 2007. The primary reason for this was our inability to purchase renewable energy.

WASTE

Northern Rock follows the principles of "Reduce, Reuse and Recycle". As a result of the restructuring of the Company, excess furniture, equipment, training materials and stationery items have been donated to local schools, colleges, businesses and charities. We continue to operate successful recycling facilities for plastic and the percentage of materials recycled continues to rise for plastic bottles, plastic cups, waxed paper cups, cans, toner cartridges, waste electrical equipment and mobile phone batteries.

WATER

We benchmark and target our water use against the DEFRA corporate environmental reporting guidance for offices, which is 0.05m³ per employee per working day. During 2008 our equivalent figure was 0.047m³.

COMMUNITY

NORTHERN ROCK FOUNDATION

The Northern Rock Foundation is a charity and a company limited by guarantee with an independent Board of Trustees that makes all decisions on governance, finance and policy. The aims of the Foundation are to tackle disadvantage and improve quality of life in North East England and Cumbria. From 1997 to 2008, Northern Rock plc donated over £200 million to the Foundation, through a covenant of 5% of its pre-tax profits each year. As a result Northern Rock was regularly ranked as one of the UK's top corporate givers.

Thanks to the generosity of the Company and to prudent house-keeping by successive boards of Trustees, the Foundation was able to continue grant-making in late 2007 and early 2008 while Northern Rock undertook its strategic review. In February 2008, as part of the arrangement under which the Company was taken into temporary public ownership, it was agreed that the Foundation would receive £15m a year in 2008, 2009 and 2010.

Further information on The Northern Rock Foundation can be obtained from;

The Northern Rock Foundation
The Old Chapel
Woodbine Road
Gosforth
Newcastle upon Tyne
NE3 1DD

Telephone: 0191 2848412

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Minicom: 0191 2845411

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NORTHERN ROCK IN THE COMMUNITY

STAFF MATCHED GIVING SCHEME

The Staff Matched Giving Scheme supports individual employees who wish to raise money for, or give money to, UK registered charities or to exempt and excepted charities. The Trustees have set a top annual limit of £1,000 per person and £250,000 for the scheme in total.

With effect from January 2008, the Foundation will single match cash donations and/or fundraising up to £1,000 per person per year.

CORPORATE CHARITY

The Corporate Charity for 2008 was Marie Curie Cancer Care. During the year staff raised £45,000 for the charity which was matched by the Foundation.

OPERATING AND FINANCIAL REVIEW

DESCRIPTION OF THE BUSINESS

Northern Rock is a mortgage and savings bank based in the UK. Its core lending business is UK residential mortgages, which comprise over 90% by value of total loans and advances to customers. The balance of loans and advances to customers includes a portfolio of personal unsecured loans and a small portfolio of secured commercial loans. The distribution network consists of over 70 branches, plus postal, telephone and internet operations. The Company also uses the UK financial intermediary market to distribute products to customers.

OVERVIEW OF 2008

In February 2008, Northern Rock was taken into a period of temporary public ownership by the UK Government. Following this, Northern Rock developed a Business Plan (the "Plan") in order to achieve the objectives of the Tripartite Authorities for Northern Rock during temporary public ownership: to protect taxpayers, to maintain wider financial stability and to protect depositors.

Under the Plan, the Company's prime objectives were:

- The repayment of the Government loan
- The release of HM Treasury guarantee arrangements
- A successful return to the private sector

Northern Rock reduced significantly the Government loan balance during 2008. On a gross basis the loan balance reduced to £15.6 billion by the end of the year. On a net basis, which takes into account liquidity deposits held with the Bank of England, other than deposits relating to swap collateral, the amount due to the Government reduced from £26.9 billion at 31 December 2007 to £8.9 billion at 31 December 2008.

Residential mortgage balances reduced by 27% to £66.7 billion (31 December 2007 – £90.8 billion), and total balance sheet assets reduced to £91.0 billion (31 December 2007 – £107.1 billion), excluding the fair value of derivatives.

Over the course of 2008, retail deposit balances showed good growth, with balances of £19.6 billion at 31 December 2008 (31 December 2007 – £10.5 billion). The increase in deposits was managed within the constraints of the self-imposed Competitive Framework which was introduced as part of the Plan.

The continued deterioration in economic conditions has resulted in a significant increase in arrears on all loan books. This increase has been exacerbated by the reduction in the size of Northern Rock's loan portfolio and the falling interest rate environment. Northern Rock continues to try to work with customers who are experiencing payment difficulties, and repossession remains a last resort.

The deterioration in credit quality has resulted in a significant increase in impairment provision charges in 2008, which rose to £894.4 million on retail customer loans (2007 – £239.7 million). Combined with the level of exceptional expenses incurred in the year related to the restructuring of the Company and impairments made on treasury investments, this has resulted in Northern Rock incurring a pre-tax loss of £1,355.9 million in 2008 (2007 – loss of £167.6 million).

OPERATING AND FINANCIAL REVIEW (continued)

2008 OPERATIONAL PERFORMANCE

LENDING

Northern Rock has maintained a presence in new mortgage lending markets, albeit at lower levels than in previous years reflecting the objective of repaying the Government loan through reducing the size of the balance sheet. An analysis of new lending and redemptions by portfolio is set out in the following table:

	Residential £m	Commercial £m	Unsecured £m	Total £m
2008 Full Year				
Gross	2,925	2	95	3,022
Redemptions	(26,571)	(24)	(1,830)	(28,425)
Net	(23,646)	(22)	(1,735)	(25,403)
Closing balances	66,700	302	5,298	72,300
2007 Full Year				
Gross	29,494	245	2,512	32,251
Redemptions	(16,188)	(1,515)	(2,337)	(20,040)
Net	13,306	(1,270)	175	12,211
Closing balances	90,778	316	7,351	98,445

Note: Lending flows represent cashflows excluding fair value adjustments. Closing balances are stated including fair value adjustments. Redemptions and net movements include asset disposals where appropriate.

New lending volumes in 2008 have been significantly lower than in previous years. Northern Rock continues to offer new mortgage loans to high quality borrowers, primarily through the intermediary network. New commercial and unsecured loans are no longer offered by the Company.

During 2008, Northern Rock had a proactive redemption programme in place, which assisted customers coming towards the end of their existing mortgage deal in finding a suitable mortgage with another provider. This programme led to significant redemption volumes in 2008, resulting in negative net residential lending, which has enabled the Company to repay a substantial proportion of the Government loan.

In January 2009, the Company announced that in order to support Government policy to increase mortgage lending capacity in the market, it would slow down the rate of mortgage redemptions. On 23 February 2009, the Company announced the conclusion of the strategic review of its business plan undertaken in close consultation with the Government. As a result, Northern Rock will offer up to £14 billion of new mortgage lending over the next two years.

RESIDENTIAL LENDING

The following is an analysis of the secured residential mortgage book at the relevant date:

	2008	2007
Number of accounts (000s)	591	777
Product type (%)		
Standard	64	67
Together	29	24
Lifetime	–	3
Buy to Let	7	6
Geographic spread (%)		
North	16	15
Scotland/Northern Ireland	10	10
Midlands	27	25
South	47	50
Indexed loan to value (%)	73	60

OPERATING AND FINANCIAL REVIEW (continued)

The average indexed Loan to Value (“LTV”) of Northern Rock’s mortgage book at the end of 2008 increased to 73% (31 December 2007 – 60%) as a result of the reduction in house prices seen over the course of the year. The average LTV of new lending in 2008 improved to 67% (2007 – 79%) reflecting the Company’s appetite for high quality new lending. Northern Rock’s loan book is geographically spread across the UK in line with the demographics of the population.

The Lifetime mortgage portfolio (comprising products aimed at homeowners aged 60 and over who wish to utilise equity in their homes to enhance their lifestyle) was sold to JP Morgan in January 2008 at a premium of 2.25% to the balance sheet value.

In February 2008, Together products were withdrawn from the new loan product range in line with other mortgage lenders. The share of Together loans as a proportion of the residential book has increased to 29% at 31 December 2008 (31 December 2007 – 24%), as Together customers on average have a higher LTV and, therefore, in current market conditions, can find it more challenging to move their mortgage to another lender.

UNSECURED

Our personal unsecured credit portfolios comprise the unsecured element of Together lending and standalone unsecured loans not linked to a residential mortgage.

In February 2008, Together products were withdrawn from Northern Rock’s new loan product range and in March 2008 the Company discontinued offering new standalone unsecured lending products. As a consequence, these unsecured loan portfolios will run-off over time.

Balances of Together unsecured loans reduced to £2.7 billion at 31 December 2008, representing 51.3% of total unsecured loan balances (31 December 2007 – £3.4 billion, 45.9%). At 31 December 2008, standalone unsecured balances were £2.6 billion and represented 48.7% (31 December 2007 – £4.0 billion, 54.1%) of total unsecured loan balances.

COMMERCIAL

Following the sale of the majority of the commercial loan portfolio to Lehman Commercial Mortgage Conduit Limited in 2007, Northern Rock’s commercial loan portfolio totalled £0.3 billion at 31 December 2008 (31 December 2007 – £0.3 billion). The Company does not offer new commercial loans and the book will continue to run-off over time.

CREDIT QUALITY AND LOAN LOSS IMPAIRMENT

The arrears position of each of our main personal lending portfolios, based upon numbers of accounts over three months in arrears, is set out in the table below:

	CML residential average	Northern Rock residential	Non- Together residential	Together secured residential	Together unsecured	Standalone unsecured
31 December 2008	1.88%	2.92%	2.25%	4.53%	3.90%	2.87%
30 June 2008	1.30%	1.18%	0.80%	2.14%	2.06%	2.00%
31 December 2007	1.08%	0.45%	0.28%	0.95%	1.12%	1.45%

Source: Northern Rock and Council of Mortgage Lenders (“CML”)

Residential arrears cases and arrears as a percentage of the residential loan book are as follows:

	31 December 2008		31 December 2007	
	Cases	%	Cases	%
Over 3 – 6 months	10,264	1.74	1,910	0.25
Over 6 – 12 months	6,259	1.06	1,439	0.18
Over 12 months	741	0.12	144	0.02
Total	17,264	2.92	3,493	0.45

During 2008, arrears cases have increased sharply due to a combination of factors. The adverse economic background has led to an increase in defaults across the sector, and in Northern Rock’s case this has been exacerbated by the reduction in the size of the

OPERATING AND FINANCIAL REVIEW (continued)

mortgage book. In addition, as previously announced, Northern Rock has strengthened its procedures regarding mortgage arrears capitalisation during the year, which has contributed to the increase in arrears. While the falling interest rate environment helps customers in terms of affordability, lower interest rates increase the quoted arrears percentage due to the nature of the arrears calculation, which has contributed to the increase in arrears in the second half of 2008 as interest rates have fallen.

Arrears over 3 months increased to 2.92% at the end of December 2008, compared with 1.18% at the end of June 2008 and 0.45% at the end of 2007. Within this total residential book number, Together arrears increased to 4.53% (31 December 2007 – 0.95%), while non-Together arrears increased to 2.25% (31 December 2007 – 0.28%).

The stock of unsold repossessed properties was 3,620 at 31 December 2008, compared with 4,201 at 30 September 2008, 3,710 at 30 June 2008 and 2,215 at the end of 2007. During the year, Northern Rock has continued to enhance its debt management function in order to work with customers who are experiencing payment difficulties. Repossession is a last resort. On average, Northern Rock has worked with customers for 15 months before repossession, and the Company has made a commitment not to take possession of an owner-occupied property for at least six months after the customer first falls into arrears. Northern Rock has also made good progress in introducing a range of rescue solutions which can help customers who experience payment problems.

In the unsecured loan books, Together unsecured arrears rose to 3.90% at 31 December 2008 (31 December 2007 – 1.12%), while standalone unsecured arrears increased to 2.87% (31 December 2007 – 1.45%).

Arrears over 3 months on commercial loans, including commercial buy to let loans, were 1.70% at 31 December 2008 (31 December 2007 – 0.81%).

Loan loss impairment balances and coverage at the year end are set out in the following table:

	Residential	Commercial	Unsecured	Total
2008				
Impairment provision £m	378.3	7.8	483.6	869.7
% share of closing balances	0.56%	2.52%	8.36%	1.19%
2007				
Impairment provision £m	63.7	0.7	178.6	243.0
% share of closing balances	0.07%	0.22%	2.37%	0.25%

Loan loss impairments have increased significantly during 2008, reflecting increasing arrears, rising unemployment and falling house prices. The loan loss impairment charge on retail customer loans was £894.4 million in 2008 (2007 – £239.7 million).

TREASURY INVESTMENTS

During 2008, following a revision to IAS 39, a number of securities previously classified as available for sale were reclassified as loans and receivables. These assets had no active market and had become highly illiquid. They were transferred to loans and receivables at their market value on transfer, and are now accounted for on an amortised cost basis. The reclassified carrying value at 31 December 2008 amounted to £2,952.8 million. The fair value loss in the available for sale reserve in respect of these reclassified assets was £670.3 million.

Below is an analysis of treasury investments at 31 December 2008.

	Nominal value £m	Carrying value £m	Impairment charge in year £m	Share of portfolio %
Deposits with central banks	9,276.0	9,276.0	–	56.3
Loans and advances to banks	3,384.4	3,384.4	–	20.5
Loans and advances to customers	845.6	422.4	90.0	2.6
Reclassified available for sale securities	3,805.1	2,952.8	177.6	17.9
Available for sale securities	619.1	422.5	53.4	2.6
Held at fair value through the income statement	28.8	11.5	–	0.1
Total	17,959.0	16,469.6	321.0	100.0

OPERATING AND FINANCIAL REVIEW (continued)

The credit ratings of unimpaired treasury investments were as follows:

Credit Rating

	2008	2007
	%	%
Central Banks	56.6	1.3
AAA	9.1	44.8
AA	13.2	22.0
A	16.1	21.9
BBB	4.2	7.6
Other rated	0.1	0.9
Not rated	0.7	1.5
Total	100.0	100.0

Loans and advances to banks are cash deposits Northern Rock has placed with other financial institutions and are carried at amortised cost, subject to a test for impairment. No impairments have been made in 2008.

Loans and advances to customers include holdings of structured investment vehicles (SIVs), other structured vehicles and local authority loans. Loans & advances to customers are carried at cost and are subject to a test for impairment. An impairment charge of £90.0 million has been made in relation to SIVs in 2008, in addition to the impairment charge of £232.2 million in 2007. The total remaining carrying value on SIVs was £17.7 million at 31 December 2008.

Reclassified available for sale (AFS) securities include illiquid Floating Rate Notes and asset backed investments. These investments have been assessed on a case by case basis, and as a result an impairment charge of £177.6 million was made in 2008, reflecting market conditions and events in the second half of the year. Investments in Lehman Brothers and the failed Icelandic banks have been impaired in full, and are included in a charge of £110.0 million. Impairments of £67.6 million have also been made against certain other asset backed securities where performance of the underlying assets is poor, particularly in the non-conforming mortgage sector.

The remaining AFS investments include collateralised debt obligations (CDOs), Government bonds, certificates of deposit and certain structured investments. An impairment charge was made in relation to structured investments of £24.0 million during 2008. In addition, impairments charges of £29.4 million have been made against US\$ CDOs in 2008 to take their carrying value down to nil. This charge was made before the assets were transferred to loans and receivables, and is shown within the AFS charge in the above analysis.

FUNDING

Northern Rock traditionally had four funding arms comprising wholesale funding, securitisation, covered bonds and retail deposits. In addition to these sources of funding, in September 2007 the Company arranged a loan facility with the Bank of England. In August 2008 the loan balance was novated to HM Treasury.

Flows of each funding channel and closing balances are shown in the following table:

	Retail £m	Wholesale £m	Securitisation £m	Covered Bonds £m	Government £m
2008 Full Year					
Net flow	9,044	(1,480)	(12,211)	–	(18,069)
Closing balances	19,623	12,924	37,987	12,550	8,861
2007 Full Year					
Net flow	(12,168)	(11,695)	1,283	2,194	26,930
Closing balances	10,469	11,472	43,070	8,938	26,930

Note: Net flow represents net cashflows excluding fair value adjustments. Closing balances are stated including fair value adjustments primarily related to exchange rate fluctuations. Such fluctuations are protected by cross-currency swaps. The Government loan balance is stated net of liquidity deposits held with the Bank of England, excluding deposits relating to swap collateral.

OPERATING AND FINANCIAL REVIEW (continued)

RETAIL

Retail funding comprised a full year net inflow of funds of £9.0 billion, compared to a net outflow in 2007 of £12.2 billion.

Closing retail balances comprised:

	2008	2007
	£m	£m
Branch accounts	4,313	3,035
Postal accounts	7,496	4,351
Internet accounts	5,398	1,531
Offshore accounts	2,023	1,088
Telephone accounts	150	181
Legal & General branded accounts	243	283
Total retail balances	19,623	10,469

Retail funding inflows were strong in 2008, reflecting in large part the level of uncertainty in the UK financial sector during the year. Northern Rock has in place a self-imposed Competitive Framework which is a set of principles and commitments to ensure that the Company does not take unfair advantage of Government support while in receipt of State aid. This Framework commits Northern Rock to:

- Not promote the Government guarantees
- Not sustain a prolonged presence as market leader
- Maintain market shares well below historic levels
- Achieve competitive differentiation through service and innovation
- Treat customers fairly and regularly monitor and review adherence to the Framework

The Competitive Framework also includes commitments to restrict the Company's share of retail deposits to no more than 1.5% in the UK and 0.8% in Ireland. At the end of 2008, Northern Rock's share of UK retail deposits was 1.49% and share of Ireland deposits was 0.56%. During the course of the year, the Company has actively managed its product range to maintain balances within the parameters defined in the Competitive Framework. During the first half of 2008, the Denmark retail deposit operation was closed. These funding balances were previously included within Offshore Accounts.

At 31 December 2008, retail funding represented 21.3% of total funding balances (31 December 2007 – 10.4%). The aim is for retail funding balances to increase to 50% of total funding in the medium term.

WHOLESALE

Reported wholesale funding balances increased during 2008 as a result of collateral placed with the Company in respect of interest and foreign exchange swaps. Excluding this collateral, wholesale balances have reduced reflecting contractual maturities. In July 2008, Northern Rock resumed new wholesale funding on a modest scale, reflecting market conditions. New wholesale balances at the end of 2008 were £1.4 billion.

SECURITISATION

Securitisation is the process whereby Northern Rock, through the Granite programme, has previously raised wholesale funding secured on a segregated pool of mortgage assets. These assets are held in special purpose entities (SPEs) set up for this purpose, which are fully consolidated in Northern Rock's financial statements. Northern Rock retains an economic interest in the SPEs through a combination of subordinated loans and profit retained in the SPEs.

No new securitisation issues were completed during 2008.

As announced in November 2008, the Current Seller Share (Northern Rock's share of the Granite trust) within Granite was below the Minimum Seller Share on two consecutive distribution dates (October and November 2008). As a result of this Non-Asset Trigger Event, Granite moved to pass-through. Under pass-through, holders of Granite securities will receive principal repayments based on principal received on the underlying mortgage assets within Granite, rather than receiving scheduled repayments. Northern Rock, as a beneficiary of the Granite mortgages trust, will not receive any distributions of principal in respect of the mortgage loans that have been securitised and are held in the Granite mortgages trust, until holders of Granite securities have been repaid in full.

OPERATING AND FINANCIAL REVIEW (continued)

The Plan assumed that Granite would gradually wind down as Northern Rock reduced its balance sheet and no new issuance from Granite was intended. Granite moving to pass-through does not change this ultimate outcome, it changes the timing and order in which Granite securities are repaid and is likely to extend the final repayment date of the Granite securities.

At 31 December 2008, securitised notes in the Group balance sheet amounted to £38.0 billion (31 December 2007 – £43.1 billion), representing 41.3% (31 December 2007 – 42.7%) of total funding balances. Balances of securitised funding at the end of 2008 are affected by foreign currency movements, which increase both the reported funding balance and the value of the associated derivative financial instruments which hedge against these rate movements. Excluding these fair value amounts, securitised note balances were £30.7 billion at 31 December 2008 (31 December 2007 – £41.9 billion).

COVERED BONDS

Covered bonds are secured by a pool of ring-fenced residential mortgages. No additional funds were raised through the covered bond programme in 2008 and no maturity of notes in issue took place.

At 31 December 2008, covered bonds in the Group balance sheet amounted to £12.6 billion (31 December 2007 – £8.9 billion), representing 13.6% (31 December 2007 – 8.9%) of total funding balances. Balances of covered bonds at the end of 2008 are affected by foreign currency movements, which increase both the reported funding balance and the value of the associated derivative financial instruments which hedge against these rate movements. Excluding these fair value amounts, covered bonds balances were £8.5 billion at 31 December 2008 (31 December 2007 – £8.5 billion).

GOVERNMENT LOAN

Borrowings provided by the Bank of England under the liquidity facility amounted to £26.9 billion at the start of 2008. Under the Plan, the repayment of the loan is a key performance objective of the business. The loan was novated to HM Treasury in August 2008.

	2008	2007
	£bn	£bn
Amount due to Government	15.6	26.9
Liquidity deposit accounts with Bank of England	(6.7)	–
	<hr/> 8.9	<hr/> 26.9

At the end of 2008, the amount due to Government, net of liquidity deposits held with the Bank of England (excluding deposits relating to swap collateral), was £8.9 billion, a reduction of £18 billion from the start of 2008. The loan balance has been reduced more quickly than planned, reflecting the success of the active redemption policy and the growth in retail deposit balances during the year.

The cost of the Government net funding and HM Treasury guarantees will be revised once approval for State aid is granted by the European Commission. This revision will be back-dated to 1 April 2008 with a retrospective adjustment made when State aid is approved. If the post State aid approval basis of charging had been applied in 2008 the reported loss before tax would have been reduced by £200 million.

As announced in January 2009, Northern Rock has agreed with HM Treasury that the rate of repayment of the loan will slow going forward as the Company reduces the rate of redemptions from the mortgage book in order to support Government policy to increase mortgage lending capacity in the market.

OPERATING AND FINANCIAL REVIEW (continued)

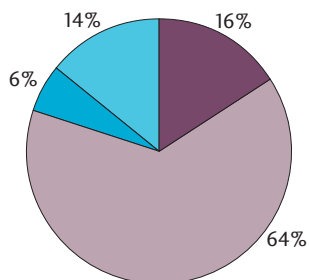
COMPOSITION OF BALANCE SHEET

Due to the fall in the sterling exchange rate and the reduction in interest rates, the fair value of derivative financial instruments recorded as an asset on the balance sheet has increased to £13.3 billion (31 December 2007 – £2.2 billion). These derivatives are primarily entered into to economically manage currency and interest rate risks in fixed and non-sterling denominated funding. Over time the fair value of these derivatives will trend to zero. Excluding these derivatives the underlying total assets reduced to £91.0 billion (31 December 2007 – £107.1 billion), a reduction of 15.0%, reflecting the planned high level of redemptions of customer loans.

The composition of the reported Group balance sheet at 31 December 2008 and 2007 is as follows:

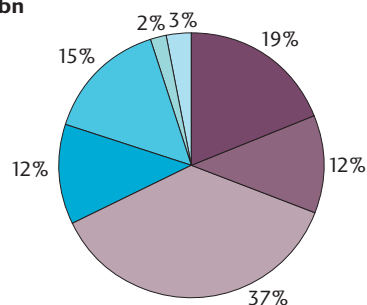
2008

Assets £104.3bn



- ▶ Liquid assets
- ▶ Residential mortgages
- ▶ Other advances
- ▶ Derivatives & fair value adjustments

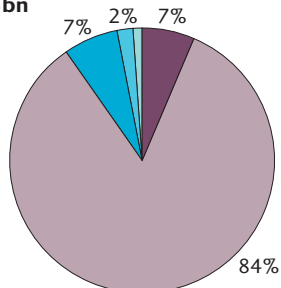
Liabilities £104.3bn



- ▶ Retail
- ▶ Wholesale
- ▶ Securitised bonds
- ▶ Covered bonds
- ▶ Government loan
- ▶ Capital
- ▶ Other

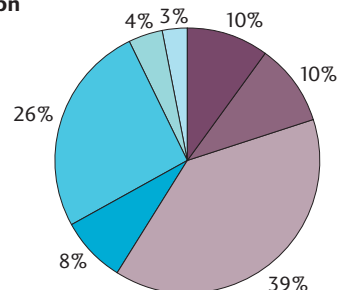
2007

Assets £109.3bn



- ▶ Liquid assets
- ▶ Residential mortgages
- ▶ Other advances
- ▶ Derivatives & fair value adjustments
- ▶ Other

Liabilities £109.3bn



- ▶ Retail
- ▶ Wholesale
- ▶ Securitised bonds
- ▶ Covered bonds
- ▶ Government loan
- ▶ Capital
- ▶ Other

OPERATING AND FINANCIAL REVIEW (continued)

2008 FINANCIAL PERFORMANCE AND POSITION

The summary income statement for 2008 and 2007 is set out as follows:

	2008	2007
	£m	£m
Net interest income	50.9	761.4
Other income	203.5	(39.0)
Total income	254.4	722.4
Administrative expenses	(269.7)	(276.1)
Exceptional expenses	(163.6)	(127.2)
Donation to The Northern Rock Foundation	(15.0)	(14.8)
Total expenses	(448.3)	(418.1)
Impairment losses on loans and advances	(894.4)	(239.7)
Impairment losses on unsecured investment loans	(267.6)	(232.2)
Loss before taxation	(1,355.9)	(167.6)
Income tax credit/(expense)	46.2	(31.4)
Loss for the year	(1,309.7)	(199.0)
Attributable to:		
Appropriations	68.3	44.5
Loss attributable to equity shareholders	(1,378.0)	(243.5)
Total	(1,309.7)	(199.0)

TOTAL INCOME AND INTEREST MARGIN AND SPREAD

The following table shows net interest income, total income and interest ratios for 2008 and 2007.

	2008	2007
	£m	£m
Net interest income	50.9	761.4
Other income	203.5	(39.0)
Total income	254.4	722.4
Interest margin (as reported)	0.05%	0.70%
Interest spread (as reported)	(0.13)%	0.52%
Interest margin (underlying)	0.41%	0.73%
Interest spread (underlying)	0.23%	0.55%

Note: Interest margin has been calculated by reference to average interest earning assets excluding fair value adjustments. Average balances have been calculated on a monthly basis. Interest spread represents the difference between interest receivable as a % of average interest earning assets, excluding fair value adjustments, and interest payable as a % of average interest bearing liabilities, excluding fair value adjustments. For the purpose of calculating interest margin and spread, average balances for assets and liabilities denominated in foreign currencies, where these have been economically hedged, are based on the contract rate implicit in the associated hedging instrument.

Underlying interest margin (which primarily excludes hedge accounting ineffectiveness and reflects the potential impact of State aid approval) at 0.41% and underlying interest spread at 0.23% for the year ended 31 December 2008 compare with 0.73% and 0.55% respectively for the previous year.

The reductions primarily reflect higher funding costs due to the Government funding being charged at a premium rate, together with the falling interest rate environment causing an increase in the relative cost of retail funding. Northern Rock has not benefited from the wider spreads on new lending seen in the mortgage market due to the significant reduction in new business written in 2008.

OPERATING AND FINANCIAL REVIEW (continued)

The table below shows an analysis of other income

	2008	2007
	£m	£m
Fee and commission income	55.9	185.1
Fee and commission expense	(59.3)	(47.7)
Other operating income	4.2	1.3
Losses on available for sale securities	(9.0)	(136.6)
Gain on disposal of loan books	49.1	23.8
Net trading income/(expense)	162.6	(64.9)
Total other income	<u>203.5</u>	<u>(39.0)</u>

Fee and commission income mainly comprises commission income generated on sales of third party products such as building and contents and payment protection insurance. The reduction in fee and commission income in 2008 reflects the significant reduction in lending volumes.

Fee and commission expense represents third party administration fees not included in interest expense. In addition, in 2008 a provision of £16.8 million has been made for an estimated levy from the Financial Services Compensation Scheme in relation to a number of retail deposit books, including the funding of the transfer of the Bradford & Bingley retail deposit book to Abbey National plc in September 2008 and UK deposits of failed Icelandic banks.

Losses on available for sale (AFS) securities in 2008 comprised a charge of £29.4 million in relation to impairments on US\$ CDOs, together with charges on other AFS securities of £24.0 million (2007 – total charge of £178.3 million). This charge was partially offset by realised gains on AFS securities sold during the year of £44.4 million (2007 – £41.7 million).

The gain on disposal of loan books in 2008 represent the gain realised on the sale of the Lifetime mortgage portfolio to JP Morgan Limited in January 2008. The book was sold at a premium of 2.25% to the balance sheet value, with proceeds of approximately £2.3 billion. The gain on disposal of loan books in 2007 represented the profit realised on the sale of the secured commercial loan portfolio to Lehman Commercial Mortgage Conduit Limited, with proceeds of £1.5 billion.

Net trading income/(expense) includes gains on fair value movements on derivatives not in designated hedge accounting relationships of £9,465.7 million (2007 – gain of £998.4 million), together with cross-currency exchange rate losses of £9,259.7 million (2007 – loss of £1,045.2 million). These are covered in more detail below within the narrative on hedge ineffectiveness. In addition, within net trading income/(expense) is a negative movement in the fair value of treasury investment securities designated as “held at fair value through the income statement” amounting to £43.4 million (2007 – £18.1 million).

OPERATING AND FINANCIAL REVIEW (continued)

HEDGE INEFFECTIVENESS

Volatility in reported results arises from hedge ineffectiveness on derivative instruments that hedge risk exposure on an economic basis. Such accounting volatility, which will offset over time, arises due to accounting ineffectiveness on designated hedges or because hedge accounting has not been adopted or is not achievable on certain transactions. The Company manages its risk exposures on an economic basis and does not include accounting hedge ineffectiveness in the assessment of its operating performance or in assessing the effectiveness of its derivative positions in any one financial period.

An analysis of hedge ineffectiveness and of other fair value gains and losses is set out below:

	2008	2007
	£m	£m
Fair value hedge ineffectiveness	(85.4)	6.7
Cashflow hedge ineffectiveness	16.5	(7.5)
Hedge ineffectiveness included within interest margin	(68.9)	(0.8)
Fair value movements on hedging derivatives	9,465.7	998.4
Cross-currency movements	(9,259.7)	(1,045.2)
	206.0	(46.8)
Total hedge ineffectiveness and other fair value gains and losses	137.1	(47.6)

Northern Rock enters into derivative financial instruments for economic hedging purposes. Some of these are designated and accounted for as IAS 39 compliant fair value or cashflow hedge relationships. Where effective fair value hedge relationships can be established, the movement in the fair value of the derivative instrument is offset in full or in part by opposite movements in the fair value of the instrument being hedged. Any ineffectiveness arising from different movements in fair value will offset over time. Ineffectiveness is included within interest income or expense, as appropriate.

Where derivatives are economically effective for hedging purposes but cannot be included within effective IAS 39 compliant accounting hedge relationships, the movement in their fair value is recorded within net trading expense. The same treatment applies to the revaluation at each balance sheet date of economically hedged foreign currency assets and liabilities.

Hedge ineffectiveness has increased in 2008 compared with 2007 as a result of volatility in interest rates and foreign exchange rates. This has led to greater volatility in the valuation of derivatives and the underlying instruments they are economically hedging. In addition, hedges in relation to instruments included in equity under IFRS – Reserve Capital Instruments and subordinated notes – cannot be included in effective accounting hedge relationships resulting in inherent hedge ineffectiveness that cannot be avoided.

In addition to the above, interest related fair value movements on forward exchange contracts represented a gain of £49.6 million in 2007, giving a net gain on hedge ineffectiveness of £2.0 million. There was no gain or loss in relation to 2008.

ADMINISTRATIVE EXPENSES

(excluding non-recurring expenses and the covenant to The Northern Rock Foundation)

	2008	2007
	£m	£m
Staff costs	163.4	158.6
Other expenses	84.4	88.6
Depreciation and amortisation	21.9	28.9
Total operating expenses	269.7	276.1

Total operating expenses amounted to £269.7 million, representing a decrease of 2.3% (2007 – £276.1 million). The reduction in headcount in 2008 is expected to benefit staff costs in 2009.

OPERATING AND FINANCIAL REVIEW (continued)

EXCEPTIONAL EXPENSES

Exceptional expenses of £163.6 million were incurred in 2008 (2007 – £127.2 million) primarily relating to professional fees and redundancy costs associated with the development of the business plan and the restructuring process, charges from the cancellation of staff share schemes and impairment charges in relation to certain property and software as described below.

	2008	2007
	£m	£m
Redundancy and associated costs	37.0	–
Professional fees incurred by the Company	29.8	21.2
Professional fees recharged by the Tripartite Authorities	10.7	12.5
Corporate advisory fees	4.2	2.5
Reimbursement of third party expenses	8.7	5.1
Cost of staff withdrawals from Save As You Earn schemes	–	4.5
Accelerated charge on cancellation of share schemes	39.6	–
Other exceptional administrative expenses	11.5	5.2
Exceptional administrative expenses	141.5	51.0
Impairment charges on tangible and intangible fixed assets	22.1	76.2
Total exceptional expenses	<u>163.6</u>	<u>127.2</u>

As a result of the business plan agreed in March 2008, it was necessary to restructure the Company which required a reduction in headcount. As a result of the restructuring, around 1,300 staff were made redundant, 500 of which were voluntary.

The accelerated charge on cancellation of share schemes represents the charge to the income statement of all previously unexpensed costs required by IFRS 2 – Share-Based Payment, after the transfer of all shares in the Company to HM Treasury on 22 February 2008.

Impairment charges on fixed assets in 2008 have arisen primarily as a result of accelerated write-off of capitalised software expenses, together with costs of closure of certain properties. The charge in 2007 reflected the impairment of properties in the course of construction in respect of costs to complete the properties in excess of their estimated value following completion. Impairment charges on fixed assets in 2008 comprised:

	£m
Reversal of part of 2007 impairment charges on head office premises due to revisions to estimated completion costs and market values	(30.8)
Onerous lease provision for properties no longer required	18.5
Write-off in relation to computer hardware no longer required	7.2
Write-off in relation to computer software no longer required	27.2
	<u>22.1</u>

OPERATING AND FINANCIAL REVIEW (continued)

TAXATION

Based on a loss before tax of £1.36 billion, the effective tax rate in 2008 is a credit of 3.41% of pre-tax losses (2007 – charge of 18.74%). This credit is unusually low and is largely due to the non recognition of a deferred income tax asset. Even though the deferred income tax asset has not been recognised for accounting purposes, it is available to reduce any future taxable profits. As at 31 December 2008, the Group has £385.6 million of unrecognised deferred income tax assets arising from the income statement to carry forward against any future taxable profits (31 December 2007 – £52.9 million).

	2008	2007
	%	%
Expected effective tax rate	(28.49)	(30.00)
Deferred income tax asset arising in the year not recognised	24.50	–
Write-off of deferred income tax asset previously recognised	1.45	33.23
Exceptional, non tax deductible costs	0.84	22.26
Current year recurring non-taxable income	(0.81)	(0.24)
Effect of UK tax rate change on deferred tax items	0.09	0.36
Utilisation of previously unrecognised tax losses	–	(2.00)
Net prior year adjustments	(0.99)	(4.87)
Effective tax rate	<u>(3.41)</u>	<u>18.74</u>

CAPITAL

The following table shows a summary of Northern Rock's capital position at the end of 2008 and 2007. Further detail on capital is disclosed in note 40 to the Accounts.

	2008	2007
	£m	£m
Tier 1 Capital		
Core Tier 1 capital	(17.1)	1,316.4
Preference share capital	396.5	396.5
Tier one notes	251.8	207.6
Reserve capital instruments	299.3	299.3
Total Tier 1 capital before regulatory deductions and restrictions	<u>930.5</u>	<u>2,219.8</u>
Regulatory deductions from and restrictions to Tier 1 capital	(1,040.9)	(625.8)
Total Tier 1 capital after deductions	<u>(110.4)</u>	<u>1,594.0</u>
Tier 2 Capital		
Upper Tier 2 capital	2,208.0	1,090.6
Lower Tier 2 capital	940.5	808.1
Total Tier 2 capital before deductions	<u>3,148.5</u>	<u>1,898.7</u>
Deductions from Tier 2 capital	(76.3)	(445.8)
Total Tier 2 capital after deductions	<u>3,072.2</u>	<u>1,452.9</u>
Deductions from Tier 1 and Tier 2 capital	<u>(5.1)</u>	<u>(5.1)</u>
Total capital resources	<u>2,956.7</u>	<u>3,041.8</u>
Risk weighted assets	27,471.4	20,691.0
Tier 1 ratio	(0.4)%	7.7%
Total capital ratio	10.8%	14.7%

OPERATING AND FINANCIAL REVIEW (continued)

In the above table the impact of exposures to securitised assets are included within regulatory deductions at 31 December 2007 but within risk weighted assets at 31 December 2008. The impact at 31 December 2008 is to increase risk weighted assets by £7,234.8 million. At 31 December 2007, deductions in respect of securitised assets amounted to £537.7 million and were made equally against Tier 1 and Tier 2 capital resources.

Capital resources have been negatively impacted by the reported loss in 2008. Regulatory core Tier 1 capital fell to minus £17.1 million at 31 December 2008 (31 December 2007 – £1,316.4 million) and total tier 1 after deductions reduced to minus £110.4 million (31 December 2007 – £1,594.0 million). As a result, the Tier 1 ratio at 31 December 2008 was (0.4)% (31 December 2007 – 7.7%) and the total capital ratio was 10.8% (31 December 2007 – 14.7%).

In July 2008, at the Company's request, the FSA agreed to waive the limits on use by the Company of Tier 2 capital. This waiver enabled all available Tier 2 capital to be included within capital resources without restriction for the purposes of meeting the Company's minimum regulatory capital requirements. The original waiver granted was on a temporary basis until the recapitalisation of the Company following the obtainment of State aid approval or 31 December 2008, whichever was earlier. The FSA has subsequently extended the waiver to 30 April 2009.

On 23 February 2009, the Company announced that it had concluded the strategic review of its business plan, in close consultation with the Government. To facilitate anticipated new lending, a legal and capital restructuring of the Company will be undertaken. This will include a strengthening of the Company's capital base by up to £3 billion. The restructuring will be implemented subsequent to State aid approval of the revised plan.

SOCIAL RESPONSIBILITY – THE NORTHERN ROCK FOUNDATION

Since demutualisation in 1997, Northern Rock has supported The Northern Rock Foundation, which supports community and charitable causes in the North East of England and Cumbria. Following the Company entering into temporary public ownership, a commitment has been made that the Foundation will receive at least £15.0 million per year in 2008, 2009 and 2010. The donation for 2008 amounts to £15.0 million (2007 – £14.8 million). This results in over £200 million having been donated since the Foundation's inception in 1997. Further information on The Northern Rock Foundation is available on the Company's website.

EMPLOYEES

Northern Rock values its reputation as a caring employer and has always sought to attract and retain high calibre employees. Opportunities for training are given a high priority to ensure that all individuals can contribute to their own career development. This approach extends itself to the fair treatment of people with disabilities in relation to their recruitment, training and development.

Restructuring the organisation and its operations to meet the revised objectives of the business has resulted in lower staffing levels. Throughout the restructuring process the Company was committed to communicating openly with staff and provided the best possible support for staff, working closely with UNITE and regional agencies such as One NorthEast.

OUTLOOK

Economic conditions are expected to continue to deteriorate in 2009 with increasing unemployment and further falls in house prices, although affordability of loan repayments will be enhanced for many customers as interest rates on variable rate loans have fallen as Bank Base Rate has reduced. As a result of the economic conditions, loan loss impairment charges are expected to increase in 2009 resulting in further losses being incurred.

In line with the revised business plan announced on 23 February 2009, new mortgage lending of around £5 billion is planned for 2009 and up to £9 billion from 2010 onwards, subject to market demand. With the anticipated slow down in mortgage redemptions, cash flow available to repay the Government loan will reduce.

In order to maximise the Company's capacity for new lending, there will be a legal and capital restructuring of the Company. The additional capital requirement of up to £3 billion will be implemented following receipt of State aid approval by the European Commission for the revised business plan.

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2008

The Directors present their report and the audited financial statements for the year ended 31 December 2008.

For the purposes of section 417 Companies Act 2006, the information set out under Corporate Governance (pages 6 to 10), the Corporate Social Responsibility Report (pages 17 to 19) and the Operating and Financial Review (pages 20 to 33) are incorporated by reference in this report.

PRINCIPAL ACTIVITIES

The principal activities of the Group are discussed in the Operating and Financial Review on pages 20 to 33.

REVIEW OF BUSINESS, FUTURE DEVELOPMENTS, PRINCIPAL RISKS AND UNCERTAINTIES

A review of the business, future developments, principal risks and uncertainties, objectives and associated KPIs are set out in the Operating and Financial Review on pages 20 to 33. A review of the principal risks and uncertainties is set out in note 40 to the Accounts.

DIVIDENDS

The Directors do not propose the payment of any dividends on the Ordinary shares in respect of the year ended 31 December 2008.

TANGIBLE FIXED ASSETS

Land and buildings, which are included in the balance sheet at cost less accumulated depreciation and impairment losses, amounted to £104.3 million at 31 December 2008. Based on valuations carried out by the Group's qualified chartered surveyors reflecting current market conditions, it is the Directors' opinion that the market value of the properties on a vacant possession basis is £67.0 million.

Details of changes to tangible fixed assets are included in note 25 to the Accounts.

POST BALANCE SHEET EVENTS

Details of post balance sheet events are given in note 44 to the Accounts

DIRECTORS

The current composition of the Board of Directors together with brief biographical details of each Director is shown on page 4. The following table shows details of Board appointments and retirements up to the date of this report.

Sir Ian Gibson	Retired 22 February 2008
D A Jones	Retired 22 February 2008
B K Sanderson	Retired 22 February 2008
P A Thompson	Appointed 25 January 2008. Retired 22 February 2008
R A Sandler	Appointed 22 February 2008
A F Godbehere	Appointed 22 February 2008. Retired 31 January 2009
P J Remnant	Appointed 22 February 2008
T W Scholar	Appointed 22 February 2008
S A M Hester	Appointed 22 February 2008. Retired 1 October 2008
M J Queen	Retired 1 May 2008
M K Atkinson	Appointed 5 August 2008
J R Coates	Appointed 5 August 2008
A M Kuipers	Retired 7 September 2008
G A Hoffman	Appointed 1 October 2008
R J Davies	Appointed 10 October 2008
S T Laffin	Retired 31 December 2008

L P Adams and J F Devaney were Directors of the Company for the full financial year ended 31 December 2008.

Following temporary public ownership taking effect on 22 February 2008, no Director had any interest in the shares of the Company.

The powers of the Directors, along with provisions relating to their appointment and replacement, are set out in the Articles of Association and The Northern Rock plc Transfer Order 2008 and are also governed by UK company law. Any alteration to the Articles of Association must be approved by shareholders.

The Company's Articles of Association provide an indemnity to Directors against certain liabilities incurred as a result of their office. The indemnities extend to defending any proceedings in which judgment is given in the Directors' favour or in which they are acquitted or in any proceedings in which relief is granted by a court from liability for negligence, default, breach of duty or breach of trust in relation to the affairs of the Company.

The Company has also provided each Director with a Deed of Indemnity indemnifying them to the fullest extent permitted by law against all losses suffered or incurred in respect of acts and omissions arising as a result of holding office. The indemnity also extends to reimbursing each Director with the costs of defending any proceedings, regulatory investigation or proposed action by a regulator brought in connection with any alleged negligence, default, misfeasance, breach of duty or breach of trust against the Director in relation to the Group. Reimbursement is subject to the Director's obligation to repay the Company in accordance with the provisions of the Companies Act 2006. The payment obligations of the Company under each Deed of Indemnity are backed by a specific guarantee in favour of the Director entered into between the Company and HMT.

The Company has also arranged Director's and Officer's Insurance on behalf of the Directors in accordance with the provisions of the Companies Act 2006.

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2008 (continued)

SHARES

Details of the structure of the Company's authorised and issued share capital as at the year end, as well as any movements in and changes to the authorised and issued share capital during the year, are provided in note 37 to the Accounts.

As at 1 January 2008, the Company had issued share capital of £124.0m, comprising £105.3m (84.92% of the Company's nominal capital issued) in Ordinary shares, £18.6m (15%) in Foundation shares and £0.1m (0.08%) in Preference shares. Holders of Ordinary shares had the rights accorded to them under UK company law including the right to receive the Company's Annual Report and Accounts, to attend and speak at general meetings, to appoint proxies and to exercise voting rights. Holders of Preference shares had limited voting rights and in general could only vote on a variation of class rights, on a resolution to wind up the Company or in the event of the preference dividend being unpaid. Holders of Foundation shares had limited voting rights and in general could only vote on a variation of class rights. Holders of Foundation shares did not, in general, have any right to participate in the profits of the Company.

Pursuant to The Northern Rock plc Transfer Order dated 22 February 2008, the Foundation shares converted into Ordinary shares and, along with all other Ordinary shares and Preference shares in the Company, were transferred to the Treasury Solicitor as nominee for Her Majesty's Treasury. As at 1 January 2009, the Company had issued share capital of £124.0m, comprising £123.9m (99.92% of the Company's nominal capital issued) in Ordinary shares, and £0.1m (0.08%) in Preference shares.

Further details regarding the rights and obligations attaching to the current share classes are contained in the Company's Articles of Association.

EMPLOYEES

Employee communications are vital to the success of the Company, and good staff relations are a key part of management responsibility at all levels. Employee consultation takes place with the national

committee of UNITE. The Company also issues weekly news bulletins to employees.

The Company is committed to equal employment opportunities for everyone, and treats applicants for work solely on their ability to do the job.

During 2008, the Company undertook a sizeable redundancy exercise in order to reduce its operations and reflect the changes to its business during the latter part of 2007 and 2008. A collective consultation exercise was undertaken with representatives of affected employees. Approximately 1,300 staff were made redundant as a result, with the majority leaving at the end of August 2008. Employees made redundant were paid notice pay and were also made a payment in accordance with the terms of the Company's Job Security and Redundancy Agreement, which was renegotiated during the collective consultation exercise to bring it into line with the UK's age discrimination legislation.

EMPLOYEE SHARE SCHEMES

As a result of The Northern Rock plc Transfer Order 2008 all share schemes were extinguished on 22 February 2008.

FINANCIAL INSTRUMENTS

The Group's financial risk management objectives and policies, including its governance framework and approach to the management of key risks including credit risk, market risk and liquidity risk, are discussed in note 40 to the Accounts.

SIGNIFICANT SHAREHOLDINGS

As at the date of this report, all of the issued share capital is held by the Treasury Solicitor as nominee for Her Majesty's Treasury.

BRANCH OFFICES

The Company has a branch office in Ireland and a subsidiary through which it operates in Guernsey.

CREDITOR PAYMENT POLICY

The Company's policy with regard to the payment of suppliers is to negotiate and agree terms and conditions with all its suppliers, which include the giving of an undertaking to pay them within an agreed payment period.

The average creditor payment period at 31 December 2008 was 20 days (2007 – 20 days).

SIGNIFICANT AGREEMENTS

The Company, or other members of the Group, are party to certain non-material agreements that contain change of control provisions in the event of the takeover of the Company but these are not considered to be significant on an individual basis.

CHARITABLE CONTRIBUTIONS AND POLITICAL DONATIONS

Details of charitable contributions relating to 2008 are included within the Operating and Financial Review on page 33.

There were no political donations in the year (2007 – nil).

GOING CONCERN

As set out in note 1 to the Accounts HM Treasury has provided various on demand facilities and comfort to the Directors in relation to the Company's future financing requirements. These facilities are subject to clearance being obtained from the European Commission. If such clearance is not obtained then the facilities may be withdrawn. Subject to this material uncertainty pertaining to the Company's funding requirements, which may cast significant doubt about the Company's ability to continue as a going concern, the Directors are satisfied at the time of approval of the financial statements that the Group has adequate resources to continue in business for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the accounts.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

Company law requires the Directors to prepare financial statements for each financial year that give a true and fair view of the state of affairs of the Company and Group as at the end of the year and of the profit or loss of the Group for the year.

The Directors consider that in preparing the financial statements on pages 38 to 94 appropriate accounting policies, consistently applied and supported by reasonable and

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2008 (continued)

prudent judgments and estimates, have been used and that applicable accounting standards have been followed.

The Directors are responsible for ensuring that the Company and Group keeps accounting records that disclose with reasonable accuracy at any time the Company and Group's financial position and that enable them to ensure that the financial statements comply with the Companies Act 1985 and the Companies Act 2006 and other applicable law and regulations. They are also responsible for safeguarding the assets of the Company and Group and hence for taking reasonable steps to prevent and detect fraud and other irregularities.

The maintenance and integrity of the Northern Rock plc website is the responsibility of the Directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

AUDITORS AND DISCLOSURE OF INFORMATION TO AUDITORS

So far as every Director as at the date of this report is aware, there is no relevant audit information needed in preparation of the auditors' report of which the auditors are not aware. The Directors have taken the steps that they need to have taken as Directors to make themselves aware of any relevant audit information and to establish that the auditors are also aware of that information.

By order of the Board

C Taylor, Company Secretary
2 March 2009

INDEPENDENT AUDITORS' REPORT TO THE SHAREHOLDER OF NORTHERN ROCK PLC

We have audited the Group and Parent Company financial statements (the "financial statements") of Northern Rock plc for the year ended 31 December 2008 which comprise the Consolidated Income Statement, the Consolidated and Parent Company Balance Sheets, the Consolidated and Parent Company Cash Flow Statements, the Consolidated and Parent Company Statements of Recognised Income and Expense and the related notes. These financial statements have been prepared under the accounting policies set out therein.

RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITORS

The Directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's shareholder in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the financial statements give a true and fair view and have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. The information given in the Directors' Report includes that specific information presented in the Operating and Financial Review that is cross referred from the Review of Business, Future Developments, Principal Risks and Uncertainties section of the Directors' Report.

In addition we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only the Chairman's Statement, the Chief Executive's Report, the Corporate Governance statement, the Directors' Remuneration Report, the Corporate Social Responsibility Report, the Operating and Financial Review and the Directors' Report. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

BASIS OF AUDIT OPINION

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

OPINION

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's affairs as at 31 December 2008 and of its loss and cash flows for the year then ended;
- the Parent Company financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the Parent Company's affairs as at 31 December 2008 and of its cash flows for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation; and
- the information given in the Directors' Report is consistent with the financial statements.

EMPHASIS OF MATTER – GOING CONCERN

In forming our opinion on the financial statements, which is not qualified, we have considered the adequacy of disclosure made in note 1 to the financial statements concerning the Company's ability to continue as a going concern. The going concern assumption is dependent on the European Commission approving financing facilities provided by HM Treasury. This outstanding approval indicates the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue as a going concern. The financial statements do not include adjustments that would result if the Company was unable to continue as a going concern.

PricewaterhouseCoopers LLP
Chartered Accountants and
Registered Auditors
Newcastle upon Tyne
2 March 2009

PRICEWATERHOUSECOOPERS 

CONSOLIDATED INCOME STATEMENT

For the year ended 31 December 2008

	Note	2008	2007
		£m	£m
Interest and similar income	4	5,706.9	6,907.5
Interest expense and similar charges	5	(5,656.0)	(6,146.1)
Net interest income		50.9	761.4
Fee and commission income		55.9	185.1
Fee and commission expense		(59.3)	(47.7)
Other operating income		4.2	1.3
Losses on available for sale securities	22	(9.0)	(136.6)
Gain on disposal of loan books	10	49.1	23.8
Net trading income/(expense)	11	162.6	(64.9)
		203.5	(39.0)
Total income		254.4	722.4
Exceptional administrative expenses	6	(141.5)	(51.0)
Exceptional impairment credits/(charges) on property, plant and equipment	25	23.6	(56.3)
Movement in provisions for onerous contracts	32	(18.5)	(12.9)
Exceptional impairment charges on intangible assets	24	(27.2)	(7.0)
		(163.6)	(127.2)
Administrative expenses	6	(247.8)	(247.2)
Depreciation and amortisation		(21.9)	(28.9)
Covenant to The Northern Rock Foundation	42	(15.0)	(14.8)
Operating expenses		(448.3)	(418.1)
Impairment losses on loans and advances	9	(894.4)	(239.7)
Impairment losses on unsecured investment loans	9	(267.6)	(232.2)
Loss before taxation		(1,355.9)	(167.6)
Income tax credit/(expense)	12	46.2	(31.4)
Loss for the year		(1,309.7)	(199.0)
Attributable to:			
Appropriations	35,36	68.3	44.5
Loss attributable to equity shareholders		(1,378.0)	(243.5)
Total loss attributable to equity holders of parent company		(1,309.7)	(199.0)

Details of dividends are set out in note 14.

The notes on pages 47 to 94 form an integral part of these accounts.

CONSOLIDATED BALANCE SHEET

At 31 December 2008

	Note	2008	2007
		£m	£m
Assets			
Cash and balances with central banks	16	9,336.8	190.2
Derivative financial instruments	17	13,314.4	2,241.0
Loans and advances to banks	18	3,384.4	1,292.5
Loans and advances to customers	19	72,721.8	98,834.6
Fair value adjustments of portfolio hedging	19	1,701.9	183.9
Investment securities	22	3,386.8	6,108.7
Intangible assets	24	64.9	95.8
Property, plant and equipment	25	198.4	184.0
Current income tax asset		21.8	115.0
Deferred income tax asset	26	35.2	–
Retirement benefit asset	8	31.7	5.7
Other assets		32.9	27.1
Prepayments and accrued income		115.0	42.5
Total assets		104,346.0	109,321.0
Liabilities			
Loans from HM Government	27	15,583.4	28,473.0
Deposits by banks	28	4,625.1	744.2
Customer accounts	29	20,722.7	11,562.8
Derivative financial instruments	17	2,220.8	1,743.4
Debt securities in issue			
Securitised notes	20	37,986.9	43,069.5
Covered bonds	21	12,550.3	8,938.1
Other	30	7,199.1	9,633.7
Other liabilities		82.6	66.3
Accruals and deferred income	31	949.4	962.9
Deferred income tax liability	26	6.9	45.5
Provisions for liabilities and charges	32	18.5	12.9
Subordinated liabilities	33	1,514.9	1,161.8
Tier one notes	34	251.8	207.6
		103,712.4	106,621.7
Equity			
Shareholders' funds			
Called up share capital			
Ordinary	37	123.9	123.9
Preference	37	0.1	0.1
Share premium account			
Ordinary	38	6.8	6.8
Preference	38	396.4	396.4
Capital redemption reserve	38	7.3	7.3
Other reserves	38	(872.2)	(122.9)
Retained earnings	39	(64.5)	1,251.9
Total equity attributable to equity shareholders		(402.2)	1,663.5
Non shareholders' funds			
Reserve capital instruments	35	299.3	299.3
Subordinated notes	36	736.5	736.5
Total non shareholders' funds		1,035.8	1,035.8
Total equity		633.6	2,699.3
Total equity and liabilities		104,346.0	109,321.0

The notes on pages 47 to 94 form an integral part of these accounts.

Approved by the Board on 2 March 2009 and signed on its behalf by:

R A Sandler
Chairman

G A Hoffman
Chief Executive Officer

COMPANY BALANCE SHEET

At 31 December 2008

	Note	2008	2007
		£m	£m
Assets			
Cash and balances with central banks	16	9,336.8	190.2
Derivative financial instruments	17	6,041.8	1,038.7
Loans and advances to banks	18	3,236.1	1,046.0
Loans and advances to customers	19	72,893.8	99,286.5
Fair value adjustments of portfolio hedging	19	1,701.9	183.9
Investment securities	22	3,226.2	10,892.6
Shares in Group undertakings	23	85.0	85.0
Intangible assets	24	34.2	65.1
Property, plant and equipment	25	187.1	172.1
Current income tax asset		22.1	115.3
Retirement benefit asset	8	31.7	5.7
Other assets		161.6	109.3
Prepayments and accrued income		118.9	49.0
Total assets		97,077.2	113,239.4
Liabilities			
Loans from HM Government	27	15,583.4	28,473.0
Deposits by banks	28	4,817.2	1,294.8
Customer accounts	29	51,180.4	59,310.0
Derivative financial instruments	17	2,209.7	835.8
Debt securities in issue			
Covered bonds	21	12,550.3	8,938.1
Other	30	7,199.1	9,633.7
Other liabilities		225.4	133.6
Accruals and deferred income	31	896.9	712.5
Deferred income tax liability	26	3.8	19.7
Provisions for liabilities and charges	32	18.5	12.9
Subordinated liabilities	33	1,514.9	1,161.8
Tier one notes	34	251.8	207.6
		96,451.4	110,733.5
Equity			
Shareholders' funds			
Called up share capital			
Ordinary	37	123.9	123.9
Preference	37	0.1	0.1
Share premium account			
Ordinary	38	6.8	6.8
Preference	38	396.4	396.4
Capital redemption reserve	38	7.3	7.3
Other reserves	38	(869.5)	(173.4)
Retained earnings	39	(75.0)	1,109.0
Total equity attributable to equity shareholders		(410.0)	1,470.1
Non shareholders' funds			
Reserve capital instruments	35	299.3	299.3
Subordinated notes	36	736.5	736.5
Total non shareholders' funds		1,035.8	1,035.8
Total equity		625.8	2,505.9
Total equity and liabilities		97,077.2	113,239.4

The notes on pages 47 to 94 form an integral part of these accounts.

Approved by the Board on 2 March 2009 and signed on its behalf by:

R A Sandler
Chairman

G A Hoffman
Chief Executive Officer

CONSOLIDATED STATEMENT OF RECOGNISED INCOME AND EXPENSE

For the year ended 31 December 2008

	Note	Called up share capital £m	Share premium account £m	Capital redemption reserve £m	Other reserves £m	Retained earnings £m	Total shareholders' funds £m	Non shareholders' funds £m	Total equity £m
Net movement in available for sale reserve	38	-	-	-	(531.5)	-	(531.5)	-	(531.5)
Net movement in cash flow hedge reserve	38	-	-	-	(240.5)	-	(240.5)	-	(240.5)
Actuarial gains and losses	8	-	-	-	-	25.5	25.5	-	25.5
Tax effects of the above		-	-	-	22.7	(7.1)	15.6	-	15.6
Total of items recognised directly in equity		-	-	-	(749.3)	18.4	(730.9)	-	(730.9)
Loss for the year		-	-	-	-	(1,378.0)	(1,378.0)	68.3	(1,309.7)
Total recognised income and expense for the year		-	-	-	(749.3)	(1,359.6)	(2,108.9)	68.3	(2,040.6)
Note – reconciliation of movements in equity									
Total – as above		-	-	-	(749.3)	(1,359.6)	(2,108.9)	68.3	(2,040.6)
Appropriations		-	-	-	-	-	-	(68.3)	(68.3)
Movement in own shares	39	-	-	-	-	43.2	43.2	-	43.2
Balance at 31 December 2007		124.0	403.2	7.3	(122.9)	1,251.9	1,663.5	1,035.8	2,699.3
Balance at 31 December 2008		124.0	403.2	7.3	(872.2)	(64.5)	(402.2)	1,035.8	633.6

CONSOLIDATED STATEMENT OF RECOGNISED INCOME AND EXPENSE

For the year ended 31 December 2007

	Note	Called up share capital £m	Share premium account £m	Capital redemption reserve £m	Other reserves £m	Retained earnings £m	Total shareholders' funds £m	Non shareholders' funds £m	Total equity £m
Net movement in available for sale reserve	38	-	-	-	(132.6)	-	(132.6)	-	(132.6)
Net movement in cash flow hedge reserve	38	-	-	-	(29.4)	-	(29.4)	-	(29.4)
Actuarial gains and losses	8	-	-	-	-	29.5	29.5	-	29.5
Tax effects of the above		-	-	-	40.4	(8.4)	32.0	-	32.0
Total of items recognised directly in equity		-	-	-	(121.6)	21.1	(100.5)	-	(100.5)
Loss for the year		-	-	-	-	(243.5)	(243.5)	44.5	(199.0)
Total recognised income and expense for the year		-	-	-	(121.6)	(222.4)	(344.0)	44.5	(299.5)
Note – reconciliation of movements in equity									
Total – as above		-	-	-	(121.6)	(222.4)	(344.0)	44.5	(299.5)
Dividends	14	-	-	-	-	(132.8)	(132.8)	-	(132.8)
Appropriations		-	-	-	-	-	-	(44.5)	(44.5)
Movement in own shares	39	-	-	-	-	(34.5)	(34.5)	-	(34.5)
Balance at 31 December 2006		124.0	403.2	7.3	(1.3)	1,641.6	2,174.8	1,035.8	3,210.6
Balance at 31 December 2007		124.0	403.2	7.3	(122.9)	1,251.9	1,663.5	1,035.8	2,699.3

COMPANY STATEMENT OF RECOGNISED INCOME AND EXPENSE

For the year ended 31 December 2008

	Note	Called up share capital £m	Share premium account £m	Capital redemption reserve £m	Other reserves £m	Retained earnings £m	Total shareholders' funds £m	Non shareholders' funds £m	Total equity £m
Net movement in available for sale reserve	38	-	-	-	(457.9)	-	(457.9)	-	(457.9)
Net movement in cash flow hedge reserve	38	-	-	-	(240.5)	-	(240.5)	-	(240.5)
Actuarial gains and losses	8	-	-	-	-	25.5	25.5	-	25.5
Tax effects of the above		-	-	-	2.3	(7.1)	(4.8)	-	(4.8)
Total of items recognised directly in equity		-	-	-	(696.1)	18.4	(677.7)	-	(677.7)
Loss for the year	13	-	-	-	-	(1,245.6)	(1,245.6)	68.3	(1,177.3)
Total recognised income and expense for the year		-	-	-	(696.1)	(1,227.2)	(1,923.3)	68.3	(1,855.0)
Note – reconciliation of movements in equity									
Total – as above		-	-	-	(696.1)	(1,227.2)	(1,923.3)	68.3	(1,855.0)
Appropriations		-	-	-	-	-	-	(68.3)	(68.3)
Movement in own shares	39	-	-	-	-	43.2	43.2	-	43.2
Balance at 31 December 2007		124.0	403.2	7.3	(173.4)	1,109.0	1,470.1	1,035.8	2,505.9
Balance at 31 December 2008		124.0	403.2	7.3	(869.5)	(75.0)	(410.0)	1,035.8	625.8

COMPANY STATEMENT OF RECOGNISED INCOME AND EXPENSE

For the year ended 31 December 2007

	Note	Called up share capital £m	Share premium account £m	Capital redemption reserve £m	Other reserves £m	Retained earnings £m	Total shareholders' funds £m	Non shareholders' funds £m	Total equity £m
Net movement in available for sale reserve	38	-	-	-	(201.2)	-	(201.2)	-	(201.2)
Net movement in cash flow hedge reserve	38	-	-	-	(29.4)	-	(29.4)	-	(29.4)
Actuarial gains and losses	8	-	-	-	-	29.5	29.5	-	29.5
Tax effects of the above		-	-	-	59.5	(8.4)	51.1	-	51.1
Total of items recognised directly in equity		-	-	-	(171.1)	21.1	(150.0)	-	(150.0)
Loss for the year		-	-	-	-	(263.8)	(263.8)	44.5	(219.3)
Total recognised income and expense for the year		-	-	-	(171.1)	(242.7)	(413.8)	44.5	(369.3)
Note – reconciliation of movements in equity									
Total – as above		-	-	-	(171.1)	(242.7)	(413.8)	44.5	(369.3)
Dividends	14	-	-	-	-	(132.8)	(132.8)	-	(132.8)
Appropriations		-	-	-	-	-	-	(44.5)	(44.5)
Movement in own shares	39	-	-	-	-	(34.5)	(34.5)	-	(34.5)
Balance at 31 December 2006		124.0	403.2	7.3	(2.3)	1,519.0	2,051.2	1,035.8	3,087.0
Balance at 31 December 2007		124.0	403.2	7.3	(173.4)	1,109.0	1,470.1	1,035.8	2,505.9

CONSOLIDATED CASH FLOW STATEMENT

For the year ended 31 December 2008

	Note	2008	2007
		£m	£m
Net cash inflow/(outflow) from operating activities			
Loss before taxation		(1,355.9)	(167.6)
Adjusted for:			
Depreciation and amortisation		21.9	28.9
Impairment (credits)/charges on property, plant and equipment	25	(23.6)	56.3
Impairment charges on intangible assets	24	27.2	7.0
Impairment charges on loans and advances	9	894.4	239.7
Impairment charges on unsecured investment loans	9	267.6	232.2
Income taxes refunded/(paid)		91.8	(69.3)
Fair value adjustments on financial instruments		(604.4)	(552.7)
Other non cash movements		333.5	(114.4)
Net cash outflow from operating (losses)/profits before changes in operating assets and liabilities		(347.5)	(339.9)
Changes in operating assets and liabilities			
Net decrease in deposits held for regulatory or monetary control purposes		16.9	11.4
Net decrease/(increase) in loans and advances		24,852.0	(12,044.3)
Net increase in derivative financial instruments receivable		(11,073.4)	(1,369.7)
Net (increase)/decrease in other assets		(78.3)	42.3
Net decrease in debt securities in issue		(4,728.9)	(2,567.2)
Net (decrease)/increase in loans from HM Government		(12,889.6)	28,473.0
Net increase/(decrease) in deposits from other banks		3,881.0	(1,392.1)
Net increase/(decrease) in amounts due to customers		9,044.4	(15,313.6)
Net increase/(decrease) in derivative financial instruments payable		477.4	(649.1)
Net increase/(decrease) in other liabilities		16.3	(56.3)
Net (decrease)/increase in accruals and deferred income		(13.5)	43.2
Net cash inflow/(outflow) from operating activities		9,156.8	(5,162.3)
Net cash inflow from investing activities			
Net investment in intangible assets		(14.7)	(32.7)
Net investment in property, plant and equipment		5.7	(51.8)
Purchase of investment securities		(126.7)	(3,550.8)
Proceeds from sale and redemption of investment securities		2,424.9	3,784.4
		2,289.2	149.1
Net cash (outflow)/inflow from financing activities			
Issue of subordinated liabilities		-	328.1
Ordinary dividend paid	14	-	(105.0)
Preference dividend paid	14	-	(27.8)
Appropriations (including tax of £3.2m, 2007 £19.4m)		(71.5)	(63.9)
		(71.5)	131.4
Net increase/(decrease) in cash and cash equivalents		11,374.5	(4,881.8)
Opening cash and cash equivalents		1,435.9	6,317.7
Closing cash and cash equivalents	43	12,810.4	1,435.9

COMPANY CASH FLOW STATEMENT

For the year ended 31 December 2008

	Note	2008	2007
		£m	£m
Net cash inflow from operating activities			
Loss before taxation		(1,186.7)	(165.6)
Adjusted for:			
Depreciation and amortisation		21.3	28.3
Impairment (credits)/charges on property, plant and equipment	25	(23.6)	56.3
Impairment charges on intangible assets	24	27.2	7.0
Impairment charges on loans and advances	9	894.4	239.7
Impairment charges on unsecured investment loans	9	267.6	232.2
Income taxes refunded/(paid)		92.1	(68.6)
Fair value adjustments on financial instruments		(602.6)	(573.7)
Other non cash movements		402.0	(151.1)
Net cash outflow from operating (losses)/profits before changes in operating assets and liabilities		(108.3)	(395.5)
Changes in operating assets and liabilities			
Net decrease in deposits held for regulatory or monetary control purposes		16.9	11.4
Net decrease/(increase) in loans and advances		25,131.8	(11,878.5)
Net increase in derivative financial instruments receivable		(5,003.1)	(247.5)
Net (increase)/decrease in other assets		(122.2)	75.8
Net increase/(decrease) in debt securities in issue		351.9	(5,390.0)
Net (decrease)/increase in loans from HM Government		(12,889.6)	28,473.0
Net increase/(decrease) in deposits from other banks		3,522.5	(2,986.8)
Net decrease in amounts due to customers		(8,245.1)	(7,312.8)
Net increase/(decrease) in derivative financial instruments payable		1,373.9	(224.1)
Net increase/(decrease) in other liabilities		91.8	(102.5)
Net increase in accruals and deferred income		184.4	28.7
Net cash inflow from operating activities		4,304.9	51.2
Net cash inflow/(outflow) from investing activities			
Net investment in intangible assets		(14.7)	(32.7)
Net investment in property, plant and equipment		5.7	(51.0)
Purchase of investment securities		(0.1)	(8,472.5)
Proceeds from sale and redemption of investment securities		7,283.8	3,624.4
		7,274.7	(4,931.8)
Net cash (outflow)/inflow from financing activities			
Issue of subordinated liabilities		-	328.1
Ordinary dividend paid	14	-	(105.0)
Preference dividend paid	14	-	(27.8)
Appropriations (including tax of £3.2m, 2007 £19.4m)		(71.5)	(63.9)
		(71.5)	131.4
Net increase/(decrease) in cash and cash equivalents		11,508.1	(4,749.2)
Opening cash and cash equivalents		1,154.0	5,903.2
Closing cash and cash equivalents	43	12,662.1	1,154.0

1. Basis of preparation

Principles underlying going concern assumption

As a result of disruption in the liquidity and wholesale funding markets in August and September 2007, Northern Rock approached the Bank of England for loan facilities in the event that it was unable to obtain adequate funds from other sources to meet its obligations. Following significant withdrawals by retail customers, together with wholesale maturities, Northern Rock drew on the facilities during September 2007.

During the remaining period of 2007, the Chancellor of the Exchequer announced arrangements to guarantee, should it be necessary, all existing deposits in Northern Rock, including all unsecured retail products, all uncollateralised and unsubordinated wholesale deposits and wholesale borrowings, all payment obligations under any uncollateralised derivative transactions and all obligations of the Company to make payments on the repurchase of mortgages under the documentation for the Granite securitisation programme.

On 21 February 2008, the Banking (Special Provisions) Bill received Royal Assent. This enabled Northern Rock to be brought into temporary public ownership which was effected on 22 February 2008.

On 30 April 2008, the Bank of England amended and extended the loan agreement with the Company to provide additional loan facilities to enable the Company to pursue its restructuring plans. Details of these facilities are given in note 27 below.

On 28 August 2008, the loan facilities were novated to HM Treasury with no further amendments to the terms of the facilities.

On 23 February 2009, the Company announced that it had concluded the strategic review of its business plan, in close consultation with the Government. As part of this revised plan the Company will offer up to £14 billion of new mortgage lending over the next two years. Additional funding to support new lending will be partly provided by an increase in the Government loan, with an extended repayment schedule. To facilitate the new lending a legal and capital restructuring of the Company will be undertaken.

On 2 March 2009, HM Treasury confirmed that it intended to continue to fund the Company so as to maintain the Company as a going concern, and enable the Company to pay its debts as they fall due, for a period of not less than twelve months. Also on 2 March 2009, HM Treasury confirmed that it would take such steps as would be needed to ensure that the Company continues to meet its regulatory capital requirements.

All of the facilities referred to above, the revised business plan and the legal and capital restructuring of the Company are subject to appropriate clearance being obtained from the European Commission for State aid for the Company and any other constraints imposed by European legislation.

The financial statements have been prepared on a going concern basis. The validity of this assumption depends on the European Commission approving the financing facilities provided by HM Treasury. If approval is not received it is likely the Company would then submit a solvent wind down plan for European Commission State aid approval. If this were not forthcoming the financing facilities may be withdrawn in which case the Company may not be able to meet its financial obligations as they fall due. The Company may then have to take appropriate insolvency proceedings and cease to trade as a going concern. Consequently this outstanding approval indicates the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue as a going concern. The financial statements do not include adjustments that would result if the Company was unable to continue as a going concern. If the Company were unable to continue as a going concern, adjustments may have to be made to reduce the monetary value of assets to recoverable amounts, to provide for further liabilities that might arise and reclassify all assets and liabilities as current assets and liabilities.

2. Principal accounting policies

a) Accounting convention

These financial statements have been prepared in accordance with EU endorsed International Financial Reporting Standards ("IFRS"), IFRIC interpretations and with those parts of the Companies Acts 1985 and 2006 applicable to companies reporting under IFRS. The financial statements have been prepared under the historical cost convention as modified by the revaluation of available for sale investments, financial assets and liabilities held at fair value. A summary of the more important group accounting policies is set out below. The preparation of financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management's best knowledge of the amount, event or actions, actual results ultimately may differ from those estimates.

The Directors consider the business to comprise one operating and geographical segment due to the similarity of risks faced within its UK based residential, commercial and unsecured lending portfolios.

b) Basis of consolidation

The financial information of the Group incorporates the assets, liabilities, and results of Northern Rock plc and its subsidiary undertakings (including Special Purpose Entities). Entities are regarded as subsidiaries where the Group has the power to govern financial and operating policies so as to obtain benefits from their activities. Inter-company transactions and balances are eliminated upon consolidation.

The purchase method of accounting is used to account for the purchase of subsidiaries which are held at cost.

c) Interest income and expense

Interest income and expense are recognised in the income statement for all instruments measured at amortised cost using the effective interest method.

The effective interest method calculates the amortised cost of a financial asset or a financial liability, and allocates the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group estimates cash flows considering all contractual terms of the financial instrument (for example prepayment options) but does not consider future credit losses. The calculation includes all amounts received or paid by the Group that are an integral part of the overall return, direct incremental transaction costs related to the acquisition or issue of a financial instrument and all other premiums and discounts.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

d) Fees and commissions

Where they are not included in the effective interest calculation, fees and commissions are generally recognised on an accruals basis when the service has been provided. Loan commitment fees for loans that are likely to be drawn down are deferred (together with related incremental direct costs) and recognised as an adjustment to the effective interest rate on the loan. Insurance commissions are recognised in the period in which they are earned.

e) Financial instruments

Financial assets can be classified in the following categories: loans and receivables, available for sale, held to maturity or financial assets at fair value through profit and loss. Management determines the classification of its financial instruments at initial recognition. The Group measures all of its financial liabilities at amortised cost, other than those instruments which have been designated as part of a hedging relationship (see below). Regular way purchases and sales of financial assets at fair value through profit or loss, held to maturity and available for sale are recognised on trade date – the date on which the Group commits to purchase or sell the asset.

2. Principal accounting policies (continued)

i) Loans and receivables and financial liabilities at amortised cost

The Group's loans and advances to banks and customers, unsecured investment loans including certain investment securities, and investments in Structured Investment Vehicles ('SIVs') are classified as loans and receivables. Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, whose recoverability is based solely on the credit risk of the customer and where the Group has no intention of trading the loan. Both loans and receivables and financial liabilities are initially recognised at fair value including direct and incremental transaction costs. Subsequent recognition is at amortised cost using the effective interest method.

ii) Available for sale financial assets

Available for sale financial assets are assets that are either designated as available for sale or are assets that do not meet the definition of loans and receivables and are not derivatives or assets held at fair value through profit and loss. These are principally but not exclusively investment securities intended to be held for an indefinite period of time which may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. They are initially measured at fair value including direct and incremental transaction costs. Subsequent measurement is at fair value, with changes in fair value being recognised in equity except for impairment losses and translation differences, which are recognised in the income statement. Upon derecognition of the asset, or where there is objective evidence that the investment security is impaired, the cumulative gains and losses recognised in equity are removed from equity and recycled to the income statement.

In October 2008 IAS 39 was amended to allow the reclassification of available for sale securities to loans and receivables where such securities would now meet the definition of loans and receivables. Northern Rock elected to make such reclassifications, and full details are contained in note 22 to the accounts. Reclassifications are made at fair value on the date of reclassification. Fair value becomes the new cost or amortised cost as applicable, and no reversals of fair value gains or losses recorded before the reclassification date are subsequently made unless the assets are subsequently impaired. Effective interest rates for financial assets reclassified to loans and receivables are determined at the reclassification date. Further changes in estimates of cash flows adjust effective interest rates prospectively. If reclassified assets are impaired after reclassification, any fair value gains or losses recorded before classification in the available for sale reserve are charged as appropriate to the income statement.

iii) Held to maturity financial assets

Held to maturity financial assets are non-derivative financial assets with fixed or determinable payments that the Group has the ability and intention to hold to maturity. They are initially measured at fair value including direct and incremental transaction costs. Subsequent measurement is at amortised cost using the effective interest method. No financial assets were classified as held to maturity during either 2007 or 2008.

iv) Financial assets at fair value through profit or loss

A financial asset or liability is classified in this category if it is held for trading or is so designated by management on initial recognition. A financial asset or liability is classified as held for trading if it is a derivative not in an IAS 39 compliant accounting hedge relationship, or if it is acquired for the purpose of selling or repurchasing in the near term. In certain circumstances other assets and liabilities may be designated as held at fair value through profit or loss on initial recognition. These are when:

- a) Doing so significantly reduces measurement inconsistencies that would arise if the asset or liability were carried at amortised cost but a related derivative was treated as held for trading;
- b) Certain investments are managed and evaluated on a fair value basis in accordance with a documented risk management strategy and are reported to management on that basis;
- c) Financial instruments contain significant embedded derivatives that significantly modify the cash flows from the instruments.

The Group holds certain investment securities, such as Collateralised Debt Obligations ('CDOs') that contain a significant embedded derivative that is not clearly and closely related. These fall under the description c) above and are therefore measured at fair value through profit and loss.

The assets are initially measured at fair value, with transaction costs taken directly to the income statement. Subsequent measurement is at fair value including interest cashflows and accruals, with changes in fair value included directly in the income statement within other income, except for derivative instruments where interest cashflows and accruals are recorded within net interest income.

The fair values of quoted investments in active markets are based on current bid prices. If the market for a financial asset is not active (and for unlisted securities), the Group establishes fair value using valuation techniques. These include the use of recent arm's length transactions, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

f) Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

g) Derivative financial instruments and hedge accounting

The Group undertakes transactions in derivative financial instruments, which include cross currency swaps, interest rate swaps, equity swaps, interest rate caps, forward rate agreements, options, foreign exchange contracts and similar instruments, for non-trading purposes.

The Group's derivative activities are entered into for the purpose of matching or eliminating risk from potential movements in interest and foreign exchange rates inherent in the Group's assets, liabilities and positions. All derivative transactions are for economic hedging purposes and so it is therefore decided at the outset which position the derivative will be hedging. Derivatives are reviewed regularly for their effectiveness as hedges and corrective action taken, if appropriate. Derivatives are measured initially at fair value and subsequently remeasured to fair value. Fair values are obtained from quoted market prices in active markets and, where these are not available, from valuation techniques including discounted cash flow models and option pricing models. Where derivatives are not designated as part of a hedging relationship, changes in fair value are recorded in the income statement. Where derivatives are designated within hedging relationships, the treatment of the fair value changes depends on the nature of the hedging relationship as explained below.

Hedge accounting is used for derivatives designated in this way provided certain criteria are met. The Group documents at inception of the hedge relationship the link between the hedging instrument and the hedged item as well as its risk management objective and strategy for undertaking various hedge transactions. The Group also documents its assessment both at hedge inception and on an ongoing basis of whether the derivatives used in hedging transactions are highly effective in offsetting changes in the fair values or cash flows of hedged items.

i) Cash flow hedges

A cash flow hedge is used to hedge exposures to variability in cash flows, such as variable rate financial assets and liabilities. The effective portion of changes in the derivative fair value is recognised in equity, and recycled to the income statement in the periods when the hedged item will affect profit and loss. The fair value gain or loss relating to the ineffective portion is recognised immediately in the income statement.

ii) Fair value hedges

A fair value hedge is used to hedge exposures to variability in the fair value of financial assets and liabilities, such as fixed rate loans. Changes in fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. If the hedge no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of the hedged item is amortised to the income statement over the period to maturity.

2. Principal accounting policies (continued)

If derivatives are not designated as hedges then changes in fair values are recognised immediately in the income statement.

iii) Embedded derivatives

Certain derivatives are embedded within other non-derivative host instruments to create a hybrid instrument. Where the economic characteristics and risks of the embedded derivatives are not closely related to the economic characteristics and risk of the host instrument, and where the hybrid instrument is not measured at fair value, the Group separates the embedded derivative from the host instrument and measures it at fair value with the changes in fair value recognised in the income statement.

h) Sale and repurchase agreements

Securities sold subject to repurchase agreements ('repos') are reclassified in the financial statements as assets pledged when the transferee has the right by contract or custom to sell or repledge the collateral; the counterparty liability is included in amounts due to other banks, deposits from banks, other deposits or deposits due to customers, as appropriate. Securities purchased under agreements to resell, ('reverse repos'), are recorded as loans and advances to banks or customers as appropriate. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method. Securities lent to counterparties are also retained in the financial statements.

Securities borrowed are not recognised in the financial statements, unless these are sold to third parties, in which case the obligation to return them is recorded at fair value as a trading liability.

i) Impairment losses

The Group assesses its financial assets or groups of financial assets for objective evidence of impairment at each balance sheet date. An impairment loss is recognised if, and only if, there is a loss event (or events) that has occurred after initial recognition and before the balance sheet date and has a reliably measurable impact on the estimated future cash flows of the financial assets or groups of financial assets. Losses that are incurred as a result of events occurring after the balance sheet date are not recognised in these accounts.

i) Assets held at amortised cost

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. Objective evidence that a financial asset is impaired includes observable data that comes to the attention of the Group about the following loss events:

- a) significant financial difficulty of the issuer or obligor;
- b) a breach of contract, such as a default or delinquency in interest or principal repayments;
- c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
- d) it becomes probable that the borrower will enter bankruptcy or other financial reorganisation;
- e) the disappearance of an active market for that financial asset because of financial difficulties; or
- f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the portfolio, including:
 - i. adverse changes in the payment status of borrowers in the portfolio;
 - ii. national or local economic conditions that correlate with defaults on the assets in the portfolio.

If the Group determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

If there is objective evidence that an impairment loss on loans and receivables has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of the estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an impairment allowance and the amount of the loss is recognised in the income statement. In future periods the unwind of the discount is recognised within interest income.

When a loan is uncollectible, it is written off against the related provision for loan impairment. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of the provision for loan impairment in the income statement.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the customer's credit rating), the previously recognised impairment loss is reversed by adjusting the impairment allowance. The amount of the reversal is recognised in the income statement.

ii) Available for sale financial assets

For available for sale financial assets, the Group assesses at each balance sheet date whether there is objective evidence that a financial asset, or group of financial assets are impaired. The amount of the loss is measured as the difference between the asset's acquisition cost less principal repayments and amortisation and the current fair value. The amount of the impairment loss is recognised in the income statement. This includes cumulative gains and losses previously recognised in equity which are recycled from equity to the income statement. If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed through the income statement.

iii) Renegotiated loans

Loans to customers whose terms have been renegotiated are no longer considered past due but are treated as fully performing loans only after at least three monthly payments under the new arrangements have been received. In subsequent years, the asset is considered to be past due and disclosed only if renegotiated again within that year.

j) Derecognition of financial assets and liabilities

Derecognition is the point at which the Group removes an asset or liability from its balance sheet. The Group's policy is to derecognise financial assets only when the contractual right to the cash flows from the financial asset expires. The Group also derecognises financial assets that it transfers to another party provided the transfer of the asset also transfers the right to receive the cash flows of the financial asset or where the Group has transferred substantially all the risks and rewards of ownership. Where the transfer does not result in the Group transferring the right to receive the cash flows of the financial assets, but it does result in the Group assuming a corresponding obligation to pay the cash flows to another recipient, the financial assets are also accordingly derecognised.

The Group derecognises financial liabilities only when the obligation specified in the contract is discharged, cancelled or has expired.

2. Principal accounting policies (continued)

k) Securitisation transactions

Certain Group companies have issued debt securities in order to finance specific loans and advances to customers. Both the debt securities in issue and the loans and advances to customers remain on the Group balance sheet within the appropriate balance sheet headings unless:

- i) a fully proportional share of all or of specifically identified cash flows have been transferred to the holders of the debt securities, in which case that proportion of the assets are derecognised;
- ii) substantially all the risks and rewards associated with the assets have been transferred, in which case the assets are fully derecognised; or
- iii) if a significant proportion of the risks and rewards have been transferred, the assets are recognised only to the extent of the Group's continuing involvement.

l) Debt and equity securities in issue

Issued securities are classified as liabilities where the contractual arrangements result in the Group having an obligation to deliver either cash or another financial asset to the security holder, or to exchange financial instruments under conditions that are potentially unfavourable to the Group. Issued securities are classified as equity where they meet the definition of equity and confer a residual interest in the Group's assets on the holder of the securities.

Financial liabilities are carried at amortised cost using the effective interest rate (see "interest income and expense"). Equity instruments are initially recognised at net proceeds, after deducting transaction costs and any related income tax. Appropriations to holders of equity securities are deducted from equity, net of any related income tax, as they become irrevocably due to the holders of the securities.

m) Foreign currency translation

The Group's financial statements are presented in sterling, which is the functional currency of the parent company. Items included in the financial statements of each of the Group's entities are measured using their functional currency, which is the currency of the primary economic environment in which they operate.

Foreign currency transactions are translated into functional currency using the exchange rates prevailing at the dates of the transactions. Monetary items denominated in foreign currencies are translated at the rate prevailing at the balance sheet date. Foreign exchange gains and losses resulting from the restatement and settlement of such transactions are recognised in the income statement. Non-monetary items measured at amortised cost and denominated in foreign currencies are translated at the exchange rate at the date of the transaction. Non-monetary items measured at fair value are translated at the exchange rate at the date of valuation. Where these are held at fair value through profit and loss, exchange differences are reported as part of the fair value gain or loss.

n) Share-based payments

Share-based payments are accounted for on a fair value basis. The Group measures the fair value of the Long Term Incentive Plan ("LTIP") using a Monte Carlo simulation model and the fair value of the Save As You Earn scheme and all other share based payment schemes using a Black-Scholes option pricing model. The fair value is calculated at grant date and is recognised in the income statement over the relevant vesting period and adjusted for forfeitures, with the number of shares expected to be forfeited estimated at each balance sheet date prior to the vesting date. The impact of any revisions to estimates is reflected in the income statement, with the corresponding adjustment recognised in equity. The only exception is where the share-based payment has vesting outcomes attached to market based performance conditions such as in the case of the LTIPs. Under these circumstances, the Monte Carlo simulation model takes into account these market based performance conditions which effectively estimate the number of shares expected to vest. No subsequent adjustment is then made to the fair value charge for shares that do not vest in the event that these performance conditions are not met.

In accordance with the transitional provisions of IFRS – 2 Share-based Payment, the Group has only applied the requirements of the standard to equity settled share-based payments granted after 7 November 2002.

o) Intangible assets

i) Goodwill

Goodwill arising on the acquisition of subsidiary companies, which is represented by the excess of fair value of the purchase consideration over the fair value of the assets acquired, is capitalised and shown as an asset in the balance sheet. It is reviewed for impairment annually. Any impairment is recognised immediately in the income statement and is not subsequently reversed.

Goodwill arising on acquisitions before the date of transition to IFRS has been retained at the previous UK GAAP amount, having been tested for impairment at 31 December 2003.

ii) Computer software

Costs incurred in acquiring and developing computer software for internal use are capitalised as intangible assets where the software leads to the creation of an identifiable non-monetary asset and it is probable that the expected future economic benefits that are attributable to the asset will flow to the Group from its use for a period of over one year. The software is classified as an intangible asset where it is not an integral part of the related hardware and amortised over its estimated useful life which is generally 3 to 5 years.

Costs associated with maintaining software are expensed as they are incurred.

p) Cash and cash equivalents

For the purposes of the cashflow statement, cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition, including cash and non-restricted balances with central banks. The facility with HM Government represents a loan and is not included within cash and cash equivalents.

q) Taxation

Income tax payable on taxable profits ('current tax') based on the applicable tax law in each jurisdiction is recognised as an expense in the period in which the profits arise. Income tax recoverable on tax allowances is recognised as an asset only to the extent that it is regarded as recoverable by offset against current or future taxable profits.

Deferred income tax is provided in full, using the liability method, on temporary differences arising between tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred tax is determined using tax rates and laws that have been enacted or substantially enacted by the balance sheet date and are expected to apply when the deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax is not accounted for if it arises from the initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither the tax profit nor the accounting profit.

Deferred tax is provided on temporary differences arising from investments in subsidiaries, except where the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the difference will not reverse in the foreseeable future.

Deferred and current tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred or current tax is also dealt with in equity.

Deferred and current tax assets and liabilities are only offset when they arise in the same reporting tax group and where there is both a legal right of offset and the intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

2. Principal accounting policies (continued)

r) Pensions and employee benefits

The Company operates the Northern Rock Pension Scheme (the "Scheme") to provide retirement benefits for staff. Staff who joined the Scheme before 1 July 1999 participate in the funded, contracted out, defined benefit section of the scheme unless they opt out. Other staff, including those employed at 1 July 1999 but not members of the defined benefit section of the Scheme at that date, together with staff employed from 1 July 1999, participate in the defined contribution section of the scheme unless they opt out. The assets of both sections of the Scheme are held in a trustee-administered fund separate from the assets of Northern Rock plc.

A full actuarial valuation of the Group's defined benefit section of the scheme is undertaken every three years with interim reviews in the intervening years; these valuations are updated to 31 December each year by qualified independent actuaries. For the purpose of these annual updates, scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method. Liabilities in the defined benefit section of the scheme are discounted using rates equivalent to the market yields at the balance sheet date on high quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability. The resulting net surplus or deficit is included in the Group's balance sheet. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the scheme.

The Group's income statement includes the current service cost of providing pension benefits, the expected return on the scheme's assets, net of administration costs, and the interest cost on the scheme's liabilities. Cumulative actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are recognised immediately through the Statement of Recognised Income and Expense.

Past service costs are recognised immediately in the income statement, unless the changes to the Scheme are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past service costs are amortised on a straight line basis over the average vesting period.

For defined contribution plans, the Company has no further payment obligations once the contributions have been paid. The contributions are recognised as an employee benefit expense when they are due. Prepaid contributions are recognised as an asset to the extent that a cash refund or a reduction in the future payments is available.

s) Property, plant and equipment

Property, plant and equipment are stated at cost less accumulated depreciation and provision for impairment, as appropriate. Additions and subsequent expenditure are included in the asset's carrying value or are recognised as a separate asset only when they improve the expected future economic benefits to be derived from the asset. All other repairs and maintenance are charged to the income statement in the period in which they are incurred.

Depreciation is provided using the straight line method to allocate costs less residual values over estimated useful lives, as follows:

Freehold property	100 years
Leasehold property	Unexpired period of the lease
Plant, equipment, fixtures and fittings	
– plant	30 years
– furniture	10 years
– other	5 years
Computer equipment	
– PCs	3 years
– other	5 years
Motor vehicles	4 years

Assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Where the cost of freehold land can be identified separately from buildings, the land value is not depreciated. Fixed assets are subject to impairment testing, if deemed appropriate.

Assets in the course of construction are not depreciated until they have been completed and transferred to the appropriate category of property, plant and equipment. The costs of financing assets in the course of construction are not included in the costs of the assets. Assets in the course of construction are included within the impairment test referred to above where appropriate.

t) Impairment of property, plant and equipment and intangible assets

Property, plant and equipment and intangible assets are assessed for indications of impairment at each balance sheet date, or more frequently where required by events or changes in circumstances. Goodwill is reviewed for impairment annually at the balance sheet date. If indications of impairment are found, these assets are subject to an impairment review. The impairment review compares the carrying value of the assets with their recoverable amounts, which are defined as the higher of the net selling price and their value in use. Net selling price is the amount at which the asset could be sold in a binding agreement in an arm's length transaction. Value in use is calculated as the discounted cash flows generated as a result of the asset's continued use including those generated by its ultimate disposal, discounted at a market rate of interest on a pre-tax basis.

Where impairments are indicated, the carrying values of fixed assets and goodwill are written down by the amount of the impairment and the charge is recognised in the income statement in the period in which it occurs. A previously recognised impairment charge on a fixed asset may be reversed in full or in part where a change in circumstances leads to a change in the estimates used to determine its recoverable amount. The carrying value of the fixed asset will only be increased to the carrying value at which it would have been held had the impairment not been recognised. Any impairment charges on goodwill are not reversed.

u) Leases

If the lease agreement transfers the risks and rewards of the asset, the lease is recorded as a finance lease and the related asset is capitalised. At inception, the asset is recorded at the lower of the present value of the minimum lease payments or fair value and is depreciated over the estimated useful life. The lease obligations are recorded as borrowings.

If the lease does not transfer the risks and rewards of the asset, the lease is recorded as an operating lease.

Operating lease payments are charged to the income statement on a straight line basis unless a different systematic basis is more appropriate. Where an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor in compensation is charged to the income statement in the period in which termination is made.

2. Principal accounting policies (continued)

v) Share capital

- i) Share issue costs
Incremental costs directly attributable to the issue of new shares or options are shown in equity as a deduction, net of tax, from the proceeds.
- ii) Dividends on shares
Dividends on shares are recognised in equity in the period in which they are approved by the Company's shareholders or paid.
- iii) Treasury shares
Where any Group company purchases the Company's equity share capital, the consideration paid is deducted from total shareholders' equity as treasury shares until they are cancelled. Where such shares are subsequently sold or reissued, any consideration received is included in shareholders' equity.

w) Implementation of new standards and amendments to published standards and interpretations effective during 2008

The following new standards, amendments to standards or interpretations are mandatory for the first time for financial years beginning on 1 January 2008 and have been endorsed for adoption by the EU, but have no financial impact on the Group:

- IFRIC 11 – IFRS 2 – Group and Treasury Share Transactions

The following new standards, amendments to standards or interpretations are mandatory for the first time for financial years beginning on 1 January 2008 but have not yet been endorsed for adoption by the EU, but have no financial impact on the Group:

- IFRIC 12 – Service concession arrangements

The Group has adopted Amendments to IAS 39 and IFRS 7: Reclassification of Financial Instruments. Details of the impacts of adoption are included in note 22 to the accounts. These amendments allow reclassification of certain financial instruments out of the held for trading and available for sale categories if specified conditions are met. They also introduce disclosure requirements in respect of reclassified financial instruments. The amendment is effective prospectively from 1 July 2008 and the Group adopted it as of that date.

x) Early adoption of standards

The Group has not early adopted any standards or interpretations during 2008.

y) Standards, interpretations and amendments to published standards that are not yet effective

The following new standards, amendments to standards or interpretations that are relevant to the Group have been issued and have been endorsed for adoption by the EU but are not effective for financial years beginning 1 January 2008 and have not been early adopted:

IFRS 8, Operating Segments, effective for financial years beginning on or after 1 January 2009. IFRS 8 requires disclosure of segmental details based on management reporting structures, and is mandatory for accounting periods beginning on or after 1 January 2009. The Group believes the application of this standard will have no material impact on the financial statements in the period of initial application.

IAS 23 (amendment) – Borrowing costs, effective for financial years beginning on or after 1 January 2009. The Group believes the application of this amendment will have no material impact on the financial statements in the period of initial application.

IAS 1 (amendment) – Presentation of financial statements, effective for financial years beginning on or after 1 January 2009. Management is assessing the impact of this amendment on its financial statements, to ensure it meets the revised disclosure requirements introduced by this amendment.

IFRIC 14 – IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction. The Group believes the application of this interpretation will have no material impact on the financial statements in the period of initial application.

Amendment to IFRS 2 Share-Based Payment: Vesting Conditions and Cancellations. This amendment will have no impact on the Group.

The following new standards, amendments to standards or interpretations that are relevant to the Group have been issued but have not yet been endorsed for adoption by the EU but are not effective for financial years beginning 1 January 2008 and have not been early adopted:

IFRS 3 (revised) – Business combinations and consequential revisions to IAS 27 – Consolidated and separate financial statements, effective prospectively for business combinations with an effective date on or after 1 July 2009. Management is assessing the impact of this amendment on its financial statements, to ensure it meets the revised disclosure requirements introduced by this amendment.

IAS 32 (amendment) – Financial instruments: presentation, and consequential amendments to IAS 1 – Presentation of financial statements, effective for financial years beginning on or after 1 January 2009. The Group believes this amendment has no impact on its financial instruments as it has no puttable instruments.

Amendment to IAS 39 Financial Instruments: Recognition and Measurement: Eligible Hedged Items, effective for accounting periods beginning on or after 1 July 2009. The Group believes that this amendment has no material impact on the financial statements in the period of initial application.

Annual improvements to IFRSs – The Group believes that none of the changes introduced by these improvements have any material impact on its financial results or their presentation.

IFRIC 15 – Agreements for the construction of real estate. The Group believes that this amendment has no material impact on the financial statements in the period of initial application.

IFRIC 16 – Hedges of a net investment in a foreign operation. The Group believes that this amendment has no material impact on the financial statements in the period of initial application.

IFRIC 17 – Distribution of Non-cash assets to Owners. The Group believes that this amendment has no material impact on the financial statements in the period of initial application.

3. Critical accounting estimates

a) Impairment losses on loans and advances

Individual impairment losses on loans and advances are calculated based on an individual valuation of the underlying asset. Collective impairment losses on loans and advances are calculated using a statistical model. The key assumptions used in the model are the probability of any account going into default in the next twelve months as a result of an event that had occurred prior to the balance sheet date, the loss incurred in the event of possession or write off, the roll rates of borrowers moving from lower levels of arrears to serious arrears and possession or write off and the time period from the date of the event causing the loss to the date of realisation of the property or write off. The probability of accounts going into default is based on application and behavioural scorecards, which are regularly recalibrated to take account of current circumstances. These key assumptions are based on observed data from historical patterns from lending over previous years and are updated regularly based on new data as it becomes available. In addition, management considers how appropriate past trends and patterns might be in the current economic situation and makes any adjustments that it believes to be necessary to reflect current conditions. The accuracy of the impairment calculation would therefore be affected by unexpected changes to the economic situation, inaccuracies within the models used compared to actual outcomes and assumptions which differ from actual outcomes. To the extent that the loss given default differs by +/- 10%, the impairment allowance would be an estimated £60.0m higher (2007 £11.8m) or £70.8m lower (2007 £15.8m) respectively.

3. Critical accounting estimates (continued)

b) Fair value calculations

Fair value is defined as the value at which assets, liabilities or positions could be closed out or sold in a transaction with a willing and knowledgeable counterparty. For the majority of instruments carried at fair value, these are determined by reference to quoted market prices. Where these are not available, fair value is based upon cash flow models, which use wherever possible independently sourced market parameters such as interest rate yield curves, currency rates and option volatilities. Other factors are also considered, such as counterparty credit quality and liquidity. Management must use judgement and estimates where not all necessary data can be externally sourced or where factors specific to Northern Rock's holdings need to be considered. The accuracy of the fair value calculations would therefore be affected by unexpected market movements, inaccuracies within the models used compared to actual outcomes and incorrect assumptions. For example, if management were to use a tightening in the credit spread of 10 basis points, the fair values of liabilities (including derivatives) would increase from the reported fair values by £77.2m (2007 £117.9m).

c) Average life of secured lending

IAS 39 requires interest earned from mortgage lending to be measured under the effective interest method. The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset.

Management must therefore use judgement to estimate the expected life of each instrument and hence the expected cash flows relating to it. The accuracy of the effective interest rate would therefore be affected by unexpected market movements resulting in altered customer behaviour, inaccuracies in the models used compared to actual outcomes and incorrect assumptions. If the estimated average life of secured loans were increased or reduced by one month, the value of such loans on the balance sheet would be increased or decreased by £20.2m (2007 £23.0m) and £21.2m (2007 £24.6m) respectively.

d) Pension benefits

The present value of the pension obligations is dependent upon an actuarial calculation which includes a number of assumptions. These assumptions include the discount rate, which is used to determine the present value of the estimated future cash outflows that will be required to meet the pension obligation. In determining the appropriate discount rate to use, the Group considers market yields of high quality corporate bonds denominated in sterling that have terms to maturity approximating the terms of the pension liability. Were this discount rate to reduce by 0.1% or increase by 0.1% from the current management estimate, the carrying value of the pension obligations would be an estimated £7.8m higher (2007 £8.4m) or £7.5m lower (2007 £8.2m) respectively.

Other key assumptions for pensions benefits including mortality tables are based in part upon current market conditions or published data. Additional information is included in note 8.

4. Interest and similar income

	2008 £m	2007 £m
On secured advances	4,684.0	5,646.1
On other lending	446.7	533.1
On investment securities and deposits	576.2	728.3
	5,706.9	6,907.5

Interest accrued on individually impaired assets was £17.1m (2007 £6.2m).

5. Interest expense and similar charges

	2008 £m	2007 £m
On retail customer accounts	956.6	1,034.1
On other deposit accounts including loans from HM Government	1,399.6	735.9
On debt securities in issue	3,174.2	4,219.0
On subordinated liabilities	103.9	132.2
On tier one notes	16.1	15.4
Other	5.6	9.5
	5,656.0	6,146.1

6. Administrative expenses

	2008 £m	2007 £m
Administrative expenses		
Wages and salaries	140.3	127.6
Social security costs	12.7	16.2
Other pension costs	10.4	14.8
Total staff costs	163.4	158.6
Other administrative expenses	84.4	88.6
	247.8	247.2

Other administrative expenses include:

Hire of equipment	4.8	2.9
Property rentals	5.3	4.8
Remuneration of auditors (see below)	1.9	2.4

6. Administrative expenses (continued)

Exceptional administrative expenses

Exceptional administrative expenses are those incurred as a result of the restructuring and strategic review of the Group's activities prior to and following Northern Rock being brought into temporary public ownership.

Exceptional administrative expenses incurred in 2008 and the second half of 2007 are analysed as follows:

	2008	2007
	£m	£m
Redundancy and other staff costs	37.0	–
Professional fees incurred by the Company	29.8	21.2
Professional fees recharged by the Tripartite Authorities	10.7	12.5
Corporate advisory fees	4.2	2.5
Reimbursement of third party expenses	8.7	5.1
Cost of staff withdrawals from Save As You Earn schemes	–	4.5
Accelerated charge on cancellation of share schemes (see note 7)	39.6	–
Other exceptional administrative expenses	11.5	5.2
	141.5	51.0

The average number of persons employed by the Group and Company was as follows:

	2008	2007
Full time	4,231	5,145
Part time	1,045	1,189

The aggregate Directors' emoluments and the emoluments of the highest paid Director together with the number of Directors to whom retirement benefits are accruing under the Company's defined benefit scheme are given in the Directors' Remuneration Report on pages 11 to 16.

Services provided by the Group's auditor and network firms

During the year the Group obtained the following services from the Group's auditor, as detailed below:

	2008	2007
	£m	£m
Administrative expenses		
Fees payable to Company auditor for the audit of parent Company and consolidated accounts	1.2	1.0
Fees payable to Company auditor and its associates for other services		
– The audit of Company's subsidiaries pursuant to legislation	0.4	0.4
– Other services pursuant to legislation (including review of half year Interim Statement)	0.1	0.3
– Reporting Accountant services (see note i)	0.2	0.7
	1.9	2.4
Exceptional administrative expenses		
Fees payable to Company auditor and its associates for other services		
– Due diligence in connection with proposed transactions	–	1.1
– Other services (see note ii)	3.3	5.1
	3.3	6.2

- i) Reporting accountant services comprise objective review of the verification of historical financial information and the performance of certain agreed upon assurance procedures for securitisation transactions and the raising of wholesale funding.
- ii) Other services comprise services provided in respect of the Company's forecasts, proposed restructuring plans (as developed by the Company), its options to manage liquidity and regulatory capital, its obligations to key financial stakeholders and its reporting and other obligations to the Tripartite authorities under various agreements all of which were incurred prior to temporary public ownership.

7. Share-based payment

As a result of The Northern Rock plc Transfer Order 2008 all share schemes were extinguished on 22 February 2008. The charge in 2008 in relation to share schemes was £39.6m arising from the acceleration through the income statement of all previously unexpensed charges for all share schemes. There was a credit to the income statement in 2007 in relation to all schemes of £4.3m.

	Options/ Rights at the beginning of the year	Options/ Rights granted during the year	Options/ Rights exercised during the year	Options/ Rights lapsed during the year	Options/ Rights expired during the year	Options/ Rights extinguished during the year	Options/ Rights outstanding at the end of the year	Options/ Rights exercisable at the end of the year
2008								
Employee Sharesave and Share Option Schemes	7,670,205	-	-	(298,619)	-	(7,371,586)	-	-
Long Term Incentive Plans	1,105,466	-	-	-	-	(1,105,466)	-	-
Share Matching Schemes	1,390,343	-	-	(2,223)	-	(1,388,120)	-	-
Deferred Share Schemes	474,858	-	-	-	-	(474,858)	-	-
2007								
Employee Sharesave and Share Option Schemes	7,701,099	3,408,559	(542,891)	(2,891,031)	(5,531)	-	7,670,205	462,758
Long Term Incentive Plans	1,852,378	693,426	(241,958)	(1,198,380)	-	-	1,105,466	-
Share Matching Schemes	1,365,464	1,059,377	(442,704)	(591,794)	-	-	1,390,343	-
Deferred Share Schemes	803,876	350,462	(354,279)	(325,201)	-	-	474,858	-

8. Retirement benefit obligations

The Company operates one main employee benefit scheme ("the Scheme") with both defined benefit and defined contribution sections.

The defined benefit section of the Scheme provides benefits based on final salary for certain employees. The assets of the Scheme are held in a separate trustee-administered fund. Contributions to the defined benefit section are assessed in accordance with the advice of an independent qualified actuary using the projected unit method. The defined benefit section was closed to new entrants in July 1999.

The Company's policy for recognising actuarial gains and losses is to recognise them immediately on the balance sheet through the statement of recognised income and expense.

The overall costs of the Scheme have been recognised in the Company's accounts in accordance with IAS19.

Summary of assumptions

	2008 %	2007 %
Price inflation	3.10	3.30
Rate of increase in salaries	4.35	4.55
Rate of increase for pre 6 April 2006 pensions in payment (in excess of any Guaranteed Minimum Pension (GMP) element)	3.60	3.70
Rate of increase for post 6 April 2006 pensions in payment	3.10	3.30
Rate of increase for deferred pensions	3.10	3.30
Discount rate	6.00	5.80
Expected rate of return on assets	4.60	4.92

The most significant non financial assumption is the assumed rate of longevity. The table below shows the life expectancy assumptions used in the accounting assessments based on the life expectancy of a member aged 60.

	2008		2007	
	Pensioner	Non-Pensioner	Pensioner	Non-Pensioner
Male	27.2 years	28.4 years	27.2 years	28.4 years
Female	29.7 years	30.8 years	29.7 years	30.8 years

The expected return on assets has been derived as the weighted average of the expected returns from each of the main asset classes. The expected return for each asset class reflects a combination of historical performance analysis, the forward looking views of the financial markets (as suggested by the yields available), and the views of investment organisations.

Categories of assets held

	2008 %	2007 %
Equities	3	2
Government and other corporate bonds	93	93
Property	3	4
Cash/other	1	1
Total	100	100

8. Retirement benefit obligations (continued)

Funded status	2008	2007	2006	2005	2004
	£m	£m	£m	£m	£m
Present value of defined benefit obligation	(335.8)	(354.6)	(350.7)	(311.0)	(251.4)
Assets at fair value	367.5	360.3	329.0	256.6	198.9
Defined benefit asset/(liability)	31.7	5.7	(21.7)	(54.4)	(52.5)

Disclosed pension expense for year:
a) Components of defined benefit pension expense

	2008	2007
	£m	£m
Current service cost	8.3	11.2
Interest cost	20.4	18.1
Expected return on assets	(17.5)	(20.9)
Curtailments	(4.1)	–
Total pension expense	7.1	8.4

b) Statement of recognised income and expense (SORIE)

	2008	2007
	£m	£m
Actuarial gain recognised in SORIE	25.5	29.5
Cumulative actuarial losses recognised at 1 January	(8.3)	(37.8)
Cumulative actuarial gains/(losses) recognised at 31 December	17.2	(8.3)

Movements in present value of defined benefit obligation during the year

	2008	2007
	£m	£m
Present value of defined benefit obligation at 1 January	354.6	350.7
Defined benefit service cost	8.3	11.2
Interest cost	20.4	18.1
Defined benefit employee contributions	1.7	2.0
Actuarial gain	(27.4)	(23.3)
Defined benefit actual benefits paid	(17.7)	(4.1)
Curtailments	(4.1)	–
Present value of defined benefit obligation at 31 December	335.8	354.6

Movements in defined benefit fair value of assets during the year

	2008	2007
	£m	£m
Fair value of assets at 1 January	360.3	329.0
Expected return on assets	17.5	20.9
Actuarial (loss)/gain	(1.9)	6.2
Defined benefit actual company contributions	7.6	6.3
Defined benefit employee contributions	1.7	2.0
Defined benefit actual benefits paid	(17.7)	(4.1)
Fair value of assets at 31 December	367.5	360.3

Experience gains and losses

	2008	2007	2006	2005	2004
	£m	£m	£m	£m	£m
Defined benefit obligation	335.8	354.6	350.7	311.0	251.4
Fair value of assets	367.5	360.3	329.0	256.6	198.9
Surplus/(deficit)	31.7	5.7	(21.7)	(54.4)	(52.5)
Experience gain/(loss) on defined benefit obligation	27.4	23.3	(21.1)	(39.4)	(7.0)
Experience (loss)/gain on assets	(1.9)	6.2	4.6	20.8	4.2

8. Retirement benefit obligations (continued)

Estimated contributions for year ending 31 December 2009

	2009
	£m
Estimated employee contributions for 2009	1.5

The level of employer contributions for 2009 are still under discussion between the Company and the Pension Fund Trustees. If contributions are retained at 2008 levels, the estimated employer contributions for 2009 would be £6.5m.

Pension costs for the defined contribution section of the Scheme were:

	2008	2007
	£m	£m
Total included in staff costs	4.1	4.2

9. Impairment losses

	On advances secured on residential property £m	On advances secured on residential buy to let property £m	On other secured advances £m	On unsecured loans £m	Total on retail loans and advances £m	On unsecured investment loans £m	Total £m
2008							
Group							
At 1 January 2008	58.4	5.3	0.7	178.6	243.0	232.2	475.2
Increase in allowance during the year net of recoveries	364.0	48.9	8.2	473.3	894.4	267.6	1,162.0
Amounts written off during the year	(87.8)	(11.8)	(1.3)	(170.1)	(271.0)	(76.6)	(347.6)
Discount unwind	0.8	0.5	0.2	1.8	3.3	-	3.3
At 31 December 2008	335.4	42.9	7.8	483.6	869.7	423.2	1,292.9
Company							
At 1 January 2008	58.4	5.3	0.7	178.7	243.1	232.2	475.3
At 31 December 2008	335.4	42.9	7.8	483.7	869.8	423.2	1,293.0
2007							
Group							
At 1 January 2007	21.3	4.9	7.4	92.4	126.0	-	126.0
Increase in allowance during the year net of recoveries	53.2	0.5	8.6	177.4	239.7	232.2	471.9
Amounts written off during the year	(17.0)	(0.3)	(13.4)	(93.0)	(123.7)	-	(123.7)
Discount unwind	0.9	0.2	0.4	1.8	3.3	-	3.3
Amounts released from disposal of loan book (note 10)	-	-	(2.3)	-	(2.3)	-	(2.3)
At 31 December 2007	58.4	5.3	0.7	178.6	243.0	232.2	475.2
Company							
At 1 January 2007	21.3	4.9	7.4	92.5	126.1	-	126.1
At 31 December 2007	58.4	5.3	0.7	178.7	243.1	232.2	475.3

10. Gain on disposal of loan books

During the first half of 2008 the Group sold £2,240.7m (net of provisions) of its residential equity release mortgage portfolio to JP Morgan Limited. Total proceeds (net of costs) amounted to £2,289.8m. The surplus on disposal amounted to £49.1m. Included in the reported results for the year ended 31 December 2008 is net interest income of £0.9m (2007 £23.6m) in relation to those assets to the date of disposal.

During 2007 the Group sold £1,437.8m (net of provisions and fair value adjustments) of its commercial loan portfolio to Lehman Commercial Mortgage Conduit Limited in three separate transactions. Total proceeds (net of costs) amounted to £1,461.6m. The surplus on disposal amounted to £23.8m. Included in the reported results for the year ended 31 December 2007 is net interest income of £7.6m in relation to those assets to the date of disposal.

11. Net trading income/(expense)

	2008 £m	2007 £m
Net losses on changes in fair value from assets held at fair value	(46.4)	(21.1)
Net income from financial assets designated at fair value	3.0	3.0
Fair value movements of future cashflows, excluding accruals, on derivatives not in hedge accounting relationships	9,465.7	998.4
Translation losses on underlying instruments	(9,259.7)	(1,045.2)
	162.6	(64.9)

12. Income tax credit/(expense)

	2008 £m	2007 £m
The income tax credit/(expense) for the year comprises:		
Current tax		
– on loss for the year	(0.4)	23.5
– adjustments in respect of prior years	(8.4)	5.7
– utilisation of previously unrecognised tax losses	–	3.4
Total current tax	(8.8)	32.6
Deferred tax (see note 26)		
– origination and reversal of temporary differences	408.0	(7.7)
– effect of UK tax rate change on deferred tax items	(1.2)	(0.6)
– write off of deferred income tax asset previously recognised	(19.6)	(55.7)
– deferred income tax asset arising in the year not recognised	(332.2)	–
Total deferred tax	55.0	(64.0)
	46.2	(31.4)

The tax on the Group's loss before tax differs from the theoretical amount that would arise using the standard weighted average rate of UK corporation tax of 28.49% (2007 30%) as follows:

	2008 £m	2007 £m
Loss before taxation	(1,355.9)	(167.6)
Tax calculated at rate of 28.49% (2007 30%)	386.3	50.3
Current year adjustments		
– deferred income tax asset arising in the year not recognised	(332.2)	–
– write off of deferred income tax asset previously recognised	(20.0)	(55.7)
– exceptional non tax deductible costs	(11.4)	(37.3)
– recurring non taxable income	11.0	0.4
– utilisation of previously unrecognised tax losses	–	0.6
– effect of UK tax rate change on deferred tax items	0.3	(0.6)
Prior year adjustments		
– utilisation of previously unrecognised tax losses	–	2.8
– other current tax	(8.4)	5.7
– write off of deferred income tax asset previously recognised	0.4	–
– other deferred tax	21.7	2.4
– effect of UK tax rate change on deferred tax items	(1.5)	–
Income tax credit/(expense)	46.2	(31.4)

As detailed in notes 38 and 39, current and deferred income tax have also been credited direct to equity. The deferred income tax credited/(charged) amounts to £15.6m for the Group (2007 charge of £(41.7m)) and £(4.8m) for the Company (2007 charge of £(22.6m)). The current income tax credit amounts to £3.6m for both the Group and the Company (2007 £68.6m).

13. Loss attributable to equity shareholders

Of the loss attributable to equity shareholders, £1,245.6m (2007 £263.8m) has been dealt with in the accounts of the Company. As permitted by section 230 of the Companies Act 1985, the Company's income statement has not been presented separately.

14. Dividends

The following tables analyse dividends when paid and the year to which they relate.

	2008 pence per share	2007 pence per share
Ordinary dividends		
2006 final dividend	–	25.3
	–	25.3

The interim dividend for 2007 was declared at 14.2p and was due to be paid in the second half of the year. However, as a result of the challenging conditions faced by the Company, the Board considered that it was not appropriate to pay this dividend, and it was therefore cancelled. There was no dividend declared for the full year 2007 and no interim dividend declared in 2008. No final dividend is proposed in respect of 2008.

	2008 £m	2007 £m
Ordinary dividends		
2006 final dividend	–	105.0
	–	105.0
Preference dividend	–	27.8
	–	132.8

15. Analysis of financial assets and financial liabilities by measurement basis

	2008								
	Financial liabilities at amortised cost £m	Loans and receivables £m	Available for sale securities £m	Designated as held at fair value £m	Assets reclassified from available for sale to loans and receivables £m	IAS 39 held for trading £m	Fair value hedge £m	Cash flow hedge £m	Total £m
Financial assets									
Cash and balances with central banks	–	9,336.8	–	–	–	–	–	–	9,336.8
Derivative financial instruments	–	–	–	–	–	8,669.7	4,644.6	0.1	13,314.4
Loans and advances to banks	–	3,384.4	–	–	–	–	–	–	3,384.4
Loans and advances to customers	–	74,423.7	–	–	–	–	–	–	74,423.7
Investment securities	–	–	422.5	11.5	2,952.8	–	–	–	3,386.8
Accrued income	–	99.3	–	–	–	–	–	–	99.3
	–	87,244.2	422.5	11.5	2,952.8	8,669.7	4,644.6	0.1	103,945.4
Non financial assets									400.6
									<u>104,346.0</u>
Financial liabilities									
Loans from HM Government	15,583.4	–	–	–	–	–	–	–	15,583.4
Deposits by banks	4,625.1	–	–	–	–	–	–	–	4,625.1
Customer accounts	20,722.7	–	–	–	–	–	–	–	20,722.7
Derivative financial instruments	–	–	–	–	–	194.6	1,757.1	269.1	2,220.8
Debt securities in issue	57,736.3	–	–	–	–	–	–	–	57,736.3
Accruals	908.5	–	–	–	–	–	–	–	908.5
Subordinated liabilities	1,514.9	–	–	–	–	–	–	–	1,514.9
Tier one notes	251.8	–	–	–	–	–	–	–	251.8
	101,342.7	–	–	–	–	194.6	1,757.1	269.1	103,563.5
Non financial liabilities									148.9
Total liabilities									103,712.4
Equity									633.6
									<u>104,346.0</u>

15. Analysis of financial assets and financial liabilities by measurement basis (continued)

2007	Financial liabilities at amortised cost £m	Loans and receivables £m	Available for sale securities £m	Designated as held at fair value £m	IAS 39 held for trading £m	Fair value hedge £m	Cash flow hedge £m	Total £m
Financial assets								
Cash and balances with central banks	-	190.2	-	-	-	-	-	190.2
Derivative financial instruments	-	-	-	-	1,415.5	817.4	8.1	2,241.0
Loans and advances to banks	-	1,292.5	-	-	-	-	-	1,292.5
Loans and advances to customers	-	99,018.5	-	-	-	-	-	99,018.5
Investment securities	-	-	6,002.7	106.0	-	-	-	6,108.7
Accrued income	-	21.8	-	-	-	-	-	21.8
	-	100,523.0	6,002.7	106.0	1,415.5	817.4	8.1	108,872.7
Non financial assets								448.3
								109,321.0
Financial liabilities								
Loans from HM Government	28,473.0	-	-	-	-	-	-	28,473.0
Deposits by banks	744.2	-	-	-	-	-	-	744.2
Customer accounts	11,562.8	-	-	-	-	-	-	11,562.8
Derivative financial instruments	-	-	-	-	1,371.5	308.3	63.6	1,743.4
Debt securities in issue	61,641.3	-	-	-	-	-	-	61,641.3
Accruals	927.2	-	-	-	-	-	-	927.2
Subordinated liabilities	1,161.8	-	-	-	-	-	-	1,161.8
Tier one notes	207.6	-	-	-	-	-	-	207.6
	104,717.9	-	-	-	1,371.5	308.3	63.6	106,461.3
Non financial liabilities								160.4
Total liabilities								106,621.7
Equity								2,699.3
								109,321.0

16. Cash and balances with central banks

	Group and Company	
	2008 £m	2007 £m
Cash in hand	9.4	19.7
Balances with Bank of England for liquidity purposes	9,163.6	-
Other balances with central banks	112.4	102.2
Included in cash and cash equivalents	9,285.4	121.9
Mandatory reserve deposits with central banks	51.4	68.3
	9,336.8	190.2

Mandatory reserve deposits with central banks are not available for use in day to day operations.

17. Derivative financial instruments

Strategy in using derivative financial instruments

The Board has authorised the use of derivative instruments for the purpose of supporting the strategic and operational business activities of the Group and reducing the risk of loss arising from changes in interest rates and exchange rates. All use of derivative instruments within the Group is to hedge risk exposure, and the Group takes no trading positions in derivatives.

The objective, when using any derivative instrument, is to ensure that the risk to reward profile of any transaction is optimised. The intention is to only use derivatives to create economically effective hedges. However, because of the specific requirements of IAS 39 to obtain hedge accounting, not all economic hedges are designated as accounting hedges, either because natural accounting offsets are expected or because obtaining hedge accounting would be especially onerous.

a) Fair value hedges

The Group designates a number of derivatives as fair value hedges. In particular the Group has three approaches establishing relationships for:

- i) Hedging the interest rate and foreign currency exchange rate risk of non-prepayable, foreign currency denominated fixed rate assets or liabilities on a one-for-one basis with fixed/floating or floating/fixed cross currency interest rate swaps.
- ii) Hedging of interest rate risk of a single currency portfolio of sterling, US Dollar and Euro non-prepayable fixed rate assets/liabilities on a one-for-one basis with vanilla fixed/floating or floating/fixed interest rate swaps.

18. Loans and advances to banks

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Fixed rate	2,335.1	477.4	2,326.7	473.6
Variable rate	1,049.3	815.1	909.4	572.4
	3,384.4	1,292.5	3,236.1	1,046.0
Current	3,384.4	1,292.5	3,236.1	1,046.0
Non-current	-	-	-	-
	3,384.4	1,292.5	3,236.1	1,046.0

19. Loans and advances to customers

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Advances secured on residential property not subject to securitisation	28,679.0	34,951.8	28,679.0	34,951.8
Advances secured on residential property subject to securitisation	32,325.0	49,326.1	32,325.0	49,326.1
	61,004.0	84,277.9	61,004.0	84,277.9
Residential buy to let loans not subject to securitisation	5,695.7	6,499.8	5,695.7	6,499.8
Total advances secured on residential property	66,699.7	90,777.7	66,699.7	90,777.7
Commercial secured advances not subject to securitisation	301.7	315.9	301.7	315.9
Unsecured loans not subject to securitisation	5,298.0	7,350.6	5,298.0	7,350.6
Unsecured investment loans	422.4	390.4	422.4	390.4
Amounts due from subsidiary undertakings	-	-	172.0	451.9
	72,721.8	98,834.6	72,893.8	99,286.5
Fixed rate	47,592.0	79,147.5	47,592.0	79,147.5
Variable rate	25,129.8	19,687.1	25,301.8	20,139.0
	72,721.8	98,834.6	72,893.8	99,286.5
Current	2,538.6	3,180.7	2,710.6	3,632.6
Non-current	70,183.2	95,653.9	70,183.2	95,653.9
	72,721.8	98,834.6	72,893.8	99,286.5

Fair value adjustments of portfolio hedging amounting to £1,701.9m (2007 £183.9m) relate to fair value adjustments of loans and advances to customers in relation to interest rate risk as a result of their inclusion in a fair value portfolio hedge relationship.

20. Securitisation

The Group's results include the results and assets and liabilities of securitisation Special Purpose Entities ("SPEs"), none of which qualify for derecognition under IAS 39, on a line by line basis. Securitised advances are subject to non-recourse finance arrangements. These loans have been purchased at par from Northern Rock plc, and have been funded through the issue of mortgage-backed bonds by the SPEs. The balances of assets subject to securitisation notes in issue at 31 December 2008 are as follows:

2008

	Gross assets securitised £m	Notes in issue £m
Granite Finance Funding Limited	5,557.9	5,980.3
Granite Finance Funding 2 Limited	25,824.3	31,566.0
	31,382.2	37,546.3
Retained interest in Granite Finance Trustees Limited	3,253.8	
Less cash deposits held with Northern Rock plc	(2,182.6)	
Total	32,453.4	37,546.3

The retained interest in Granite Finance Trustees Limited represents Northern Rock plc's share of the assets held by Granite Finance Trustees Limited.

Gross assets securitised and notes in issue as presented above reconcile to amounts included in the consolidated balance sheet within loans and advances to customers and debt securities in issue as follows:

	Gross assets securitised £m	Notes in issue £m
Total as above	32,453.4	37,546.3
Less cash deposits with third parties included within loans and advances to banks	(128.4)	
Less accrued interest on loan notes included within accruals and deferred income		(45.1)
Add loan notes issued by Whinstone Limited (see below)		485.7
Total advances subject to securitisation (see note 19)	32,325.0	
Total securitised notes as per consolidated balance sheet		37,986.9

At 31 December 2008 the SPEs had cash deposits with Northern Rock plc amounting to £3,146.7m, including collateral deposits of £964.1m (31 December 2007 £4,624.8m including collateral deposits of £nil). This balance (excluding the collateral deposits) is restricted in use to the repayment of the debt securities issued by the SPEs and other legal obligations.

Many of the securitised notes are issued in foreign currency and are translated into sterling at exchange rates prevailing at 31 December. All issuance in foreign currency is subject to cross currency swaps that provide the amounts of foreign currency required to repay the notes in exchange for an amount of sterling fixed at the outset of the securitisation, thereby protecting against foreign exchange risk. At 31 December 2008 there is a gross derivative asset on derivatives economically hedging the foreign currency notes of £7,269.0m (31 December 2007 £1,202.0m). The value of the loans assigned to the bankruptcy remote special purpose vehicles exceed the value of sterling required under the foreign exchange swaps, and therefore the debt securities in issue are more than covered by loan assets allocated for this purpose.

On 11 November 2008, as a result of a breach of a non asset trigger, the Granite Master Trust ("the Trust") moved into pass through. The main consequence of this is that the repayments of the loan notes no longer adhere to the controlled amortisation schedules found in the SPEs' offering circulars. All principal cash received by the Trust is allocated between Granite Finance Funding Limited and Granite Finance Funding 2 Limited in accordance with their respective shares of the Trust's property as at 1 November 2008, this being the last determination date prior to the breach of the non asset trigger. The principal cash allocated to Granite Finance Funding Limited is then distributed pro-rata between the relevant issuers in the Granite Finance Funding Limited group by reference to the size of their inter-company loans outstanding with Granite Finance Funding Limited at each determination date. The principal cash received by the issuers is utilised in full on each quarterly payment date to make repayments in respect of the loan notes. The priority of loan note repayment is by reference to their original credit ratings on issue, with AAA notes repaid first, then AA notes, then A notes and finally BBB notes. The principal cash allocated to Granite Finance Funding 2 Limited is used to repay the loan from Granite Master Issuer plc, which in turn uses the cash to repay the loan notes in issue by reference to their original credit ratings on issue in the same manner as detailed above. The average time taken to repay the loan notes is now expected to be significantly extended beyond the maturity profiles envisaged by the original controlled amortisation schedules. It is therefore highly unlikely that the loan notes will be called on their step up and call dates.

On 15 November 2005, Northern Rock entered into a financial guarantee contract with Whinstone Capital Management Limited, a special purpose entity, in respect of £423.0m of the first loss reserve funds held by the Granite securitisation entities repayable to Northern Rock only after repayment of all other liabilities. Whinstone Capital Management Limited simultaneously issued credit linked notes to the value of £423.0m of which £104.0m were repaid during 2008 (2007 £68.4m). The remaining credit linked notes of £221.2m are included within debt securities in issue at year end exchange rates where issued in currencies other than sterling. As a consequence of the Granite Master Trust entering pass through and the resultant extension of the expected maturities of the Granite SPEs' liabilities, the expected maturity of the notes issued by Whinstone Capital Management Limited has been significantly extended as well. It is highly unlikely that the notes will be called on their step up and call dates.

20. Securitisation (continued)

On 20 June 2006, Northern Rock entered into a financial guarantee contract with Whinstone Capital Management 2 Limited, a special purpose entity, in respect of £168.5m of the first loss reserve funds held by the Granite securitisation entities repayable to Northern Rock only after repayment of all other liabilities. Whinstone Capital Management 2 Limited simultaneously issued credit linked notes to the value of £168.5m which are included within debt securities in issue at year end exchange rates where issued in currencies other than sterling. As a consequence of the Granite Master Trust entering pass through and the resultant extension of the expected maturities of the Granite SPEs' liabilities, the expected maturity of the notes issued by Whinstone Capital Management 2 Limited has been significantly extended as well. It is highly unlikely that the notes will be called on their step up and call dates.

On 17 September 2007 the Group securitised £5,032.5m of mortgage assets under Granite Master Issuer – Series 07-3 and purchased all of the loan notes in issue relating to that series for £5,032.5m. £4,600.0m of the notes were subsequently pledged as security in a sale and repurchase agreement entered into with the Bank of England. The loan notes were fully redeemed on 19 May 2008. The market value of these notes at 31 December 2007 was £4,601.4m. These transactions had no overall effect on the Group's balance sheet position and did not lead to any derecognition because the Group retained all of the risks and rewards associated with the loan notes.

2007

	Gross assets securitised £m	Notes in issue £m
Granite Finance Funding Limited	10,607.7	10,120.0
Granite Finance Funding 2 Limited	38,216.3	37,780.7
	48,824.0	47,900.7
Retained interest in Granite Finance Trustees Limited	5,359.3	
Less cash deposits held with Northern Rock plc	(4,624.8)	
Less loan notes held by Northern Rock plc		(5,074.1)
Total	49,558.5	42,826.6

The retained interest in Granite Finance Trustees Limited represents Northern Rock plc's share of the assets held by Granite Finance Trustees Limited.

Gross assets securitised and notes in issue as presented above reconcile to amounts included in the consolidated balance sheet within loans and advances to customers and debt securities in issue as follows:

	Gross assets securitised £m	Notes in issue £m
Total as above	49,558.5	42,826.6
Less cash deposits with third parties included within loans and advances to banks	(232.4)	
Less accrued interest on loan notes included within accruals and deferred income		(263.8)
Add loan notes issued by Whinstone Limited (see above)		506.7
Total advances subject to securitisation (see note 19)	49,326.1	
Total securitised notes as per consolidated balance sheet		43,069.5

21. Covered bonds

Included within loans and advances to customers not subject to securitisation are £9,686.5m (2007 £10,389.6m) of mortgage advances assigned to a bankruptcy remote special purpose vehicle. These loans provide security to issues of covered bonds made by Northern Rock, which are included within debt securities in issue amounting to £12,550.3m (2007 £8,938.1m). Northern Rock retains substantially all the risks and rewards associated with these loans and therefore these transactions do not qualify for derecognition under IAS 39. Most of the covered bonds are issued in foreign currency and are translated into sterling at exchange rates prevailing at 31 December. The increase in the value in issuance in 2008 is due to changes in foreign exchange rates, as no new notes were issued. All issuance in foreign currency is subject to cross currency swaps that provide the amounts of foreign currency required to repay the notes in exchange for an amount of sterling fixed at the issue of the bond, thereby protecting against foreign exchange risk. At 31 December 2008 there is a gross derivative asset on derivatives economically hedging the foreign currency notes of £4,071.2m (2007 £442.8m). The value of the loans assigned to the bankruptcy remote special purpose vehicle exceed the value of sterling required under the foreign exchange swaps, and therefore the debt securities in issue are more than covered by loan assets allocated for this purpose.

22. Investment securities

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Available for sale securities	422.5	6,002.7	261.9	10,786.6
Assets held at fair value through the income statement	11.5	106.0	11.5	106.0
Assets reclassified from available for sale to loans and receivables	2,952.8	–	2,952.8	–
	3,386.8	6,108.7	3,226.2	10,892.6

a) Available for sale securities

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
At fair value				
Listed	216.3	5,763.1	100.8	10,605.2
Unlisted	206.2	239.6	161.1	181.4
	422.5	6,002.7	261.9	10,786.6
Fixed rate	281.9	2,158.8	224.9	2,049.6
Variable rate	140.6	3,843.9	37.0	8,737.0
	422.5	6,002.7	261.9	10,786.6
Current	190.1	595.1	144.7	1,272.6
Non-current	232.4	5,407.6	117.2	9,514.0
	422.5	6,002.7	261.9	10,786.6

The movement in available for sale securities was as follows:

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
At 1 January	6,002.7	6,510.1	10,786.6	6,279.6
Additions	326.8	5,845.9	120.4	10,691.5
Disposals (sales and redemptions)	(2,569.9)	(6,195.2)	(7,313.5)	(5,995.1)
Exchange differences	183.7	103.6	183.8	103.5
Net losses on changes in fair value	(607.4)	(261.7)	(602.0)	(292.9)
Assets reclassified from available for sale to loans and receivables	(2,913.4)	–	(2,913.4)	–
At 31 December	422.5	6,002.7	261.9	10,786.6

Losses on available for sale securities are analysed as follows:

	2008 £m	2007 £m
Gains on disposal of available for sale securities	44.4	41.7
Impairment of available for sale securities	(53.4)	(178.3)
	(9.0)	(136.6)

Gains of £44.4m (2007 £41.7m) previously recognised in reserves have been transferred to other income in the Group income statement on the disposal of available for sale securities.

22. Investment securities (continued)

b) Assets held at fair value through the income statement

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
At fair value				
Listed	11.5	67.8	11.5	67.8
Unlisted	–	38.2	–	38.2
	11.5	106.0	11.5	106.0
Fixed rate	–	–	–	–
Variable rate	11.5	106.0	11.5	106.0
	11.5	106.0	11.5	106.0
Current	–	–	–	–
Non-current	11.5	106.0	11.5	106.0
	11.5	106.0	11.5	106.0

The movement in assets held at fair value through the income statement was as follows:

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
At 1 January	106.0	120.3	106.0	120.3
Additions	–	0.1	–	0.1
Disposals	(60.1)	–	(60.1)	–
Exchange differences	12.2	6.7	12.2	6.7
Net losses on changes in fair value	(46.6)	(21.1)	(46.6)	(21.1)
At 31 December	11.5	106.0	11.5	106.0

Certain securities which contain an embedded derivative are classified as held at fair value through the income statement. Fair value is based on quoted prices in an active market. The Group has not reclassified any financial assets between those held at amortised cost and those held at fair value during the year (2007 £nil).

c) Assets reclassified from available for sale to loans and receivables

The reclassified assets are asset backed securities and floating rate notes which have been reclassified under the terms of IAS 39 paragraph 50E.

Assets reclassified from available for sale to loans and receivables are detailed below:

	Group and Company 2008 £m
Assets reclassified from available for sale to loans and receivables at the date of reclassification	2,913.4
Fair value loss in available for sale reserve at reclassification	(760.9)
Carrying value at 31 December 2008	2,952.8
Fair value at 31 December 2008	2,693.2
Interest income recognised in the income statement	48.9
Impairment recognised in the income statement	(177.6)

If the Group had not reclassified financial assets during the current year, fair value losses recognised in the available for sale reserve in 2008 would have been £994.9m.

Effective interest rates on financial assets reclassified into loans and receivables as at their dates of reclassification were in the range of 2.68% to 7.88%.

The estimated amounts of undiscounted cash flows the Group expected to receive on reclassified financial assets as at the date of reclassification were £3,574.8m.

23. Shares in group undertakings

	Company £m
Cost:	
At 1 January 2008 and 31 December 2008	85.0

The Company's interests in subsidiary undertakings are analysed as follows:

	2008	2007
	£m	£m
Credit institutions	50.0	50.0
Other	35.0	35.0
	85.0	85.0

The principal subsidiaries of Northern Rock plc at 31 December 2008 are listed below, all of which operate in their country of incorporation or registration.

The following subsidiaries are directly held and wholly owned by the Company:

	Nature of business	Country of incorporation
Northern Rock Mortgage Indemnity Company Limited	Provision of mortgage indemnity insurance	Guernsey
Northern Rock (Guernsey) Limited	Retail deposit taker	Guernsey

The following companies are SPEs established in connection with the Group's securitisation programme (see note 20). Although the Company has no direct or indirect ownership interest in these companies, they are regarded as legal subsidiaries under UK companies legislation. This is because they are principally engaged in providing a source of long term funding to the Group, which in substance has the rights to all benefits from the activities of the SPEs. They are therefore effectively controlled by the Group.

	Nature of business	Country of incorporation
Granite Mortgages 03-2 plc	Issue of securitised notes	England & Wales
Granite Mortgages 03-3 plc	Issue of securitised notes	England & Wales
Granite Mortgages 04-1 plc	Issue of securitised notes	England & Wales
Granite Mortgages 04-2 plc	Issue of securitised notes	England & Wales
Granite Mortgages 04-3 plc	Issue of securitised notes	England & Wales
Granite Master Issuer plc	Issue of securitised notes	England & Wales
Granite Finance Trustees Limited	Holding of interests in securitisations	Jersey
Granite Finance Funding Limited	Holding company	Jersey
Granite Finance Funding No.2 Limited	Holding company	England & Wales
Whinstone Capital Management Limited	Issue of credit linked notes	Jersey
Whinstone Capital Management 2 Limited	Issue of credit linked notes	Jersey

The Directors consider that to give full particulars of all subsidiary undertakings would lead to a statement of excessive length. A full list of subsidiary undertakings at 31 December 2008 will be annexed to the Company's next Annual Return to be filed at Companies House.

24. Intangible assets

Group	Goodwill £m	Software £m	Total £m
2008			
Cost			
At 1 January 2008	30.7	152.2	182.9
Additions	-	7.6	7.6
At 31 December 2008	30.7	159.8	190.5
Impairment and amortisation			
At 1 January 2008	-	87.1	87.1
Amortisation charged in year	-	11.3	11.3
Impairment charged in year	-	27.2	27.2
At 31 December 2008	-	125.6	125.6
Net book amount:			
At 31 December 2008	30.7	34.2	64.9

24. Intangible assets (continued)

	Goodwill £m	Software £m	Total £m
2007			
Cost			
At 1 January 2007	30.7	119.5	150.2
Additions	–	32.7	32.7
At 31 December 2007	30.7	152.2	182.9
Impairment and amortisation			
At 1 January 2007	–	59.8	59.8
Amortisation charged in year	–	20.3	20.3
Impairment charged in year	–	7.0	7.0
At 31 December 2007	–	87.1	87.1
Net book amount: At 31 December 2007	30.7	65.1	95.8
Company			
	Goodwill £m	Software £m	Total £m
2008			
Cost			
At 1 January 2008	–	152.2	152.2
Additions	–	7.6	7.6
At 31 December 2008	–	159.8	159.8
Impairment and amortisation			
At 1 January 2008	–	87.1	87.1
Amortisation charged in year	–	11.3	11.3
Impairment charged in year	–	27.2	27.2
At 31 December 2008	–	125.6	125.6
Net book amount: At 31 December 2008	–	34.2	34.2
2007			
Cost			
At 1 January 2007	–	119.5	119.5
Additions	–	32.7	32.7
At 31 December 2007	–	152.2	152.2
Impairment and amortisation			
At 1 January 2007	–	59.8	59.8
Amortisation charged in year	–	20.3	20.3
Impairment charged in year	–	7.0	7.0
At 31 December 2007	–	87.1	87.1
Net book amount: At 31 December 2007	–	65.1	65.1

Impairment losses of £27.2m have arisen in 2008 (2007 £7.0m) reflecting the changed circumstances of the Group.

25. Property, plant and equipment

Group	Land and buildings			Plant, equipment, fixtures, fittings and motor vehicles £m	Assets in the course of construction £m	Total £m
	Freehold £m	Long leasehold £m	Short leasehold £m			
2008						
Cost						
At 1 January 2008	91.9	19.9	7.8	171.4	56.3	347.3
Additions	0.2	–	–	1.7	3.0	4.9
Transfers	(1.6)	–	–	1.6	–	–
Disposals	(0.2)	(0.7)	(0.2)	(3.5)	–	(4.6)
At 31 December 2008	90.3	19.2	7.6	171.2	59.3	347.6
Depreciation						
At 1 January 2008	6.8	2.2	3.8	94.2	56.3	163.3
Charged in year	1.0	0.3	0.5	10.0	–	11.8
Impairment losses/(reversals)	–	–	–	7.2	(30.8)	(23.6)
Adjustment arising on disposals	(0.2)	–	(0.1)	(2.0)	–	(2.3)
At 31 December 2008	7.6	2.5	4.2	109.4	25.5	149.2
Net book amount:						
At 31 December 2008	82.7	16.7	3.4	61.8	33.8	198.4
2007						
Cost						
At 1 January 2007	86.1	19.9	7.4	157.3	18.7	289.4
Additions	4.8	–	0.4	13.8	47.2	66.2
Transfers	8.4	–	–	1.2	(9.6)	–
Disposals	(7.4)	–	–	(0.9)	–	(8.3)
At 31 December 2007	91.9	19.9	7.8	171.4	56.3	347.3
Depreciation						
At 1 January 2007	6.5	1.9	3.6	80.3	–	92.3
Charged in year	1.2	0.3	0.2	14.6	–	16.3
Impairment losses	–	–	–	–	56.3	56.3
Adjustment arising on disposals	(0.9)	–	–	(0.7)	–	(1.6)
At 31 December 2007	6.8	2.2	3.8	94.2	56.3	163.3
Net book amount:						
At 31 December 2007	85.1	17.7	4.0	77.2	–	184.0

25. Property, plant and equipment (continued)

Company	Land and buildings			Plant, equipment, fixtures, fittings and motor vehicles	Assets in the course of construction	Total
	Freehold	Long leasehold	Short leasehold			
2008	£m	£m	£m	£m	£m	£m
Cost						
At 1 January 2008	52.5	68.4	7.8	147.4	56.3	332.4
Additions	0.2	–	–	1.7	3.0	4.9
Transfers	(1.6)	–	–	1.6	–	–
Disposals	(0.2)	(0.7)	(0.2)	(3.5)	–	(4.6)
At 31 December 2008	50.9	67.7	7.6	147.2	59.3	332.7
Depreciation						
At 1 January 2008	5.4	5.5	3.8	89.3	56.3	160.3
Charged in year	0.6	0.9	0.5	9.2	–	11.2
Impairment losses/(reversals)	–	–	–	7.2	(30.8)	(23.6)
Adjustment arising on disposals	(0.2)	–	(0.1)	(2.0)	–	(2.3)
At 31 December 2008	5.8	6.4	4.2	103.7	25.5	145.6
Net book amount:						
At 31 December 2008	45.1	61.3	3.4	43.5	33.8	187.1
2007						
Cost						
At 1 January 2007	47.3	68.4	7.4	133.5	18.7	275.3
Additions	4.2	–	0.4	13.6	47.2	65.4
Transfers	8.4	–	–	1.2	(9.6)	–
Disposals	(7.4)	–	–	(0.9)	–	(8.3)
At 31 December 2007	52.5	68.4	7.8	147.4	56.3	332.4
Depreciation						
At 1 January 2007	5.3	4.6	3.6	76.4	–	89.9
Charged in year	1.0	0.9	0.2	13.6	–	15.7
Impairment losses	–	–	–	–	56.3	56.3
Adjustment arising on disposals	(0.9)	–	–	(0.7)	–	(1.6)
At 31 December 2007	5.4	5.5	3.8	89.3	56.3	160.3
Net book amount:						
At 31 December 2007	47.1	62.9	4.0	58.1	–	172.1

Impairment credits of £23.6m have arisen in 2008 (2007 charge of £56.3m) due primarily to reversals of £30.8m in impairments made in 2007 in respect of properties in the course of construction together with impairments on IT hardware of £7.2m on items no longer required following the review in 2008 of the Group's business plan.

In addition, the Group made provisions for onerous contracts in respect of assets in the course of construction of £12.9m in 2007 relating to future costs of completion (see note 32). This gave impairments and provisions in relation to these assets in 2007 of £69.2m.

26. Deferred income tax assets and liabilities

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Deferred income tax assets	35.2	–	–	–
Deferred income tax liabilities	(6.9)	(45.5)	(3.8)	(19.7)
	28.3	(45.5)	(3.8)	(19.7)

The full movement in deferred income tax recoverable/(payable) was as follows:

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
At 1 January	(45.5)	59.5	(19.7)	89.5
Income statement credit/(charge)	55.0	(64.0)	17.5	(87.3)
Appropriations credit	3.2	0.7	3.2	0.7
Deferred tax impact charged direct to equity				
– revaluation reserve – available for sale investments	22.7	(20.9)	2.3	(1.8)
– hedging reserve – cash flow hedges	–	0.6	–	0.6
– actuarial losses charged to statement of recognised income and expense	(7.1)	(16.3)	(7.1)	(16.3)
– share based payments	–	(5.1)	–	(5.1)
At 31 December	28.3	(45.5)	(3.8)	(19.7)

Deferred income tax assets and liabilities are attributable to the following items:

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Deferred income tax assets				
Derivative financial instruments	34.6	24.3	–	–
Change in accounting basis on adoption of IFRS	–	21.3	–	21.3
Other temporary differences	0.1	1.6	0.1	1.6
Tax losses	23.5	–	23.5	–
	58.2	47.2	23.6	22.9
Deferred income tax liabilities				
Pensions and other retirement benefits	(9.1)	(1.6)	(9.1)	(1.6)
Excess of capital allowances over depreciation	(1.2)	(7.6)	(1.1)	(7.4)
Available for sale securities	(1.0)	(22.8)	(1.9)	(3.3)
Dividend from overseas subsidiary	–	(15.1)	–	(15.1)
Unremitted earnings from overseas subsidiary	(3.3)	(30.4)	–	–
Rolled over gains	(3.8)	(2.0)	(3.8)	(2.0)
Change in accounting basis on adoption of IFRS	(11.5)	(13.2)	(11.5)	(13.2)
	(29.9)	(92.7)	(27.4)	(42.6)
Net deferred income tax asset/(liability)	28.3	(45.5)	(3.8)	(19.7)
Disclosed as deferred income tax assets	35.2	–	–	–
Disclosed as deferred income tax liabilities	(6.9)	(45.5)	(3.8)	(19.7)
	28.3	(45.5)	(3.8)	(19.7)

Deferred tax assets and liabilities are offset if and only to the extent that there is a legally enforceable right to set off and the balances relate to income tax payable to the same taxation authority on either the same taxable entity or different taxable entities within the same tax group where there is the intention and ability to settle on a net basis or realise the assets and liabilities simultaneously.

The comparative analysis of deferred tax balances shown above has been restated to disclose separately the deferred tax balances arising in respect of the change in accounting basis on adoption of IFRS and other significant items not analysed in the 2007 accounts.

The amount of deferred tax asset expected to be recovered after more than twelve months for the Group is £35.1m (2007 £nil).

The amount of deferred tax liability expected to be settled after more than twelve months is £6.9m (2007 £3.4m) for the Group and £3.8m (2007 £4.5m) for the Company.

IAS 12 requires that deferred tax assets should be recognised when it is probable that taxable profits will be available against which the deferred tax asset can be utilised. Where the entity has a history of recent losses, deferred tax is only recognised to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profits will be available. A deferred tax asset should only be recognised to the extent that the Group will realise taxable profits arising from the reversal of existing taxable temporary differences. Accordingly, deferred tax assets have not been recognised in respect of the following items:

26. Deferred income tax assets and liabilities (continued)

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Deductible temporary differences (gross)	544.6	215.1	544.6	280.2
Unused tax losses (gross)	1,615.9	–	1,615.9	–
	2,160.5	215.1	2,160.5	280.2

Under current tax legislation these unprovided deductible temporary differences and unused tax losses do not have an expiry date and can therefore be recognised in future as taxable profits arise.

Deferred income tax liabilities have not been established for tax that would be payable if earnings of the Group's overseas subsidiaries were remitted to the UK. Such amounts are either reinvested for the foreseeable future or are expected to be remitted free of tax. Unremitted earnings at 31 December 2008 totalled £42.7m (2007 £43.0m).

The deferred tax (credit)/charge in the income statement comprises the following temporary differences. The comparative figures have been restated to separately disclose the movements arising in respect of the change in accounting basis on adoption of IFRS and other significant items not analysed in the 2007 accounts.

	2008 £m	2007 £m
Pensions and other employee benefits	–	1.7
Derivative financial instruments	(10.3)	(14.4)
Excess of capital allowances over depreciation	(6.4)	(4.8)
Change in accounting basis on adoption of IFRS	21.3	85.2
Tax losses	(20.6)	–
Dividend from overseas subsidiary	(15.1)	(3.0)
Unremitted earnings from overseas subsidiary	(27.1)	(8.4)
Rolled over gains	1.8	2.0
Other temporary differences	1.4	5.7
	(55.0)	64.0

27. Loans from HM Government

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Amount due to Bank of England	–	26,930.0	–	26,930.0
Repo funding from Bank of England	–	1,543.0	–	1,543.0
Amount due to HM Treasury	15,583.4	–	15,583.4	–
	15,583.4	28,473.0	15,583.4	28,473.0

The amount due to the Bank of England was repayable on demand and was charged interest at a margin above the Official Bank Rate. It consisted of three facilities; a repo facility secured on investment securities fully repaid during the first half of 2008 (2007 £3,590.0m secured on investment securities with a market value of £5,221.5m), Facility A which at 31 December 2007 comprised £6,910.0m secured on residential mortgages with a value of £9,905.0m and Facility B, which at 31 December 2007 amounted to £16,430.0m, which was secured by a fixed and floating charge over the assets and undertakings of the Group that were not already encumbered under prior arrangements such as securitisation vehicles (see note 20) and covered bonds (see note 21). In addition to the interest payable on the amount due to the Bank of England, the Group paid a guarantee fee to the Bank of England in respect of the Group's obligations that are guaranteed by the Bank of England. The amount due to the Bank of England was novated to HM Treasury on 28 August 2008 with unchanged terms and conditions. The amounts outstanding on Facilities A and B respectively were £nil and £15,583.4m at 31 December 2008.

The repo funding at 31 December 2007 represented repos with the Bank of England as part of their public open market operations and was secured against assets with a market value of £1,647.6m (see note 41).

28. Deposits by banks

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Amounts due to subsidiaries	–	–	1,156.1	550.6
Other deposits	4,625.1	744.2	3,661.1	744.2
	4,625.1	744.2	4,817.2	1,294.8
Fixed rate	145.0	78.1	145.0	78.1
Variable rate	4,480.1	666.1	4,672.2	1,216.7
	4,625.1	744.2	4,817.2	1,294.8
Current	4,384.9	560.7	4,577.0	1,111.3
Non-current	240.2	183.5	240.2	183.5
	4,625.1	744.2	4,817.2	1,294.8

29. Customer accounts

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Retail funds and deposits	19,622.8	10,468.8	18,553.8	9,995.7
Amounts due to securitisation special purpose entities	–	–	31,526.7	48,220.3
Other customer accounts	1,099.9	1,094.0	1,099.9	1,094.0
	20,722.7	11,562.8	51,180.4	59,310.0
Fixed rate	9,992.5	6,147.9	9,336.3	5,900.4
Variable rate	10,730.2	5,414.9	41,844.1	53,409.6
	20,722.7	11,562.8	51,180.4	59,310.0
Current	19,382.3	10,564.5	22,734.8	16,370.0
Non-current	1,340.4	998.3	28,445.6	42,940.0
	20,722.7	11,562.8	51,180.4	59,310.0

Amounts due to securitisation special purpose entities represent the beneficial interests held in mortgage portfolios by securitisation special purpose entities (see note 20). Because the mortgage loans do not qualify for derecognition from Northern Rock's balance sheet, the securitisation special purpose entities beneficial interests in the mortgage portfolios are represented by a deemed loan to Northern Rock. This is equivalent in value to the beneficial interest in the mortgage portfolios plus associated inter group balances directly relating to the beneficial interests in the mortgage portfolios.

30. Other debt securities in issue

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Bonds and medium term notes	6,752.6	9,362.3	6,752.6	9,362.3
Other debt securities in issue	446.5	271.4	446.5	271.4
	7,199.1	9,633.7	7,199.1	9,633.7
Fixed rate	894.7	1,250.3	894.7	1,250.3
Variable rate	6,304.4	8,383.4	6,304.4	8,383.4
	7,199.1	9,633.7	7,199.1	9,633.7
Current	3,719.9	4,322.4	3,719.9	4,322.4
Non-current	3,479.2	5,311.3	3,479.2	5,311.3
	7,199.1	9,633.7	7,199.1	9,633.7

31. Accruals and deferred income

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Accrued interest	885.6	924.8	833.4	675.1
Deferred income	1.0	1.3	1.0	1.3
Other accruals	62.8	36.8	62.5	36.1
	949.4	962.9	896.9	712.5

32. Provisions for liabilities and charges

	Group and Company	
	2008 £m	2007 £m
The movement in the onerous contracts provision was as follows:		
At 1 January	12.9	–
Utilised in the year	(12.9)	–
Charged in the year	18.5	12.9
At 31 December	18.5	12.9

The provision in 2008 is in respect of leasehold properties no longer required as a result of changes to the Group's business plan in 2008. The provision in 2007 was for onerous contracts in respect of assets in the course of construction relating to future costs of completion which was fully utilised in 2008.

33. Subordinated liabilities

	Group and Company	
	2008 £m	2007 £m
5.625% Subordinated bonds due 2015	304.7	294.4
11.734% Subordinated loan 2016	27.1	25.9
5.75% Subordinated bonds due 2017	265.9	247.4
10% Subordinated bonds due 2018	50.5	50.6
9% Subordinated bonds due 2021	149.0	148.9
6.594% Perpetual fixed to floating rate subordinated notes	574.4	353.7
HM Government PIK interest	143.3	40.9
	1,514.9	1,161.8

The 5.625% subordinated bonds due 2015 are not redeemable in the ordinary course of business before 13 January 2010.

The 11.734% subordinated loan 2016 is repayable in five equal annual instalments from 2012 to 2016.

The 5.75% subordinated bonds due 2017 are not redeemable in the ordinary course of business before 28 February 2012.

The 10% subordinated bonds due 2018 are not redeemable in the ordinary course of business before 25 March 2018.

The 9% subordinated bonds due 2021 are not redeemable in the ordinary course of business before 17 October 2021.

The 6.594% Perpetual fixed to floating rate subordinated notes were issued on 25 June 2007. These notes are not redeemable in the ordinary course of business before 28 June 2017.

The HM Government PIK interest represents the amount of the margin payable to HM Government which was subordinated under the terms of the facility (see note 27). Repayment of this amount is not due until five years after repayment of the other HM Government facilities. Interest is rolled up and capitalised until all other facilities are repaid, after which it becomes repayable in cash. Interest is payable on this loan at a floating rate above the Official Bank Rate.

All subordinated liabilities other than the 6.594% perpetual fixed to floating rate notes (which are denominated in US dollars) are denominated in sterling.

Redemptions of any subordinated liabilities prior to their final maturity date are subject to obtaining prior consent of the Financial Services Authority.

The rights of repayment of holders of subordinated liabilities are subordinated to the claims of other creditors.

34. Tier one notes

The tier one notes were issued for a value of £200m on 21 August 2002 and are undated. They carry a coupon of 7.053% payable annually in arrears on 21 September each year. At each payment date Northern Rock will decide whether to declare or defer the coupon, only if payment of the coupon would lead to breaches of regulatory capital requirements. If Northern Rock decides to defer the coupon, this can then only be satisfied upon the date on which the issue is redeemed. No interest will accrue on any deferred coupon. If Northern Rock defers the coupon, it may not pay a dividend on any share or pay any coupon on the reserve capital instruments, nor redeem or repurchase any of its share capital or reserve capital instruments until it next makes a coupon payment for the tier one notes. While Northern Rock is in temporary public ownership, deferred coupons can only be satisfied in accordance with the terms of Article 5 of The Northern Rock Transfer Order 2008 which was made on 21 February 2008 pursuant to the Banking (Special Provisions) Act 2008.

Northern Rock has a call option after 25 years, which it can only exercise with the consent of the Financial Services Authority. If the issue is not called, the coupon resets to yield 1.835% above 6-month LIBOR.

The full amount of tier one notes is permitted for inclusion within Tier 1 for regulatory capital purposes.

35. Reserve capital instruments

Reserve capital instruments were issued for a value of £200m in September 2000 and £100m in May 2001 and are undated. They carry a coupon of 8.399% payable annually in arrears on 21 September each year. At each payment date Northern Rock will decide whether to declare or defer the coupon. If Northern Rock decides to declare the coupon, the holder will receive a cash payment equivalent to the coupon which will be achieved either by the payment of cash directly, or while Northern Rock is in temporary public ownership, as per the terms of Article 5 of The Northern Rock Transfer Order 2008 (the "Transfer Order") which was made on 21 February 2008 pursuant to the Banking (Special Provisions) Act 2008. If Northern Rock elects to defer the coupon, it may not declare or pay a dividend on any share until the deferred coupons are satisfied. While Northern Rock is in temporary public ownership, deferred coupons and any interest accruing thereon can only be satisfied in accordance with the terms of Article 5 of the Transfer Order.

Northern Rock has a call option after 15 years, which it can only exercise with the consent of the Financial Services Authority. If the issue is not called, the coupon resets to yield 4.725% above the prevailing 5-year benchmark Gilt rate.

The maximum amount of reserve capital instruments permitted to be included in Tier 1 for regulatory capital purposes is 15% of overall Tier 1 capital, as defined by the Financial Services Authority. Any excess is allocated to Upper Tier 2 capital.

In accordance with the requirements of IAS 32, reserve capital instruments are classified as non shareholders' equity. Coupons on these notes are treated as appropriations and amounted to £24.1m (2007 £17.5m) after tax credit of £1.1m (2007 £7.7m).

36. Subordinated notes

	Group and Company	
	2008	2007
	£m	£m
12 ⁵ / ₈ % Perpetual subordinated notes	19.8	19.8
8% Undated subordinated notes	62.1	62.1
6.75% Fixed rate step-up undated subordinated notes	195.4	195.4
Floating rate undated subordinated notes	66.0	66.0
5.6% Undated subordinated notes	393.2	393.2
	736.5	736.5

In accordance with the requirements of IAS 32, undated subordinated liabilities are classified as non shareholders' equity, as there is no contractual obligation to pay the interest coupon. Coupons on these notes are treated as appropriations and amounted to £44.2m (2007 £27.0m) after tax credit of £2.1m (2007 £11.7m).

The 12⁵/₈% perpetual subordinated notes were created on the transfer of business from Northern Rock Building Society and were issued to holders of Permanent Interest Bearing Shares of the Society.

The 8% undated subordinated notes are denominated in US dollars; the proceeds and coupon payments have been swapped into sterling. The notes became redeemable on 15 June 2004 and may be subsequently redeemed in the ordinary course of business on coupon dates which fall on 15 March, 15 June, 15 September and 15 December.

The 6.75% fixed rate step-up undated subordinated notes are not redeemable in the ordinary course of business before 17 June 2024.

The floating rate undated subordinated notes are denominated in US dollars; the proceeds and coupon payments have been swapped into sterling. They are not redeemable in the ordinary course of business before 23 February 2011. Interest is payable at 1% above 3 month US\$ LIBOR.

The 5.6% undated subordinated notes are denominated in US dollars; the proceeds and coupon payments have been swapped into sterling. The notes are not redeemable in the ordinary course of business before 30 April 2014.

All subordinated notes, other than the 8% undated subordinated notes, the floating rate undated subordinated notes and the 5.6% undated subordinated notes are denominated in sterling.

Redemptions of any subordinated notes are at the issuer's option only and are subject to obtaining prior consent of the Financial Services Authority.

The rights of repayment of holders of subordinated notes are subordinated to the claims of other creditors.

37. Called up share capital

	2008	2008	2008	2007	2007	2007
	Number	£m	€m	Number	£m	€m
Authorised share capital						
Ordinary shares of 25p each	718.5m	179.6	-	614.0m	153.5	-
Foundation shares of 25p each	-	-	-	104.5m	26.1	-
Perpetual non-cumulative callable Preference shares of 25p each	100.0m	25.0	-	100.0m	25.0	-
Perpetual non-cumulative callable Preference shares of 25c each	100.0m	-	25.0	100.0m	-	25.0
	918.5m	204.6	25.0	918.5m	204.6	25.0

	2008	2008	2007	2007
	Number	£m	Number	£m
Issued and fully paid share capital				
Ordinary shares of 25p each	495.6m	123.9	421.2m	105.3
Foundation shares of 25p each	-	-	74.4m	18.6
Perpetual non-cumulative callable Preference shares of 25p each	0.4m	0.1	0.4m	0.1
	496.0m	124.0	496.0m	124.0

37. Called up share capital (continued)

On 22 February 2008, under the terms of The Northern Rock plc Transfer Order 2008 (SI 2008 No. 432), all shares in Northern Rock plc were transferred to the Treasury Solicitor as nominee of the Treasury. Each Foundation share was converted into and redesignated as one Ordinary share in Northern Rock plc.

The Foundation shares were held by The Northern Rock Foundation at 31 December 2007. These shares carried no rights to dividends but ranked pari passu with the Ordinary shares in respect of other distributions and in the event of a winding up. These shares did not confer any rights in relation to attendance or voting at any general meeting of the Company.

Dividends on Preference shares are discretionary and, subject to Board approval, are payable annually on 4 July at a rate of 6.8509%. No dividend was paid in 2008.

38. Reserves

Share premium account

	Group and Company Ordinary £m	Preference £m
At 1 January 2008 and 31 December 2008	6.8	396.4

Capital redemption reserve

	Group and Company £m
At 1 January 2008 and 31 December 2008	7.3

Other reserves

a) Revaluation reserve – available for sale investments

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Balance at 1 January	(93.7)	(1.3)	(144.2)	(2.3)
Net losses from changes in fair value	(562.0)	(269.2)	(488.3)	(339.4)
Losses transferred to net income due to impairment	53.4	178.3	53.4	178.3
Net profits on disposal transferred to net income	(44.4)	(41.7)	(44.5)	(40.1)
Amortisation of fair value differences in respect of securities transferred to loans and receivables	(21.8)	–	(21.8)	–
Losses transferred to net income due to impairment of securities transferred to loans and receivables	43.3	–	43.3	–
Current income taxes	–	61.1	–	61.1
Deferred income taxes	23.1	(23.0)	2.4	(2.5)
Effect of UK tax rate change on deferred tax items	(0.4)	2.1	(0.1)	0.7
Balance at 31 December	(602.5)	(93.7)	(599.8)	(144.2)

b) Hedging reserve – cash flow hedges

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Balance at 1 January	(29.2)	–	(29.2)	–
Amounts recognised in equity	(218.5)	(48.7)	(218.5)	(48.7)
Amounts transferred to interest payable	(22.0)	19.3	(22.0)	19.3
Current income taxes	–	(0.4)	–	(0.4)
Deferred income taxes	–	0.4	–	0.4
Effect of UK tax rate change on deferred tax items	–	0.2	–	0.2
Balance at 31 December	(269.7)	(29.2)	(269.7)	(29.2)

Total other reserves

At 31 December	(872.2)	(122.9)	(869.5)	(173.4)
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39. Retained earnings

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Balance at 1 January	1,251.9	1,641.6	1,109.0	1,519.0
Loss for the year	(1,378.0)	(243.5)	(1,245.6)	(263.8)
Dividends paid (see note 14)	–	(132.8)	–	(132.8)
Adjustment in respect of own shares	43.2	(34.5)	43.2	(34.5)
Net actuarial gains from changes in fair value of pension scheme assets and liabilities	25.5	29.5	25.5	29.5
Current income taxes on actuarial gains	–	7.9	–	7.9
Deferred income taxes on actuarial gains	(7.2)	(16.6)	(7.2)	(16.6)
Deferred income taxes on actuarial gains – effect of UK tax rate change on deferred tax items	0.1	0.3	0.1	0.3
Balance at 31 December	(64.5)	1,251.9	(75.0)	1,109.0

The amounts deducted from the retained earnings in respect of own shares, which are held at cost, are as follows:

	Group and Company	
	2008 £m	2007 £m
Own shares in relation to employee share schemes	–	94.2

Movements in the amount deducted from retained earnings in respect of own shares are as follows:

	2008	2007
	£m	£m
At 1 January	94.2	75.8
Purchases of shares	–	31.6
Use of shares on exercise of employee options and for other employee share plans	–	(13.2)
Transfer of shares to Treasury Solicitor	(94.2)	–
At 31 December	–	94.2

As a result of The Northern Rock plc Transfer Order 2008, all shares were transferred to the Treasury Solicitor as nominee for the Treasury on 22 February 2008. Consequently, Northern Rock plc no longer owns any of its shares. The consideration it will receive for these shares has not yet been determined and therefore no asset has been recognised for the proceeds in these accounts.

The credit/(charge) to retained earnings is as follows:

	2008	2007
	£m	£m
Value of employee services	–	0.5
Accelerated charge on cancellation of share schemes	39.6	–
Cash received on exercise of employee options and for other employee share plans	–	1.7
Deferred income tax impact of share based payments	–	(5.1)
Current income tax impact of share based payments	3.6	–
Purchase of shares	–	(31.6)
	43.2	(34.5)

40. Financial risk management

A) Financial Risk Management

Governance

The Board of Directors is responsible for determining strategies and policies for the Group. It works within the terms of the Shareholder Framework, and has the primary responsibilities of:

- Developing and recommending a business plan aligned to the objectives of the Shareholder; and,
- Delivering the plan.

The Risk Committee's main role is to review, on behalf of the Board, the key risks inherent in the business, the systems of control necessary to manage such risks, and to present its findings to the Board. This responsibility requires the Risk Committee to keep under review the effectiveness of the Group's system of internal controls, which includes financial, operational, compliance and risk management controls and to foster a culture that emphasises and demonstrates the benefits of a risk-based approach to internal control and management of the Group. The Risk Committee fulfils this remit by reinforcing management's control consciousness and making appropriate recommendations to the Board on all significant matters relating to the Group's risk strategy and policies. Other responsibilities of the Risk Committee include keeping under review the effectiveness of the Group's risk management infrastructure. This involves an assessment of risk management procedures (for the identification, measurement and control of key risk exposures) in accordance with changes in the operating environment. It is also primarily responsible for considering any major findings of the Financial Services Authority ('FSA') and management's response to any risk management review undertaken by Internal Audit or the external auditors. To assist the Board in discharging its responsibilities for the setting of risk policy, the Risk Committee periodically reviews the Group's credit risk, interest rate risk, liquidity risk and operational risk exposures in relation to the Board's risk appetite and the Group's capital adequacy. The Committee has responsibility for monitoring the performance of the Company's Basel credit rating systems and reviewing reports prepared by the Company's Basel designated committees. During the year, the Risk Committee attended detailed risk review sessions facilitated by the Chief Risk Officer ('CRO') and now has much greater and more transparent risk reporting.

40. Financial risk management (continued)

The Audit Committee considers and, where appropriate, advises the Board on all matters relating to regulatory, prudential and accounting requirements that may affect the Group. It reports to the Board on both financial and non-financial controls and monitors the integrity of the financial statements of the Group and any formal announcements relating to the Group's financial performance. The Committee regularly receives reports of reviews conducted throughout the Group by the Internal Audit and Compliance functions, and considers the reports made by the Money Laundering Reporting Officer. The Audit and Risk Committees are closely co-ordinated to ensure minimum overlap and maximum risk coverage.

Executive Committee ('Exco') is the most senior management operating committee, and is chaired by the Chief Executive Officer ('CEO'). Exco is responsible for developing and delivering against a Board approved strategy, and for ensuring the effective and smooth running of the business within Board approved risk appetites. It is responsible for putting in place effective monitoring and control mechanisms, which enable it to have appropriate oversight of business activities. Exco has seen radical membership change throughout the year with a number of new and external appointments. The new team has reviewed and refined its governance and operating framework to ensure that there are effective relationships with the Board and strong management oversight and control of all operations. As part of this new framework, Exco has established six sub committees which provide for greater focus in respect of risk management (Asset and Liability Committee, Credit Risk Committee and Operational Risk Committee), capital and liquidity management (Capital and Liquidity Management Committee) and business change (Retail Products and Major Projects Committees).

Risk Management

Definitions

The principal risks that the Group manages are as follows;

- Credit risk: the current or prospective loss to earnings and capital (expected and unexpected loss) arising from lending as a result of debtors or counterparties defaulting on their obligations due to the Group.
- Market risk: the risk that changes in the level of interest rates, the rate of exchange between currencies or the price of securities or other financial contracts, including derivatives, will have an adverse impact on the results of operations or financial condition of the Group.
- Liquidity risk: the risk that the Group is unable to meet its obligations as they fall due.
- Operational risk: the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events.
- Compliance risk: the risk of legal or regulatory sanctions, material financial loss or loss of reputation the Group may suffer as a result of its failure to comply with laws, regulations, rules, principles, self-regulatory organisation standards, and codes of conduct applicable to its activities (together, "compliance standards and requirements"); and/or the risk posed to the achievement of broad regulatory goals and outcomes that the compliance standards and requirements are aimed at delivering.

Developments in Risk Management

During 2008, the Company has greatly increased its focus on Risk Management, recruiting a CRO to provide more strategic and specialised leadership for a newly integrated Risk function comprising approximately 200 people. The CRO has an independent reporting line directly to the CEO and reports on a dotted line basis to the Chair of the Risk Committee. As the independent second line of defence, the Risk function now takes an integrated, holistic view of risks and ensures that a joined-up and consistent approach to the aggregation and management of risks is in place, and integrated into business management and decision making.

Key developments in 2008 include;

- Development of a new Risk Management Strategy.
- Board approved risk appetite, re-defined to align with changing business profile, with much reduced risk tolerances.
- A review of governance structures, roles and responsibilities.
- Redefinition of the Risk Management Frameworks for each major risk category.
- Development of action plans for the ongoing improvement of the Group's risk management capabilities.
- A reorganisation of the Risk function has been undertaken, with specialist teams now focusing upon providing more in-depth analysis and understanding of specific risk profiles. In addition, a cross functional team looks across the risk spectrum and provides additional assurance in relation to the policies, models and methodologies used, delivering an integrated, enterprise wide risk view.

Each of the major risk categories are listed below together with a brief description of the risk management framework.

i) Credit risk

Risk appetite

Credit risk appetite is an expression of boundaries (qualitative and quantitative) that provide clear guidance on the level of risk exposure that the Board considers acceptable and in line with corporate strategy. A revised credit risk appetite aligned to the current business strategy and external environment was approved by the Board in November 2008.

The Board's high level expression of a desired credit risk appetite is also translated into specific maximum risk limits in relation to product and lending policy parameters within which management must operate. In addition there are whole book parameters reflecting the inherent risks of previous lending, with trigger levels above which specific control actions are initiated. Monitoring and reporting against the risk appetite and the associated limits and triggers are in place for both new lending and whole book.

Credit Risk Management Framework

The holistic environment within which credit is managed and controlled within the Group is defined in the Credit Risk Management Framework. This outlines the business approach to establishing credit risk appetite, credit policies and the processes and controls employed by both the Risk functions and Line Management. Lending procedures are developed and maintained to remain within the approved risk appetite, policies and approved authority levels at all times.

The Credit Risk Framework incorporates Board approved Credit Risk Policies which provide more detailed parameters within which lending may be underwritten, each of which is supported by strong localised procedures and delegated authority frameworks. In determining lending policy the Group places responsible lending as the first priority. A clear approach to calculating customer affordability is built into lending processes and aims to ensure that customers can meet contractual loan repayments.

Lending policy criteria

New lending is tightly controlled using an appropriate mix of statistical and experiential analysis. New business quality is constantly monitored and controlled by the Credit Risk team using sophisticated scoring techniques and a number of other core control components as follows;

- Credit scoring. Automated statistically-based credit scoring methods are used in the decision making process for new and existing customers. These are subject to regular monitoring, review and approval.

40. Financial risk management (continued)

- **Affordability, underwriting and mandates.** To lend responsibly, the group employs experienced underwriters to determine the customers' overall financial situation and ability to repay credit. The ability to agree a credit agreement with a customer is prescribed in Board delegated authority levels to specific individuals who have been proven to have the requisite credit skills.
- **Valuations.** Property assets are independently valued at mortgage inception. Where a revaluation is required, this is led by a specialist Property Risk function using a range of valuation methods.
- **Monitoring and Performance.** The credit portfolios are monitored regularly, with a range of prescribed reports distributed to key stakeholders. Detailed management information is provided to the Retail Credit Risk Committee and Executive Committee.
- **Collections and recoveries.** The Group's debt management process is led by a recently recruited specialist Director of Debt Management. A team of specialists manage all aspects of collections and recoveries with the aim of helping customers who encounter financial difficulties to achieve a positive outcome for the customer and the Group.
- **Stress testing and scenario analysis,** to simulate outcomes and calculate the risk impact.

Credit Risk Measurement

The credit risk of lending to customers is a factor of three components;

- The probability of default (PD) by the customer in contractual obligations.
- The exposure at default by the customer on contractual obligations.
- The likely recovery of defaulted obligations (loss given default ("LGD")).

Internal rating models are used to assess customer probability of default, exposure at default and loss given default. The rating models use statistical analysis combined with external data and are subject to rigorous internal monitoring and change control. FSA approval is required.

These credit risk models are used throughout the Group to support the analytical elements of the credit risk management framework, in particular the quantitative risk assessment part of the credit approval process, ongoing credit monitoring as well as portfolio level analysis and reporting.

Credit risk models used by the Group can be grouped broadly into two categories;

- **PD/customer credit grade** – these models assess the probability that a customer will fail to make full and timely repayment of credit obligations over a time horizon. Each customer is assigned a score which corresponds to a probability of default. There are a number of different credit grading models in use across the Group, each of which considers particular customer characteristics. The credit grading models use a combination of quantitative inputs, such as recent financial performance, credit bureau data and customer behaviour.
- **LGD** – these models estimate the expected loss that may be suffered by the Group on a credit facility in the event of default. The Group's LGD models take into account the type of borrower and any security held.

The Group does not operate internal risk assessment models for commercial mortgage loans due to the very small scale of its commercial lending (now in run off). Details of the risk profiles of commercial mortgage loans neither past due nor impaired can be found in the tables on pages 80 to 84 relating to loan to value ratios and loan sizes.

Corporate and Wholesale Credit Risk

Corporate Credit Counterparty risk arises through Treasury hedging and investment activities and related balance sheet management requirements.

Credit risk can be broken down into two elements:

- Counterparty risk (the risk of default or migration of derivative counterparties).
- Wholesale credit risk (the risk of default or rating migration of issuers in the Treasury investment portfolio).

The Board has approved a framework for maximum credit counterparty limits against which total exposures are continually monitored and controlled. The credit limit structure adopts a risk based matrix whereby lower rated counterparties are afforded lower overall levels of limit. Although publicly available ratings produced by rating agencies provide a useful guide to the credit worthiness of counterparties, an internal rating is also used in the limit assignment process. Single counterparties are assigned maximum limits in accordance with the ratings matrix, based on the lowest rating afforded to any part of the counterparty group.

Maximum exposure to credit risk as at 31 December

	2008	2007
	£m	£m
On balance sheet		
Cash and balances with central banks	9,336.8	190.2
Derivative financial instruments	13,314.4	2,241.0
Loans and advances to banks	3,384.4	1,292.5
Loans and advances to customers	72,721.8	98,834.6
Investment securities	3,386.8	6,108.7
	102,144.2	108,667.0
Off balance sheet		
Loan commitments	4,265.2	6,010.8

Loans and advances by credit quality:

2008	Loans and advances to banks £m	Residential mortgage loans £m	Commercial mortgage loans £m	Unsecured personal loans £m	Unsecured investment loans £m
Neither past due nor impaired	3,384.4	61,455.9	290.4	5,046.9	404.6
Past due but not impaired	–	4,325.5	4.5	151.7	–
Impaired	–	918.3	6.8	99.4	17.8
	3,384.4	66,699.7	301.7	5,298.0	422.4

40. Financial risk management (continued)

2007	Loans and advances to banks £m	Residential mortgage loans £m	Commercial mortgage loans £m	Unsecured personal loans £m	Unsecured investment loans £m
Neither past due nor impaired	1,292.5	88,480.5	305.4	6,797.8	295.3
Past due but not impaired	–	2,153.9	0.9	199.7	–
Impaired	–	143.3	9.6	353.1	95.1
	1,292.5	90,777.7	315.9	7,350.6	390.4

The credit quality of loans neither past due nor impaired may be assessed by reference to the internal ratings and probability of default bandings allocated to loans by the company's internal credit assessment models as set out in the tables below:

	2008 Loans and advances to banks £m	2008 Unsecured investment loans £m	2007 Loans and advances to banks £m	2007 Unsecured investment loans £m
AAA	–	16.5	–	–
AA+	182.6	–	–	–
AA	896.2	–	448.0	–
AA–	549.9	–	456.3	–
A+	1,069.7	–	152.8	–
A	559.4	–	234.4	–
A–	92.8	–	–	–
BBB+	9.0	–	–	–
BBB	18.0	113.4	–	86.6
BBB–	4.9	274.7	1.0	208.7
BB+	1.9	–	–	–
Not rated	–	–	–	–
	3,384.4	404.6	1,292.5	295.3

	2008 Residential mortgage loans £m	2008 Unsecured personal loans £m	2007 Residential mortgage loans £m	2007 Unsecured personal loans £m
PD band				
Risk 1 – very low risk	52,029.2	2,390.2	73,780.2	4,315.4
Risk 2 – low risk	3,666.4	1,343.1	6,767.4	1,641.6
Risk 3 – medium risk	2,960.0	1,041.9	3,499.0	696.5
Risk 4 – high risk	2,800.3	271.7	4,433.9	144.3
	61,455.9	5,046.9	88,480.5	6,797.8

Available for sale securities and assets reclassified from available for sale to loans and receivables by credit quality:

	2008 Available for sale securities £m	2008 Assets reclassified from available for sale to loans and receivables £m	2007 Available for sale securities £m	2007 Assets reclassified from available for sale to loans and receivables £m
Neither past due nor impaired	412.3	2,905.9	5,996.5	–
Past due but not impaired	–	–	–	–
Impaired	10.2	46.9	6.2	–
	422.5	2,952.8	6,002.7	–

40. Financial risk management (continued)

The credit quality of available for sale securities and assets reclassified from available for sale to loans and receivables by reference to credit ratings is set out in the table below:

	2008		2007	
	Available for sale securities £m	Assets reclassified from available for sale to loans and receivables £m	Available for sale securities £m	Assets reclassified from available for sale to loans and receivables £m
AAA	120.7	1,368.3	3,449.4	–
AA+	–	2.1	2.9	–
AA	49.4	220.4	313.1	–
AA-	45.0	211.1	474.0	–
A+	18.0	174.4	298.3	–
A	57.1	510.8	721.5	–
A-	–	158.7	274.4	–
BBB+	3.3	92.5	125.2	–
BBB	–	130.2	149.1	–
BBB-	–	45.9	12.6	–
BB+	–	12.8	35.7	–
BB	–	1.1	27.7	–
B	–	1.7	2.2	–
B-	–	0.5	–	–
CC	0.1	–	–	–
C	0.1	–	–	–
D	–	–	0.1	–
Not rated	128.8	22.3	116.5	–
Total	422.5	2,952.8	6,002.7	–

Past due not impaired loans:

	2008			
	Loans and advances to banks £m	Residential mortgage loans £m	Commercial mortgage loans £m	Unsecured personal loans £m
Up to one month	–	–	–	–
In one to three months	–	2,531.3	3.6	139.4
In three to six months	–	1,351.6	–	6.5
Over six months	–	442.6	0.9	5.8
	–	4,325.5	4.5	151.7
	2007			
	Loans and advances to banks £m	Residential mortgage loans £m	Commercial mortgage loans £m	Unsecured personal loans £m
Up to one month	–	–	–	–
In one to three months	–	1,616.8	–	171.7
In three to six months	–	344.8	0.9	13.8
Over six months	–	192.3	–	14.2
	–	2,153.9	0.9	199.7

Renegotiated loans that would otherwise be past due or impaired at 31 December 2008 amounted to £2.1m (2007 £193.2m). These are all included within residential mortgage loans and do not include any loans (2007 £10.3m) which prior to renegotiation were included within unsecured personal loans.

40. Financial risk management (continued)

Collateral

Due to the nature of the Group's exposures (comprising primarily residential mortgages), the only collateral held against credit risk was that in respect of the counterparty risk arising on derivative transactions (in the form of cash) and in respect of residential and commercial lending (in the form of mortgage charges over residential and commercial property). Valuations on residential and commercial property are carried out on a quarterly basis. Cash collateral held against counterparty credit risk at 31 December 2008 amounted to £4,239.9m (2007 £482.5m), residential and commercial property held amounted to £99,661.1m (2007 £164,628.2m). The table below shows an estimate of the fair value of collateral held against financial assets.

2008	Loans and advances to banks £m	Residential mortgage loans £m	Commercial mortgage loans £m	Derivative financial instruments £m
Neither past due nor impaired				
Property	–	93,210.9	386.1	–
Cash	–	–	–	4,239.9
Other	–	–	–	–
Past due but not impaired				
Property	–	5,126.6	6.4	–
Cash	–	–	–	–
Other	–	–	–	–
Impaired				
Property	–	924.1	7.0	–
Cash	–	–	–	–
Other	–	–	0.5	–
Total	–	99,261.6	400.0	4,239.9
2007				
	Loans and advances to banks £m	Residential mortgage loans £m	Commercial mortgage loans £m	Derivative financial instruments £m
Neither past due nor impaired				
Property	–	161,084.4	419.4	–
Cash	–	–	–	482.5
Other	–	–	–	–
Past due but not impaired				
Property	–	2,985.3	1.1	–
Cash	–	–	–	–
Other	–	–	–	–
Impaired				
Property	–	133.3	4.7	–
Cash	–	–	–	–
Other	–	–	0.5	–
Total	–	164,203.0	425.7	482.5

Impairment

All credit portfolios are regularly reviewed to assess for impairment. A loan or portfolio of loans is considered to be impaired if there is any observable data indicating that there has been a measurable decrease in the estimated future cash flow or their timings. This will include identification of;

- Significant financial difficulty of the customer,
- Default or delinquency in interest or principal payments,
- The borrower entering bankruptcy or other financial reorganisation, and
- Adverse changes in the payment status of borrowers

In the retail mortgage portfolio, individual impairments may occur where the Group has taken possession of the property or where specific circumstances indicate that a loss is likely to be incurred. In addition, collective impairment allowances across the retail credit portfolios are calculated on a portfolio basis using formulae which take into account the probability of default, the roll to write-off or possession and the loss given default, less the value of any security held. These parameters are kept under regular review to ensure that, as far as possible, they reflect current economic circumstances and risk profile.

Concentration risk

Concentration risk is managed at portfolio, product, and counterparty levels. This is carried out through the application of limits relating to geographical spread, the size of loan relative to property value (at counterparty and portfolio levels) and the concentration of borrowers in each risk band.

NOTES TO THE ACCOUNTS (continued)

40. Financial risk management (continued)

The following table breaks down the Group's main credit exposures by geographical region at their carrying amounts. Exposures are allocated to regions based on the country of domicile of the counterparty:

2008	UK £m	Europe £m	US £m	Other countries £m	Total £m
Derivative financial instruments	4,520.0	6,678.6	2,053.9	61.9	13,314.4
Loans and advances to banks	1,519.8	1,370.5	277.0	217.1	3,384.4
Loans and advances to customer					
Residential mortgage lending	66,699.7	–	–	–	66,699.7
Other secured lending	301.7	–	–	–	301.7
Unsecured lending	5,314.5	–	–	405.9	5,720.4
Available for sale debt securities	284.7	100.7	–	37.1	422.5
Assets reclassified from available for sale to loans and receivables	1,217.1	829.8	236.1	669.8	2,952.8
Financial assets designated at fair value	–	–	–	11.5	11.5
As at 31 December 2008	79,857.5	8,979.6	2,567.0	1,403.3	92,807.4
2007	UK £m	Europe £m	US £m	Other countries £m	Total £m
Derivative financial instruments	639.6	954.5	494.3	152.6	2,241.0
Loans and advances to banks	958.1	223.7	110.7	–	1,292.5
Loans and advances to customers					
Residential mortgage lending	90,777.7	–	–	–	90,777.7
Other secured lending	315.9	–	–	–	315.9
Unsecured lending	7,741.0	–	–	–	7,741.0
Available for sale debt securities	3,720.3	1,772.9	335.2	174.3	6,002.7
Financial assets designated at fair value	65.6	40.4	–	–	106.0
As at 31 December 2007	104,218.2	2,991.5	940.2	326.9	108,476.8

LTV (%) – Indexed value as of financial year end

	Residential mortgage loans		Commercial mortgage loans	
	2008	2007	2008	2007
	£m	£m	£m	£m
<70%	15,746.0	39,714.2	66.0	72.9
70%-75%	3,147.4	9,024.9	53.4	61.7
75%-80%	3,670.0	10,756.7	123.6	127.2
80%-85%	4,366.6	11,214.5	43.6	48.4
85%-90%	4,993.3	9,500.7	1.2	0.3
90%-95%	5,841.0	6,033.1	–	–
95%-100%	6,832.9	4,101.8	–	–
>100%	22,102.5	431.8	13.9	5.4
	66,699.7	90,777.7	301.7	315.9

Loan size by outstanding balance

Outstanding balance	Residential mortgage loans	
	2008	2007
	£m	£m
£0-£100k	17,196.5	22,801.9
£100-£250k	35,737.4	47,622.2
£250-£500k	8,862.9	13,428.6
£500k-£1m	3,174.1	4,675.5
£1m-£2.5m	1,224.8	1,695.0
>£2.5m	504.0	554.5
	66,699.7	90,777.7
Outstanding balance	Commercial mortgage loans	
	2008	2007
	£m	£m
£0-£500k	8.9	11.0
£500k-£1m	9.6	9.9
£1m-£5m	76.2	67.3
£5m-£10m	70.4	74.7
£10m-£25m	70.5	63.9
>£25m	66.1	89.1
	301.7	315.9

40. Financial risk management (continued)

ii) Market Risk

Market risk is the risk that changes in the level of interest rates, the rate of exchange between currencies or the price of securities or other financial contracts, including derivatives, will have an adverse impact on the results of operations or financial condition of the company. Northern Rock does not trade or make markets in any areas and market risk arises only as a consequence of carrying out and supporting core business activities.

Market risk within the Group can be subdivided into the following risks:

- Mismatch. The effect that variations in the relationship between different points on the yield curve indices have on the value of fixed rate assets and liabilities.
- Curve. The effect that variations in the relationship between different points on the yield curve indices have on the value of fixed rate assets and liabilities,
- Prepayment. The effect that variations in early repayment have on expected run off profiles of fixed rate loans and therefore on the effectiveness of hedging transactions,
- Basis. Created where balance sheet assets and liabilities are sensitive to different underlying indices. Basis risk arises for example where mortgage interest rates are linked to Bank Base but the liabilities funding them are linked to LIBOR,
- Reset. Exposure to the timing of repricing of asset and liabilities or to a sudden spike in a key underlying index on a particular day, and
- Foreign Exchange (FX). Volatility in earnings resulting from movements in exchange rates altering the sterling value of unmatched foreign currency income streams, assets and liabilities (principally US\$ and Euro positions for Northern Rock).

The Group offers numerous banking, mortgage and savings products with varying interest rate features and maturities which create potential interest rate risk exposures. Primary risks arise as a result of timing differences on the repricing of assets and liabilities, unexpected changes in yield curves and changes in the correlation of interest rates between different financial instruments. In addition, structural interest rate risk arises in the Group's consolidated balance sheet as a result of fixed rate, variable rate and non interest bearing assets and liabilities.

Risk exposures are controlled using gross risk position limits and net 'earnings at risk' volatility limits which require Treasury to manage proactively expected interest margins to within pre-defined limits. In addition, the impact of specific stress scenarios on portfolio exposures are analysed to ensure that unexpected events do not carry unacceptable risk levels.

Interest Rate Risk

Interest rate sensitivity arises from the relationship between interest rates and net interest income resulting from the periodic repricing of assets and liabilities. The Group also offers fixed rate residential mortgages and savings products on which the interest rate paid by or to the customer is fixed for an agreed period of time at the start of the contract. The Group closely monitors mortgage redemption and repayment patterns and reduces the mismatch of the expected maturity profiles of its interest earning assets and interest bearing liabilities through the use of derivatives.

The Group uses a number of measures to monitor and control interest rate risk and sensitivity. One such measure evaluates the difference in principal value between assets and liabilities repricing in various gap periods. Risk weights are assigned to each gap period which reflect potential losses for a given change in rates, and based on these an economic value impact of a positive 200bp interest rate shock is calculated for each period on the total balance sheet. The economic impact of this shock was £(30.6m) as at 31 December 2008 (2007 (£323.1m)).

The following table gives an analysis of the repricing periods of assets and liabilities on the Group balance sheet at 31 December.

Items are allocated to time bands in the table below by reference to the earlier of the next contractual interest rate repricing date and the residual maturity date. Amounts shown in respect of loans and advances to customers include fair value adjustments of portfolio hedging.

2008	Within	After	After	After	After	Non	Total
	3 months	3 months	6 months	1 year			
	£m	£m	£m	£m	£m	£m	£m
Assets							
Cash and balances with central banks	9,292.3	–	–	–	–	44.5	9,336.8
Loans and advances to banks	3,180.5	–	–	–	–	203.9	3,384.4
Loans and advances to customers	32,463.3	5,003.7	8,260.4	26,238.7	2,457.6	–	74,423.7
Investment securities	2,959.6	220.1	16.9	121.2	30.5	38.5	3,386.8
Other assets	–	–	–	–	–	13,814.3	13,814.3
Total assets	47,895.7	5,223.8	8,277.3	26,359.9	2,488.1	14,101.2	104,346.0
Liabilities							
Loans from HM Government	15,583.4	–	–	–	–	–	15,583.4
Deposits by banks	4,529.0	96.1	–	–	–	–	4,625.1
Customer accounts	14,194.1	1,450.3	3,378.9	1,699.4	–	–	20,722.7
Debt securities in issue	44,754.9	2,027.1	116.5	4,382.5	6,455.3	–	57,736.3
Subordinated liabilities	161.0	–	–	617.8	736.1	–	1,514.9
Tier one notes	–	–	–	–	251.8	–	251.8
Other liabilities	–	–	–	–	–	3,278.2	3,278.2
Shareholders' equity	–	–	–	–	–	(402.2)	(402.2)
Non shareholders' equity	–	–	–	–	–	1,035.8	1,035.8
Total liabilities	79,222.4	3,573.5	3,495.4	6,699.7	7,443.2	3,911.8	104,346.0
Notional values of derivatives affecting interest rate sensitivity	(23,484.3)	2,739.7	5,032.4	19,662.8	(3,950.6)	–	–
	55,738.1	6,313.2	8,527.8	26,362.5	3,492.6	3,911.8	104,346.0
Total interest rate sensitivity gap	(7,842.4)	(1,089.4)	(250.5)	(2.6)	(1,004.5)	10,189.4	–
Cumulative interest rate sensitivity gap	(7,842.4)	(8,931.8)	(9,182.3)	(9,184.9)	(10,189.4)	–	–

40. Financial risk management (continued)

2007	Within 3 months £m	After 3 months but within 6 months £m	After 6 months but within 1 year £m	After 1 year but within 5 years £m	After 5 years £m	Non interest bearing funds £m	Total £m
Assets							
Cash and balances with central banks	113.2	–	–	–	–	77.0	190.2
Loans and advances to banks	1,210.3	–	–	–	–	82.2	1,292.5
Loans and advances to customers	26,599.4	7,960.0	17,340.0	44,175.4	2,943.7	–	99,018.5
Investment securities	4,035.3	213.2	58.7	989.5	812.0	–	6,108.7
Other assets	–	–	–	–	–	2,711.1	2,711.1
Total assets	31,958.2	8,173.2	17,398.7	45,164.9	3,755.7	2,870.3	109,321.0
Liabilities							
Loans from central bank	28,473.0	–	–	–	–	–	28,473.0
Deposits by banks	692.7	43.5	8.0	–	–	–	744.2
Customer accounts	7,629.3	1,150.8	1,787.2	995.5	–	–	11,562.8
Debt securities in issue	51,018.5	51.0	60.5	3,969.4	6,541.9	–	61,641.3
Subordinated liabilities	–	–	–	541.8	620.0	–	1,161.8
Tier one notes	–	–	–	–	207.6	–	207.6
Other liabilities	–	–	–	–	–	2,831.0	2,831.0
Shareholders' equity	–	–	–	–	–	1,663.5	1,663.5
Non shareholders' equity	–	–	–	–	–	1,035.8	1,035.8
Total liabilities	87,813.5	1,245.3	1,855.7	5,506.7	7,369.5	5,530.3	109,321.0
Notional values of derivatives affecting interest rate sensitivity	(52,667.8)	6,095.9	14,872.0	37,693.6	(5,993.7)	–	–
	35,145.7	7,341.2	16,727.7	43,200.3	1,375.8	5,530.3	109,321.0
Total interest rate sensitivity gap	(3,187.5)	832.0	671.0	1,964.6	2,379.9	(2,660.0)	–
Cumulative interest rate sensitivity gap	(3,187.5)	(2,355.5)	(1,684.5)	280.1	2,660.0	–	–

In addition to the calculation of the sensitivity of the total balance sheet to a positive 200bp interest rate shock, a separate sensitivity calculation is carried out for the fixed mortgage book. The calculation measures the sensitivity of each portfolio to a 200bp parallel shift in rates.

	200bp sensitivity (fixed rate mortgages) £m
2008	(48.0)
2007	(32.6)

Use of Derivatives

The Board has authorised the use of derivative instruments where their use is appropriate in reducing the risk of loss arising from changes in interest rates and exchange rates. All use of derivative instruments within the Group is to hedge economic risk exposure, and the Group takes no trading positions in derivatives.

The Group uses a number of derivative instruments to reduce interest rate risk and currency risk. These have, from time to time, included interest rate swaps, interest rate options, forward rate agreements, interest rate and bond futures, currency swaps and forward foreign exchange contracts. Where either a balance sheet derivative instrument or an alternative balance sheet asset or liability could be used for a specific purpose, or where more than one derivative instrument could be used, the Group will select the instrument that optimises the following conditions;

- Minimise capital utilisation.
- Maximise income or minimise cost.
- Maximise liquidity.
- Minimise administrative and accounting complexity.
- Minimise the Group's tax liability.

The benefit of using derivative instruments is measured by examining the anticipated consequences of not hedging the perceived risk in terms of revenue or capital loss. The vast majority of the Group's derivatives activity is contracted with major banks and financial institutions.

Derivative instruments will be used by the Group for the following purposes;

- To reduce the interest rate risk and FX risk in the Group's balance sheet.
- To protect the Group's earnings from unexpected movements caused by market risks.
- To develop retail products without creating unacceptably high structural risk for the Group.
- To protect the Treasury investment portfolio from changes in interest rate and exchange rates or default risk.

40. Financial risk management (continued)

Non derivative cashflows

The table below analyses the Group's non derivative cashflows payable into relevant maturity groupings based on the remaining period at balance sheet date to contractual maturity date. The amounts disclosed are the contractual undiscounted cashflows. These differ from balance sheet values due to the effects of discounting on certain balance sheet items and due to the inclusion of contractual future interest flows.

2008	Within 3 months £m	After 3 months but within 6 months £m	After 6 months but within 1 year £m	After 1 year but within 5 years £m	After 5 years £m	Total £m
Liabilities						
Loans from HM Government	15,826.5	–	–	–	–	15,826.5
Deposits by banks	4,389.9	3.8	2.9	276.3	–	4,672.9
Customer accounts	15,855.2	1,103.6	2,751.8	1,513.4	–	21,224.0
Debt securities in issue	6,098.3	4,300.9	4,033.3	29,493.4	27,382.1	71,308.0
Subordinated liabilities	186.2	15.9	30.0	815.2	782.2	1,829.5
Tier one notes	–	–	14.1	56.4	397.5	468.0
	42,356.1	5,424.2	6,832.1	32,154.7	28,561.8	115,328.9

2007	Within 3 months £m	After 3 months but within 6 months £m	After 6 months but within 1 year £m	After 1 year but within 5 years £m	After 5 years £m	Total £m
Liabilities						
Loans from HM Government	28,869.0	–	–	–	–	28,869.0
Deposits by banks	555.7	5.2	12.9	171.1	38.9	783.8
Customer accounts	8,237.5	1,059.5	1,724.2	945.5	–	11,966.7
Debt securities in issue	4,808.1	4,026.5	7,285.1	44,740.8	11,903.7	72,764.2
Subordinated liabilities	77.8	12.0	26.2	300.8	1,478.9	1,895.7
Tier one notes	–	–	14.1	56.4	411.6	482.1
	42,548.1	5,103.2	9,062.5	46,214.6	13,833.1	116,761.5

Derivative cash flows

The following table analyses cashflows for the Group's derivative financial liabilities that will be settled on a net basis into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date. The amounts disclosed are the contractual undiscounted cashflows. Derivatives included within this analysis are single currency interest rate swaps.

2008	Within 3 months £m	After 3 months but within 6 months £m	After 6 months but within 1 year £m	After 1 year but within 5 years £m	After 5 years £m	Total £m
Derivatives in economic but not accounting hedges	(6.8)	(11.7)	(6.8)	(10.7)	(3.3)	(39.3)
Derivatives in accounting hedge relationships	(57.8)	(302.7)	(584.9)	(919.9)	(66.4)	(1,931.7)
	(64.6)	(314.4)	(591.7)	(930.6)	(69.7)	(1,971.0)

2007	Within 3 months £m	After 3 months but within 6 months £m	After 6 months but within 1 year £m	After 1 year but within 5 years £m	After 5 years £m	Total £m
Derivatives in economic but not accounting hedges	(2.5)	(1.4)	0.2	(10.0)	(5.3)	(19.0)
Derivatives in accounting hedge relationships	42.8	(5.3)	(65.5)	(355.6)	(5.0)	(388.6)
	40.3	(6.7)	(65.3)	(365.6)	(10.3)	(407.6)

40. Financial risk management (continued)

The following table analyses cashflows for the Group's derivative financial liabilities that will be settled on a gross basis into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date. The amounts disclosed are the contractual undiscounted cashflows. Derivatives included within this analysis are cross currency interest rate swaps and forward currency contracts

	2008					Total £m
	Within 3 months £m	After 3 months but within 6 months £m	After 6 months but within 1 year £m	After 1 year but within 5 years £m	After 5 years £m	
Derivatives in economic but not accounting hedges						
Outflows	(130.1)	(48.4)	(73.3)	(572.1)	(24.9)	(848.8)
Inflows	114.8	36.2	55.3	445.2	18.6	670.1
Derivatives in accounting hedge relationships						
Outflows	-	-	-	-	-	-
Inflows	-	-	-	-	-	-
Total outflows	(130.1)	(48.4)	(73.3)	(572.1)	(24.9)	(848.8)
Total inflows	114.8	36.2	55.3	445.2	18.6	670.1
	2007					Total £m
	Within 3 months £m	After 3 months but within 6 months £m	After 6 months but within 1 year £m	After 1 year but within 5 years £m	After 5 years £m	
Derivatives in economic but not accounting hedges						
Outflows	(1,667.0)	(1,407.3)	(3,093.2)	(13,908.7)	(1,026.1)	(21,102.3)
Inflows	1,459.0	1,265.0	2,750.3	13,234.7	998.1	19,707.1
Derivatives in accounting hedge relationships						
Outflows	(48.8)	(20.1)	(36.9)	(299.1)	(1,905.8)	(2,310.7)
Inflows	26.6	0.6	58.4	255.9	1,993.7	2,335.2
Total outflows	(1,715.8)	(1,427.4)	(3,130.1)	(14,207.8)	(2,931.9)	(23,413.0)
Total inflows	1,485.6	1,265.6	2,808.7	13,490.6	2,991.8	22,042.3

Off balance sheet items

Loan commitments

Contractual amounts to which the Group is committed for extension of credit to customers are summarised in the table below.

Operating lease commitments

Minimum future lease payments under non-cancellable operating leases are summarised in the table below.

Capital commitments

Capital commitments for the acquisition of buildings and equipment are summarised in the table below.

	2008			Total £m
	Within one year £m	In one to five years £m	Over five years £m	
Loan commitments	516.1	3.0	3,746.1	4,265.2
Operating lease commitments				
Land and buildings	0.5	1.1	3.8	5.4
Other operating leases	-	4.6	-	4.6
Capital commitments	5.0	1.1	-	6.1
	521.6	9.8	3,749.9	4,281.3
	2007			Total £m
	Within one year £m	In one to five years £m	Over five years £m	
Loan commitments	1,596.9	10.0	4,403.9	6,010.8
Operating lease commitments				
Land and buildings	0.4	1.2	3.9	5.5
Other operating leases	-	4.8	-	4.8
Capital commitments	42.0	7.4	-	49.4
	1,639.3	23.4	4,407.8	6,070.5

40. Financial risk management (continued)
Currency risk

Currency risk arises as a result of the Group having assets, liabilities and derivative items that are denominated in currencies other than sterling as a result of normal banking activities, including wholesale funding.

In addition to raising funds through sterling money markets, capital markets and the domestic retail savings market, the Group raises Euro denominated retail funds through its branch in Ireland. The Group's policy is to minimise exchange rate exposures by using cross currency swaps and forward foreign exchange contracts, or to match exposures with assets denominated in the same currency.

At 31 December 2008, liabilities exceeded assets in US\$, after taking into account foreign currency derivatives, by \$76.5m, or £52.8m (2007 \$996.8m/£501.5m). Liabilities exceeded assets denominated in € at the same date by €1.6m, or £1.6m (2007 assets exceeded liabilities by €934.1m/£685.7m) after taking into account foreign currency derivatives. As a result of these currency exposures, the Group made foreign currency gains of £108m in 2008 (2007 £130m). The Group was sensitive to exchange rate gains and losses of £0.4m for each 1c movement in the £: US\$ exchange rate at 31 December 2008 (2007 £2.5m), and of less than £0.1m for each 1c movement in the £:€ exchange rate at the same date (2007 £5.2m).

The table below gives values of assets and liabilities at sterling carrying values denominated in different currencies at the balance sheet date.

2008	US\$ £m	€ £m	Other £m	Total £m
Assets				
Cash and balances with central banks	–	18.6	–	18.6
Loans and advances to banks	298.2	2,036.5	–	2,334.7
Loans and advances to customers	52.2	353.7	–	405.9
Investment securities	219.2	1,372.1	–	1,591.3
Other assets	1.1	10.8	–	11.9
Total assets	570.7	3,791.7	–	4,362.4
Liabilities				
Deposits by banks	120.8	964.4	–	1,085.2
Customer accounts	10.0	973.4	–	983.4
Debt securities in issue	17,257.2	28,080.1	1,116.9	46,454.2
Other liabilities	23.0	238.6	1.7	263.3
Subordinated liabilities	574.6	–	–	574.6
Total liabilities	17,985.6	30,256.5	1,118.6	49,360.7
Notional value of derivatives affecting currency exposures	(17,362.1)	(26,463.2)	(1,115.5)	(44,940.8)
	623.5	3,793.3	3.1	4,419.9
Net position	(52.8)	(1.6)	(3.1)	(57.5)
2007				
	US\$ £m	€ £m	Other £m	Total £m
Assets				
Cash and balances with central banks	–	13.3	–	13.3
Loans and advances to banks	545.1	235.3	175.8	956.2
Loans and advances to customers	120.2	270.5	–	390.7
Investment securities	404.7	1,562.3	–	1,967.0
Other assets	4.8	6.3	1.8	12.9
Total assets	1,074.8	2,087.7	177.6	3,340.1
Liabilities				
Deposits by banks	191.7	356.5	–	548.2
Customer accounts	2.1	441.1	179.9	623.1
Debt securities in issue	20,620.4	25,203.7	1,367.4	47,191.5
Other liabilities	33.9	195.3	3.0	232.2
Total liabilities	20,848.1	26,196.6	1,550.3	48,595.0
Notional values of derivatives affecting currency exposures	(19,271.8)	(24,794.6)	(1,368.4)	(45,434.8)
	1,576.3	1,402.0	181.9	3,160.2
Net position	(501.5)	685.7	(4.3)	179.9

40. Financial risk management (continued)

Fair values of financial assets and liabilities

The following table summarises the carrying amounts and fair values of those financial assets and liabilities not presented on the Group's balance sheet at their fair value. Assets are presented at bid prices, whereas offer prices are used for liabilities. The accounting policy note sets out the key principles for estimating the fair values of financial instruments. This note provides some additional information in respect of financial instruments carried at amortised cost. Similar additional information in respect of instruments carried at fair value is included in the respective note for the instrument.

	Carrying value		Fair value	
	2008	2007	2008	2007
	£m	£m	£m	£m
Financial assets				
Cash and balances with central banks	9,336.8	190.2	9,336.8	190.2
Loans and advances to banks	3,384.4	1,292.5	3,384.4	1,292.5
Loans and advances to customers	72,721.8	98,834.6	72,495.8	95,831.5
Assets reclassified from available for sale to loans and receivables	2,952.8	-	2,662.6	-
Financial liabilities				
Loans from HM Government	15,583.4	28,473.0	15,583.4	28,473.0
Deposits by banks	4,625.1	744.2	4,635.3	744.2
Customer accounts	20,722.7	11,562.8	20,990.2	11,574.3
Debt securities in issue	57,736.3	61,641.3	39,596.1	58,306.0
Subordinated liabilities	1,514.9	1,161.8	930.4	803.2
Tier one notes	251.8	207.6	115.0	130.3

Valuation methods for calculations of fair values in this table are set out below:

Cash and balances with central banks

Fair value approximates to carrying value because they have minimal credit losses and are either short term in nature or reprice frequently.

Loans and advances to banks

Fair value was estimated by using discounted cash flows applying either market rates where practicable or rates offered by other financial institutions for loans with similar characteristics. The fair value of floating rate placements, fixed rate placements with less than six months to maturity and overnight deposits is their carrying amount.

Loans and advances to customers

The Group provides loans of varying rates and maturities to customers. The fair value of loans with variable interest rates is considered to approximate to carrying value. For loans with fixed interest rates, fair value was estimated by discounting cash flows using market rates or rates normally offered by the Group. The increase in interest rates since the majority of these loans were originated means that their fair value is below their carrying value. However, as the Group's policy is to hedge fixed rate loans in respect of interest rate risk, this does not indicate that the Group has an exposure to this difference in value. The carrying value of unsecured investment loans approximates the fair value due to the impairment of these assets in the year (see note 9) to the value of the future expected cash flows.

Deposits by banks and customer accounts

Fair values of deposit liabilities repayable on demand or with variable interest rates are considered to approximate to carrying value. The fair value of fixed interest deposits with less than six months to maturity is their carrying amount. The fair value of all other deposit liabilities was estimated using discounted cash flows, applying either market rates or rates currently offered by the Group for deposits of similar remaining maturities.

Debt securities in issue, subordinated liabilities and tier one notes

Fair values are based on quoted prices where available, or by using discounted cash flows, applying market rates.

iii) Liquidity risk

Liquidity risk represents the risk of being unable to pay liabilities as they fall due and arises from the mismatch in cash flows generated from current and expected assets, liabilities and derivatives.

As a result of the liquidity difficulties the Group encountered in 2007, it approached the Bank of England for loan facilities. Following significant withdrawals by retail customers, together with wholesale maturities, these facilities were drawn upon in September 2007. By 31 December 2007, the loan from HM Government had reached £26.9 billion.

On 30 April 2008, the loan from HM Government was amended to incorporate a new liquidity management framework ('the Framework') which details the controls, processes, limits and authorities for managing funding and liquidity requirements. The Framework supports the objective of rapid repayment of the Government loan whilst ensuring that an adequate level of core structural liquidity is maintained.

Under the Framework, liquidity management has two key segments as follows:

- Back book liquidity. Cash flows are generated from repayments and redemptions of retail customer loans and from maturities of Treasury investments. These cash flows are used to repay wholesale funding maturities and after maintaining adequate liquidity to meet anticipated outflows are used to repay the Government loan.
- Front book liquidity. New lending to customers is required to be funded from new retail or new wholesale funding. Liquidity levels are maintained to meet expected and unexpected levels of liquidity outflows with any permanent surplus liquidity used to repay the Government loan.

The liquidity framework governance structure operates within the Board's delegated authorities and reports into Liquidity Management Group (LMG), Capital and Liquidity Management Committee (CLMC), Assets and Liability Committee (ALCO), Risk Committee, Executive Committee and Board. Group Treasury and Finance monitor liquidity on a daily basis, using daily cash flow liquidity reports, together with daily movement reports, liquidity performance indicators, portfolio analyses and maturity profiles. LMG reviews on a weekly basis proposed daily cashflows to ensure key liquidity performance indicators are met. Any changes in legislation, regulation and other guidance which may affect the Group's liquidity position or any other matters relating to its obligations under the Government loan are reported directly to the Chief Financial Officer ('CFO'). CLMC, ALCO and Risk Committee receive monthly liquidity analysis and profiles and report directly to Executive Committee, who makes recommendations to Board for its approval, policies and strategies to ensure that capital and liquidity management are optimised to meet internal and external stakeholder requirements.

40. Financial risk management (continued)

iv) Operational risk

The Group defines operational risk as “the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.” This accords with the Basel Committee’s definition of operational risk. In managing operational risk, the Group considers indirect financial costs and regulatory, reputational and customer impacts. As part of the Group’s programme for strengthening its risk and control environment, it has established an Operational Risk function reporting to the CRO, it has approved an operational risk management framework and it is implementing revised risk management policies and processes. These include risk and control assessment, risk event reporting, new product approval, corporate insurance, fraud prevention and investigation, incident management and business continuity planning.

Roles and responsibility for managing and reporting operational risk are defined by the Group’s three lines of defence model;

- The first line of defence is provided by business line management who are responsible for identifying and assessing the risks and controls within their business lines and managing the risks within agreed tolerances using defined policies and processes,
- The second line of defence is the Operational Risk function, which defines the operational risk management policies and processes and provides support, training, tools, oversight and challenge to the business lines in their operation, and
- The third line of defence is Internal Audit, which provides independent assurance over the effectiveness of the operational risk management framework and its application.

The Group calculates its capital requirement for operational risk using the Basel II Standardised Approach.

v) Compliance risk

Compliance risk is the risk that because of a failure to comply with compliance standards and requirements, the Group suffers legal or regulatory sanctions, financial loss or a loss of reputation.

To manage the risk, the Group has a dedicated Compliance function headed by an independent Compliance professional who reports to the CRO. A regulatory Compliance framework has been established which has a number of key components. These include the establishment of a regulatory compliance risk policy to set out the Group’s approach to compliance risk and regulatory compliance and how the business is expected to operate within the regulatory compliance framework. The framework also includes the governance and policy controls to enable identification of key regulatory risks, and of prevailing and emerging regulatory risk developments, issues and trends. The impacts of these developments on the Group are then assessed by the business or Compliance function. Where new procedures or changes in procedures are required to ensure full compliance with new developments is achieved, it is the role of the Compliance function to work with the Executive and assist line management to ensure that they are implemented fully.

In addition to ensuring compliance with new developments, the framework requires ongoing review and challenge of the Group’s compliance related processes and practices. It also requires the monitoring of consistent application of policies, on a risk based approach. The results of the reviews are reported to the Risk Committee, Audit Committee and Executive on a regular basis.

B) Capital Management

The Group manages its capital resources to meet the regulatory requirements established by its regulator, the FSA. Capital adequacy is monitored on an ongoing basis by the Group’s executive management and Board, based on the regulations established by the FSA. The required capital information is filed with the FSA on a quarterly basis.

The Group has adopted the Retail Internal Ratings Based (IRB) approach for residential and personal unsecured loans, the Foundation IRB approach for treasury portfolios and the Standardised approach for commercial loans and operational risk.

The Group’s securitised assets are “off balance sheet” for regulatory capital purposes. The impact of these exposures is included within risk weighted assets at 31 December 2008 but as a regulatory deduction at 31 December 2007. The impact at 31 December 2008 is to increase risk weighted assets by £7,234.8m. At 31 December 2007, deductions in respect of securitised assets amounted to £537.7m and were made equally against Tier 1 and Tier 2 capital resources.

In July 2008, at the Company’s request, the FSA agreed to waive the limits on use by the Company of Tier 2 capital. This waiver enabled all available Tier 2 capital to be included within capital resources without restriction for the purposes of meeting the Company’s minimum regulatory capital requirements. The original waiver granted was on a temporary basis until the recapitalisation of the Company following the obtainment of State aid approval or 31 December 2008, whichever was earlier. The FSA has subsequently extended the waiver to 30 April 2009.

On 23 February 2009, the Company announced that it had concluded the strategic review of its business plan, in close consultation with the Government. To facilitate anticipated new lending a legal and capital restructuring of the Company will be undertaken. This will include a strengthening of the Company’s capital base by up to £3 billion. The restructuring will be implemented subsequent to State aid approval of the revised plan.

40. Financial risk management (continued)

The following table is presented in accordance with Basel II requirements, subject to the temporary exemption granted to Northern Rock by the FSA waiving the restriction that total Tier 2 capital must not exceed total Tier 1 capital.

	2008	2007
	£m	£m
Core Tier 1		
Ordinary share capital	123.9	123.9
Share premium on ordinary share capital	6.8	6.8
Capital redemption reserve	7.3	7.3
Retained earnings	(145.2)	1,187.8
Pension scheme	(9.9)	(9.4)
Total Core Tier 1 capital	(17.1)	1,316.4
Perpetual Non-Cumulative Preference Shares		
Preference share capital	0.1	0.1
Share premium on preference share capital	396.4	396.4
Tier one notes	251.8	207.6
Total Perpetual Non-Cumulative Preference Shares	648.3	604.1
Innovative Tier 1		
Reserve capital instruments	299.3	299.3
Total Innovative Tier 1 capital	299.3	299.3
Regulatory deductions from and restrictions to Tier 1	(1,040.9)	(625.8)
Tier 1 capital after deductions	(110.4)	1,594.0
Upper Tier 2		
Perpetual subordinated debt	1,310.9	1,090.2
Reserve capital instruments restricted from inclusion in Tier 1 capital	299.3	–
Other non core Tier 1 capital restricted from inclusion in Tier 1 capital	595.2	–
Collectively assessed impairment allowance	2.6	0.4
Total Upper Tier 2 capital	2,208.0	1,090.6
Lower Tier 2		
Term subordinated debt	940.5	808.1
Total Tier 2 capital	3,148.5	1,898.7
Regulatory deductions from Tier 2	(76.3)	(445.8)
Tier 2 capital after deductions	3,072.2	1,452.9
Deductions from totals of Tier 1 and Tier 2		
Investments in subsidiary undertakings	(5.1)	(5.1)
Total capital resources	2,956.7	3,041.8
Risk weighted assets	27,471.4	20,691.0
Tier 1 ratio	(0.4)%	7.7%
Total capital	10.8%	14.7%

C) Contingent Liabilities

The Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS) is the UK's statutory fund of last resort for customers of authorised financial services firms and pays compensation if a firm is unable to pay claims against it. The FSCS has borrowed from HM Treasury to fund the compensation costs associated with institutions that failed in 2008 and will receive receipts from asset sales, surplus cash flow and other recoveries from these institutions in the future.

The FSCS meets its obligations by raising management expenses levies. These include amounts to cover the interest on its borrowings and compensation levies on the industry. Each deposit-taking institution contributes in proportion to its share of total protected deposits.

In 2008 the Group has accrued £16.8m in respect of its current obligation to meet management expenses levies.

If the FSCS does not receive sufficient funds from the failed institutions to repay HM Treasury in full it will raise compensation levies. At this time it is not possible to estimate the amount or timing of any shortfall resulting from the cash flows received from the failed institutions and, accordingly, no provision for compensation levies, which could be significant, has been made in these financial statements.

41. Collateral pledged and received

Northern Rock enters into securitisation transactions whereby portfolios of residential mortgage loans are sold or assigned to special purpose vehicles funded through the issue of mortgage backed securities. Holders of these securities are only entitled to receive payments of interest and principal to the extent of the resources of the securitisation companies and have no other form of recourse. At 31 December 2008, £32,325.0m of residential mortgage loans (2007 £49,326.1m) and £128.4m of cash (2007 £232.4m) were so assigned. This is detailed further in note 20.

Northern Rock also operates a covered bond programme, under which securities are issued to investors, secured on a ring-fenced pool of residential mortgage loans. At 31 December 2008, £9,686.5m of residential mortgage loans (2007 £10,389.6m) had been pledged as security for covered bonds. This is detailed further in note 21.

Cash collateral is given and received as part of normal derivative operations. At 31 December 2008, £642.1m (2007 £391.7m) had been pledged and £4,239.9m (2007 £482.5m) had been received as cash collateral.

Northern Rock enters into sale and repurchase transactions, which are accounted for as secured borrowings or collateralised loans. At 31 December 2007 outstanding transactions were with the Bank of England (see note 27). The carrying value of assets pledged as collateral under such transactions at 31 December 2008 was £nil (2007 £6,869.1m) and the amount of collateral received was £nil (2007 £nil). These transactions are entered into on terms that are usual and customary to repo transactions, standard lending, and securities borrowing and lending activity.

42. Related party transactions

A number of banking transactions are entered into with related parties as part of normal banking business. These include loans and deposits. The volumes of related party transactions, outstanding balances at the year end and related income and expense for the year are set out below.

	Directors and key management personnel	
	2008	2007
	£m	£m
Loans		
Loans outstanding at 1 January	6.6	8.7
Movements due to changes in Directors and key management personnel	(4.5)	–
Net amounts repaid	(0.7)	(2.1)
Loans outstanding at 31 December	1.4	6.6
Interest income paid	0.1	0.4
Deposits		
Deposits outstanding at 1 January	2.7	4.4
Movements due to changes in Directors and key management personnel	(2.7)	–
Net amounts (repaid)/deposited	0.3	(1.7)
Deposits outstanding at 31 December	0.3	2.7
Interest income earned	–	0.2
	2008	2007
	£m	£m
Directors and key management personnel		
Salaries and other short term benefits	4.1	6.5
Post-employment benefits	0.2	1.0
Share-based payments	1.2	(6.6)
	5.5	0.9

The credit in respect of share based payments in 2007 arises from the remeasurement of compensation expense of various employee share schemes due to non-market conditions not being met.

On 22 February 2008, under the terms of The Northern Rock plc Transfer Order 2008, all shares in Northern Rock plc were transferred to the Treasury Solicitor as nominee of the Treasury, and the Foundation shares were converted to Ordinary shares. At this point, therefore, The Northern Rock Foundation ceased to be a related party. No transactions occurred between Northern Rock plc and The Northern Rock Foundation during the period 1 January 2008 to 22 February 2008. Total contributions paid under deed of covenant by Northern Rock plc to The Northern Rock Foundation were £14.8m for the year ended 31 December 2007.

As a consequence of the Transfer Order, the Company regards HM Government as a related party. Details of loan facilities with the Bank of England and HM Treasury are set out in note 27 above. Interest and guarantee fees payable on these loans from 22 February 2008 to 31 December 2008 were £1,212.6m.

In addition to these loans and guarantees the Group has transactions with numerous Government bodies on an arm's length basis in relation to the payment of corporation tax, value added tax and employment taxes and the payment of regulatory fees and levies. Transactions with these entities are not disclosed owing to the volume of transactions conducted.

The Company owns Northern Rock (Guernsey) Limited, which operates as a retail deposit taker. The net funding borrowed by the Company from Northern Rock (Guernsey) Limited during the year amounted to £605.5m (2007 £1,594.7m repaid to Northern Rock (Guernsey) Limited).

During the year the Company received £nil (2007 £nil) from Northern Rock Mortgage Indemnity Company Limited in settlement of mortgage indemnity insurance claims.

During the year the Company repaid a net £16,693.6m to its securitisation SPEs (see note 20), being the net payment arising from securitisation transactions in the year (2007 borrowed a net £6,379.9m).

On 7 November 2007, the Guernsey Financial Services Commission altered the terms of the licence granted to Northern Rock Mortgage Indemnity Company Limited to prevent it from repatriating funds to Northern Rock plc or any other Group company without its prior written approval.

43. Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise the following balances with less than three months maturity from the date of acquisition:

	Group		Company	
	2008	2007	2008	2007
	£m	£m	£m	£m
Cash and balances with central banks	9,285.4	121.9	9,285.4	121.9
Loans and advances to banks	3,384.4	1,278.5	3,236.1	1,032.1
Loans and advances to customers	16.5	–	16.5	–
Investment securities	124.1	35.5	124.1	–
	12,810.4	1,435.9	12,662.1	1,154.0

44. Events after the balance sheet date

On 23 February 2009, the Company announced that it had concluded the strategic review of its business plan, in close consultation with the Government. As part of this revised plan the Company will offer up to £14 billion of new mortgage lending over the next two years. Additional funding to support new lending will be partly provided by an increase in the Government loan, with an extended repayment schedule. To facilitate the new lending a legal and capital restructuring of the Company will be undertaken.

45. Ultimate controlling party

As a result of The Northern Rock plc Transfer Order 2008, which transferred all shares in the Company to the Treasury Solicitor as nominee for HM Treasury on 22 February 2008, the Company considers Her Majesty's Government to be the ultimate controlling party from that date.

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