



**NORTHERN ROCK PLC**  
**PILLAR 3 DISCLOSURES**  
**31 December 2008**

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## 1. Introduction

Northern Rock plc operates under the Basel 2 capital adequacy framework which consists of three pillars, each of which covers a different aspect of capital adequacy and stability.

Pillar 1 sets out quantitative rules to calculate the minimum capital required by a firm to ensure its capital is sufficient to cover potential losses arising from its operations. This is calculated by reference to three key risks – credit risk, market risk and operational risk.

Pillar 2 relates to the internal capital adequacy processes within firms, and covers risks beyond those covered in Pillar 1. This ensures that all relevant risks are assessed by firms, and forms part of regular dialogue between firms and their regulators.

Pillar 3 provides public disclosure of a firm's risk and capital position, giving qualitative information on risk management and governance, and quantitative data on risk and capital as calculated under Pillar 1.

This document sets out the quantitative disclosures required under the Financial Services Authority ('FSA') handbook set out in BIPRU Chapter 11, which represent the regulatory disclosure requirements in the UK of the Pillar 3 requirements of Basel 2. For the purposes of these disclosures, credit exposure is the maximum loss that the group may suffer in the event of default or loss in value of an asset. This may differ from the amounts disclosed in the balance sheet in the Annual Report and Accounts, because the balance sheet only discloses drawn balances whereas credit exposures include amounts where customers have contractual rights to draw down further balances. The qualitative disclosures required under Pillar 3 are included in the Northern Rock plc Annual Report and Accounts.

This report will be made on an annual basis in relation to exposures and processes in place at 31 December annually, and will be published on the group's website ([www.northernrock.co.uk](http://www.northernrock.co.uk)).

Disclosures have not been subject to external audit. The only disclosures which will have undergone external audit will be those that are equivalent to those made in published audited financial statements.

## 2. Scope of application of directive requirements

Northern Rock plc is a UK bank regulated by the Financial Services Authority ('FSA'). It is the parent company of the Northern Rock plc group. The disclosures in this report have been prepared for the Northern Rock plc regulatory group in accordance with the requirements of the FSA handbook set out in BIPRU chapter 11.

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 securitisation special purpose entities ('SPEs') established in connection with the Group's securitisation programme. Although Northern Rock plc 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 Northern Rock plc regulatory group differs from the Northern Rock plc group for financial reporting purposes. Securitisation SPEs in both the Granite and Whinstone structures are included within the financial reporting group, but are treated as off-balance sheet for regulatory reporting purposes and are therefore excluded from the regulatory group for capital disclosures within this report. Additionally, Northern Rock Mortgage Indemnity Company Limited is regulated by the Guernsey Financial Services Commission as an insurance company and is therefore not included within the Northern Rock plc regulatory group.

The ability of Northern Rock (Guernsey) Limited and Northern Rock Mortgage Indemnity Company Limited to pay dividends to Northern Rock plc is restricted by regulatory requirements in Guernsey. Apart from these, there are no current or foreseen material legal or practical impediments to the prompt transfer of capital resources or repayment of liabilities when due between Northern Rock plc and its subsidiaries.

Northern Rock plc reports to the FSA on a solo-consolidated basis under the provisions of the FSA Handbook BIPRU Chapter 2.1. The solo-consolidated group includes Northern Rock plc and several subsidiary companies providing support services to the Group. Northern Rock plc holds 100% of the share capital and voting rights in these subsidiary companies, all of which adhere to the minimum standards set by the FSA for solo-consolidation.

### 3. Capital resources

The following table sets out the capital resources of Northern Rock plc at 31 December 2008 and 2007:

	Note	2008 £m	2007 £m
<b>Core Tier 1</b>			
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 reserves	1	(145.2)	1,187.8
Pension scheme	2	(9.9)	(9.4)
		<u>(17.1)</u>	<u>1,316.4</u>
<b>Tier 1</b>			
Preference share capital	3	0.1	0.1
Share premium on preference share capital	3	396.4	396.4
Tier One Notes	4	251.8	207.6
		<u>648.3</u>	<u>604.1</u>
Regulatory deductions from and restrictions to Tier 1		(741.6)	(625.8)
Tier 1 capital after deductions		<u>(110.4)</u>	<u>1,294.7</u>
<b>Innovative tier 1</b>			
Reserve Capital Instruments	5	299.3	299.3
Restrictions to use of Reserve Capital Instruments as Tier 1 capital		(299.3)	-
<b>Upper tier 2</b>			
Perpetual subordinated debt		1,310.9	1,090.2
RCIs restricted from inclusion as Tier 1 capital		299.3	-
Other non core Tier 1 capital restricted from inclusion as Tier 1 capital		595.2	-
Collectively assessed impairment allowance		2.6	0.4
		<u>2,208.0</u>	<u>1,090.6</u>
<b>Lower tier 2</b>			
Term subordinated debt		940.5	808.1
Deductions from Tier 2		(76.3)	(445.8)
Total innovative Tier 1 and Tier 2 after deductions		<u>3,072.2</u>	<u>1,752.2</u>
Deductions from Tier 1 and Tier 2		(5.1)	(5.1)
<b>Total capital resources</b>		<u>2,956.7</u>	<u>3,041.8</u>

Notes:

1. Retained reserves exclude reserves of companies outside the regulatory group, and also exclude cash flow hedging reserves and available for sale reserves.
2. Regulatory capital rules exclude pension scheme assets from capital when the scheme is in surplus, therefore this adjusts the regulatory capital available.
3. On 29 June 2006, Northern Rock issued 400,000 perpetual non-cumulative callable 25p preference shares for £1,000 each. Proceeds of £400 million were received less issue costs of £3.5 million. Dividends on these shares are discretionary and, subject to Board approval, will be paid annually on 4 July at a rate of 6.8509%.
4. The tier one notes were issued on 21 August 2002 for £200m 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 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 plc Transfer Order 2008 which was made on 22 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 capital for regulatory capital purposes as a result of the provisions of the FSA Handbook GENPRU Transitional Provisions 8.5.

5. 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 plc Transfer Order 2008 which was made on 22 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.

Although innovative tier 1 capital is shown below total tier 1 capital in the above table, this is solely for Pillar 3 reporting purposes. For capital gearing purposes, innovative tier 1 is allowable as tier 1 capital up to a maximum of 15% of total tier 1 capital. Any excess is allocated to upper tier 2 capital.

On 31 July 2008, Northern Rock plc was granted a waiver by the FSA in respect of its capital requirements. This waiver disapplies the requirements of GENPRU 2.2.46R which relate to the restrictions on tier 2 capital, and modifies the requirements of BIPRU TP 2.10R to

disapply the limits on the use of tier 2 capital set out in Chapter CA paragraphs 11.4.7(a), (c) and (f). This waiver has been given until the earlier of the date on which Northern Rock's capital resources are again restored to a level which is adequate to enable it to comply with the capital resources requirements under the FSA's rules as if the waiver had not been granted, and 30 June 2009.

**4. Assessment of internal capital**

The following table sets out the Pillar 1 capital requirements for each exposure type for exposures held by the Group at 31 December 2008 and 2007.

	2008 Capital requirement £m	2007 Capital requirement £m
<b>IRB approach</b>		
Retail exposures secured by real estate collateral	722.7	725.5
Other retail exposures	423.3	500.8
Central Governments and Central Banks Institutions	-	0.4
Corporates	205.9	71.4
Securitisation positions	1.2	6.3
Equity positions	683.1	190.2
	24.4	7.5
<b>Standardised approach</b>		
Exposures secured on commercial real estate	95.6	105.9
Other assets	41.6	53.4
Operational risk	102.6	102.4
Market risk	6.6	51.9
Total capital requirement	2,307.0	1,815.7

## 5. Counterparty credit risk

The following table sets out the gross positive fair value of derivatives contracts, and the potential credit exposures, at 31 December 2008 and 2007.

	2008 £m	2007 £m
Gross positive fair values of contracts	10,447.5	1,052.6
Potential credit exposure	856.5	1,218.9
Total exposure	11,304.0	2,271.5

Counterparty credit risk (CCR) is the risk that the counterparty to a derivative transaction could default during the life of the transaction.

The duration of the derivative and the credit quality of the counterparty are both factored into the internal capital and credit limits for counterparty credit exposures.

Credit Support Annexes (CSA) exist for collateralising derivative transactions with counterparties to which the Group has its largest derivative exposures in order to mitigate the risk of loss on default. Although these CSAs are taken into consideration when setting the internal credit risk limits for derivative counterparties, they are not recognised as credit risk mitigation for reducing the exposure at default (EAD) on the derivative transactions in the Pillar 1 regulatory capital calculations.

A downgrade in the Group's credit rating could reduce the thresholds and minimum transfer amounts for margin calls on some of the CSAs. This could result in a potential increase in the amount of collateral the Group would have to provide against the derivatives within the CSAs. However, due to the small number of CSAs with downgrade triggers, this is not deemed a significant risk for the Group. A one notch short term or long term rating downgrade could result in the Group being required to either post collateral or find a Guarantor for the swaps it provides to its securitisation vehicles with the amount of collateral needing to be posted being dependent on the valuation and duration of the swaps.

The Group measures exposure value on counterparty credit exposures under the CCR mark to market method. This exposure value is derived by adding the gross positive fair value of the contract (replacement cost) to the contracts potential credit exposure, which is derived by applying a multiple based on the contracts residual maturity to the notional value of the contract.

## 6. Credit risk and dilution risk

### 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 the 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 the minimum number of required 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.

The following tables set out the exposures at default for the various types of asset held by Northern Rock plc at 31 December 2008 and 2007, and the average exposure at default during each year:

	Exposure at 31 December 2008 £m	Average exposure in period £m
Retail exposures secured by real estate collateral	71,306.0	84,761.8
Other retail exposures	5,786.0	6,932.0
Central Governments and Central Banks	9,387.7	5,555.5
Regional Governments or Local Authorities	16.5	8.2
Institutions	11,103.1	7,813.5
Corporates	859.0	920.7
Securitisation positions	3,024.1	3,347.8
Equity positions	82.4	48.3
Exposures secured on commercial real estate	11.5	11.6
	101,576.3	109,399.4

	Exposure at 31 December 2007 £m	Average exposure in period £m
Retail exposures secured by real estate collateral	98,217.6	92,900.0
Other retail exposures	8,077.9	7,952.1
Central Governments and Central Banks	1,723.4	2,649.2
Regional Governments or Local Authorities	-	27.5
Institutions	4,524.0	8,241.3
Corporates	982.4	153.4
Securitisation positions	3,671.6	3,507.2
Equity positions	14.2	16.1
Exposures secured on commercial real estate	11.7	0.5
	<u>117,222.8</u>	<u>115,447.3</u>

The tables below give details of the geographical distributions of exposures at 31 December 2008 and 2007:

	Exposure at 31 December 2008		
	UK	Europe	Rest of World
	£m	£m	£m
Retail exposures secured by real estate collateral	71,301.3	2.2	2.5
Other retail exposures	5,786.0	-	-
Central Governments and Central Banks	9,363.5	24.2	-
Regional Governments or Local Authorities	16.5	-	-
Institutions	3,248.6	5,943.7	1,910.8
Corporates	726.0	43.7	89.3
Securitisation positions	1,436.5	661.9	925.7
Equity positions	-	-	82.4
Exposures secured on commercial real estate	10.3	1.2	-
	<u>91,888.7</u>	<u>6,676.9</u>	<u>3,010.7</u>
	Exposure at 31 December 2007		
	UK	Europe	Rest of World
	£m	£m	£m
Retail exposures secured by real estate collateral	98,210.6	5.8	1.2
Other retail exposures	8,077.9	-	-
Central Governments and Central Banks	1,705.0	18.4	-
Regional Governments or Local Authorities	-	-	-
Institutions	1,415.5	1,928.8	1,179.7
Corporates	842.2	54.8	85.4
Securitisation positions	1,656.8	292.1	1,722.7
Equity positions	-	-	14.2
Exposures secured on commercial real estate	10.5	1.2	-
	<u>111,918.5</u>	<u>2,301.1</u>	<u>3,003.2</u>

The following tables give details of the contractual residual maturities of exposures at 31 December 2008 and 2007:

	Exposure at 31 December 2008		
	Residual maturity		
	£m	£m	£m
	< 1 year	1-5 yrs	>5 years
Retail exposures secured by real estate collateral	92.2	1,187.7	70,026.1
Other retail exposures	123.1	1,122.9	4,540.0
Central Governments and Central Banks	9,363.5	-	24.2
Regional Governments or Local Authorities	16.5	-	-
Institutions	4,738.8	3,175.4	3,188.9
Corporates	24.0	196.3	638.7
Securitisation positions	19.2	170.6	2,834.3
Equity positions	-	-	82.4
Exposures secured on commercial real estate	-	5.8	5.7
	<u>14,377.3</u>	<u>5,858.7</u>	<u>81,340.3</u>

	Exposure at 31 December 2007		
	Residual maturity		
	£m	£m	£m
	< 1 year	1-5 yrs	>5 years
Retail exposures secured by real estate collateral	72.1	964.8	97,180.7
Other retail exposures	598.4	1,825.4	5,654.1
Central Governments and Central Banks	300.0	805.0	618.4
Institutions	1,722.8	2,005.2	796.0
Corporates	59.7	192.7	730.0
Securitisation positions	505.8	1,518.7	1,647.1
Equity positions	-	14.2	-
Exposures secured on commercial real estate	-	5.8	5.9
	<u>3,258.8</u>	<u>7,331.8</u>	<u>106,632.2</u>

The tables below indicate the level of impaired and past due exposures by exposure class, and of the levels of provisions against them at 31 December 2008 and 2007:

	31 December 2008		
	Impaired exposures	Past due exposures	Impairment provisions
	£m	£m	£m
Retail exposures secured by real estate collateral	925.1	4,330.0	386.1
Other retail exposures	99.4	151.7	483.6
Central Governments and Central Banks	-	-	-
Institutions	21.8	-	110.8
Securitisation positions	53.1	-	544.1
Equity positions	-	-	-
Exposures secured on commercial real estate	-	0.3	-
	<u>1,099.4</u>	<u>4,482.0</u>	<u>1,524.6</u>

	31 December 2007		
	Impaired exposures	Past due exposures	Impairment provisions
	£m	£m	£m
Retail exposures secured by real estate collateral	152.9	2,154.8	64.4
Other retail exposures	353.1	199.7	178.6
Central Governments and Central Banks	-	-	-
Institutions	-	-	-
Securitisation positions	95.1	-	410.5
Equity positions	-	-	-
Exposures secured on commercial real estate	-	-	-
	<u>601.1</u>	<u>2,354.5</u>	<u>653.5</u>

All retail impairment charges relate to exposures within the UK.

Impairments on securitisation positions relate to exposures denominated in US dollars.

Movements in impairment provisions in 2008 and 2007 are detailed in the following tables:

	Retail mortgages	Other retail exposures	Securitisation positions	Institutions
	£m	£m	£m	£m
Impairment provisions				
At 1 January 2008	64.4	178.6	410.5	-
Increase in provision during year net of recoveries	421.1	473.3	210.2	110.8
Amounts written off during the year	(100.9)	(170.1)	(76.6)	-
Discount unwind	1.5	1.8	-	-
At 31 December 2008	<u>386.1</u>	<u>483.6</u>	<u>544.1</u>	<u>110.8</u>

	Retail mortgages	Other retail exposures	Securitisation positions
	£m	£m	£m
Impairment provisions			
At 1 January 2007	33.6	92.4	-
Increase in provision during year net of recoveries	62.3	177.4	410.5
Amounts written off during the year	(30.7)	(93.0)	-
Discount unwind	1.5	1.8	-
Amounts released from disposal of loan book	(2.3)	-	-
At 31 December 2007	<u>64.4</u>	<u>178.6</u>	<u>410.5</u>

## 7. IRB disclosures for specialised lending and equity classes

Northern Rock has no specialised lending exposures.

The group uses the simple risk weight approach for calculating risk weighted exposure amounts for equity exposures.

	Equity exposures	
	31 December 2008 £m	31 December 2007 £m
Risk weighting		
190%	-	-
290%	-	-
370%	82.4	14.2

	Carrying value £m	Fair value £m	31 December 2008
			Market price %
Exchange traded	-	-	-
Private equity	82.4	82.4	100.0
Other	-	-	-

	Carrying value £m	Fair value £m	31 December 2007
			Market price %
Exchange traded	-	-	-
Private equity	14.2	14.2	100.0
Other	-	-	-

Equity exposures are accounted for as available for sale securities, and are valued in accordance with British Venture Capital Association guidelines. No realised or unrealised gains or losses are included in capital in respect of these equity exposures.

## 8. Interest Rate Risk in the Banking Book

A discussion of the nature and management of interest rate risk in the banking book is included above in the Annual Report and Accounts for Northern rock plc for the year ended 31 December 2008. The table below indicates the effect on economic value of a 1% parallel interest rate shock in each of the main currencies within the banking book.

Currency	<u>Increase/(decrease) in economic value</u>	
	31 December 2008 £ m	31 December 2007 £ m
£	(23.4)	(155.1)
US \$	10.6	(0.3)
Euro	(2.5)	(6.2)

## 9. Securitisation

Securitisation has been a key element of the Group's funding since 1999 although market conditions and Northern Rock specific events meant that it has not been possible to bring any new public transactions to market since May 2007.

The principal objective of securitisation has been to provide funding diversification, giving access to a wide range of investors in different geographic areas. Securitisation has also served to generate liquidity from different illiquid asset types, principally residential and commercial mortgage loans. In addition, securitisation has been used to assist capital management and to provide risk transfer.

The Company continues to act as sole administrator in relation to the securitised loans and has serviced the securitised loans on the same basis as non-securitised loans. The Company also acts as cash manager to the various securitisations. Although services of investment banks and legal advisers are utilised in originating new deals, the management of existing securitisation is undertaken by the Company. The Company also operates as basis rate swap provider to the securitisations providing swaps which convert the interest basis asset cash flows into flows which match the interest bases of the liabilities.

The approach taken to calculating risk weighted exposure amounts is to establish the maximum retained exposure to loss and to treat this as a one-for-one deduction from capital with the associated assets being accorded a nil risk weighting. To the extent that such treatment leads to a disadvantageous capital position, on a programme by programme basis, risk weighted assets are capped at the level which would have applied had the assets not been securitised.

In relation to synthetic securitisation transactions the assets are risk weighted based upon the credit standing of the credit default swap counterparty with a deduction from capital being taken for any retained first loss piece. Under the Basel 2 regime the Company ignores synthetic transactions for the purposes of the Company's capital position, although some credit is still recognised in the transitional period by virtue of lowering the Basel 1 floor.

Both the debt securities in issue and the loans which they are financing remain on balance sheet under IFRS.

### **External credit assessment institutions used for securitisations**

The Granite programme has been rated by Standard and Poor's and Moody's Investor Services since inception in 1999 and by Fitch Ratings since 2001. The ratings assigned assess the ability of the structure to allow for the timely payment of interest and the ultimate payment of principal of each of the rated notes. As part of the ratings process each of the agencies is committed to ongoing transaction monitoring to ensure that, in their view, the assigned ratings remain an appropriate reflection of the issued notes' credit risk.

The following table analyses for the Granite programme, as at 31 December 2008 and 2007, the ratings of the outstanding notes in issue by rating class, based on the original ratings assigned at the time of issue and the current notional value of the notes in issue:

Rating Class	31 Dec 2008	31 Dec 2007
	£m	£m
AAA	25,988	41,872
AA	1,394	1,848
A	1,221	1,483
BBB	1,659	2,199
Total	<u>30,262</u>	<u>47,402</u>

There are 167 (220 as at 31 December 2007) note classes or series outstanding and significant numbers of these notes have been upgraded by each of the rating agencies. Standard and Poor's have upgraded 34 (2007: 50) of the outstanding notes, Moody's have upgraded 30 notes (2007: 43) and Fitch have upgraded 34 notes (2007: 50).

The Whinstone programme is similarly rated by each of Standard and Poor, Moody's and Fitch Ratings. The Standard and Poor's and Moody's ratings of Whinstone address the timely payment of interest and ultimate principal on the notes whereas the Fitch rating addresses ultimate payment of both interest and principal. The Whinstone transactions are rated down to BB.

The following table analyses for the Whinstone programme, as at 31 December 2008, the ratings of the notes in issue by rating class, based on the original ratings assigned at the time of issue and the current notional:

Rating Class	31 Dec 2008	31 Dec 2007
	£m	£m
BBB	104	208
BB	286	286
Total	<u>390</u>	<u>494</u>

There are 8 note classes or series outstanding, 6 of which have been upgraded by Fitch.

### **Total outstanding exposures**

As at 31 December 2008 the total outstanding securitisation debt was £30,652m (2007: £47,896m). This value represents the sterling equivalent amount taking into account the cross currency swaps in place and does not agree directly to the accounting disclosures in the Group Annual Report and Accounts which take into account movements in currency rates and in the fair values of the swaps. It is considered appropriate to disclose the exposures in terms of their economic value rather than their accounting value.

The following table analyses the movements in outstanding debt securities for the Granite programme.

As at 1 January 2008 £m	Advances £m	Repayments £m	As at 31 December 2008 £m
47,402	0	(17,140)	30,262

The debt securities in issue are supported by trust assets comprising predominantly residential mortgage assets but also cash. As at 31 December 2008 the total trust mortgage assets were £32,316m (2007: £49,324m).

The excess of trust assets over the debt securities in issue adjusted for any cash distributed to the SPVs represents the Company's retained interest in the Trust.

There were no gross exposures securitised during the year (2007: £23,422m). Repurchases of loans from Northern Rock plc totalled £1,372m (2007: £11,104m).

The following table analyses the movement in outstanding debt securities by issuer for the Whinstone programme.

As at 1 January 2008 £m	Advances £m	Repayments £m	As at 31 December 2008 £m
494	0	(104)	390

### Analysis of impaired assets, past due exposures and losses

The following analysis of past due exposures details loans in arrears split by number and balance as at 31 December 2008 for the Granite programme:

	Number No.	Principal £m	Arrears £m	By number %	By value %
> = 1 < 3 Months	10,088	1,216	13	3.42%	3.77%
> = 3 < 6 Months	5,246	665	16	1.77%	2.06%
> = 6 < 12 Months	2,998	378	17	1.02%	1.17%
> = 12 Months	291	43	2	0.08%	0.13%
Total	18,623	2,302	48	6.29%	7.13%

The following analysis of past due exposures details loans in arrears split by number and balance as at 31 December 2007 for the Granite programme:

	Number No.	Principal £m	Arrears £m	By number %	By value %
> = 1 < 3 Months	6,946	820	6	1.65%	1.65%
> = 3 < 6 Months	1,502	169	3	0.36%	0.36%
> = 6 < 12 Months	740	82	6	0.17%	0.15%
> = 12 Months	55	7	0	0.00%	0.00%
Total	9,243	1,078	15	2.18%	2.16%

Total losses recognised on exposures within the Granite securitisation during the year were £35.7m (2007: £ 5.5m).

Impaired assets included within the Granite securitisation at 31 December 2008 had a book value of £201.9m (2007: £124.2m).

### Retained and purchased securitisation positions

The following table gives details of the values of notes issued under the Granite and Whinstone programmes held by Northern Rock plc at 31 December 2008 and 2007:

	31 December 2008 £m	31 December 2007 £m
AAA	-	4,600
AA	-	133
A	-	160
BBB	-	140
	<hr/>	<hr/>
	-	5,033

The following tables give details of the positions in securitised exposures of other issuers purchased by Northern Rock plc and held at 31 December 2008 and 2007:

	Senior exposures	Base risk weight exposure	31 December 2008 Exposure backed by non granular pools	Exposures rated BBB- or lower
Risk weighting				
7%	459.7	-	-	-
8%	-	-	-	-
10%	-	-	-	-
12%	-	875.5	-	-
15%	-	363.6	-	-
18%	-	30.5	-	-
20%	-	240.6	279.6	-
25%	-	-	64.7	-
35%	-	29.5	63.6	-
50%	-	0.4	10.2	-
60%	-	-	-	-
75%	-	138.8	23.7	-
100%	-	-	-	4.3
250%	-	-	-	1.3
425%	-	-	-	1.1
650%	-	-	-	-
1250%	-	-	-	-
Deducted	-	-	-	31.2
	<hr/>	<hr/>	<hr/>	<hr/>
	459.7	1,678.9	441.8	37.9

Northern Rock plc – Pillar 3 disclosures

	Senior exposures	Base risk weight exposure	31 December 2007 Exposure backed by non granular pools	Exposures rated BBB- or lower
Risk weighting				
7%	515.1	-	-	-
8%	-	-	-	-
10%	-	-	-	-
12%	-	1,054.8	-	-
15%	-	386.4	-	-
18%	-	8.1	-	-
20%	-	235.5	286.4	-
25%	-	-	63.5	-
35%	-	69.1	72.2	-
50%	-	2.8	2.8	-
60%	-	-	-	-
75%	-	148.0	103.6	-
100%	-	-	-	361.7
250%	-	-	-	4.3
425%	-	-	-	10.1
650%	-	-	-	1.6
1250%	-	-	-	345.6
Deducted	-	-	-	-
	515.1	1,904.7	528.5	723.3

## **10. IRB disclosures**

The scope of the Group's IRB permission is as set out below:

### **Retail IRB**

Retail exposures secured by real estate collateral

Other retail exposures – unsecured retail lending

### **Foundation IRB**

Central governments and central banks

Institutions

Corporates

Equities

Securitisation positions

The Group's IRB (Internal Ratings Based) Waiver Application Pack was approved by the FSA on 29 June 2007 for capital adequacy monitoring and reporting from 30 June 2007 onwards. The scope of this permission covers the retail business of retail exposures secured by real estate collateral, unsecured personal loans, exposures to central governments and banks, institutions, corporates, equities and securitised positions.

The areas of the business falling outside the scope of the Group's IRB permission are limited to commercial lending. Asset classes not falling within the scope of the Group's IRB permission are treated under the standardised approach. The retail credit risk function is responsible for the development, validation, implementation, monitoring and use of credit rating models for the Retail IRB approach, and Treasury Risk Management is responsible for the Foundation IRB approach. In order to ensure the integrity and independence of these models, the risk functions have clearly segregated duties from those responsible for originating exposures. Each risk area is responsible for monitoring the validity of its models and completeness of the supporting documentation and reporting on these to either the Retail Credit Risk Committee ('RCRC') or ALCO. Both RCRC and ALCO have been established as the principal forums for independently overseeing the Group's credit rating models, to ensure that the systems are producing consistent and accurate results in line with the Group's objectives and FSA minimum requirements.

### **Retail IRB**

The Group has extensive internal loss data histories which have enabled it to build in-house credit rating models for the residential mortgage and unsecured personal loan portfolios. These models facilitate an appropriate risk sensitive approach to risk management and capital allocation. The models determine long run average probabilities of default (PD), downturn loss given default (LGD) and appropriate exposures at default (EAD) for each segment in order to calculate expected loss and risk weighted assets. In addition, the models are used to support lending strategy, determine the level of impairment allowances and the provision of management information.

The rating models group obligors into segments differentiated by a number of factors, which include application and behavioural scores and delinquency status. For each segment a long run average PD, downturn LGD and EAD are estimated from a combination of recent and historic data. Data covering the period back to the early 1990s are utilised in the derivation of the PD, LGD and EAD. Internal loss data is supplemented with external industry loss data

where there is not sufficient internal data. For all products EAD is restricted so that it cannot be lower than 100% of the current exposure. An EAD for undrawn assets such as applications not yet taken up is also built into the models through the use of credit conversion factors.

#### Foundation IRB

For exposures subject to the Foundation IRB approach, the Group utilises regulatory LGDs for determining risk weighted assets. Internal ratings models are used to generate obligor PDs. Exposures to financial institutions arise in Treasury operations. An in-house model combining quantitative and qualitative measures is used to assess the creditworthiness of these financial institutions by assigning them an internal rating. This model delivers a point in time rating that is calibrated to long run external loss data supplied by an External Credit Assessment Institution (ECAI) to generate a long run average PD for each rating.

#### Exposures by exposure class

	2008	2007
	£m	£m
<b>Retail IRB</b>		
Retail exposures secured by real estate collateral	70,939	85,802
Other retail exposures	5,786	7,022
	<u>76,725</u>	<u>92,824</u>
<b>Foundation IRB</b>		
Central governments and central banks	9,397	1,723
Institutions	11,421	4,509
Corporates	64	117
Equities	82	14
	<u>20,964</u>	<u>6,363</u>
<b>Other IRB</b>		
Securitisation positions	<u>3,024</u>	<u>3,672</u>

The following tables detail the Group's exposures by IRB exposure class. These relate to exposure at default, and include all on and off balance sheet exposures.

### Retail exposures secured by real estate collateral

#### 2008

PD Band	LRA PD	Exposure (£m)	Downturn LGD	RWA%	RWA (£m)
Very low	0.16%	55,608	19.09%	6.93%	3,851
Low	1.01%	3,714	22.87%	29.70%	1,103
Medium	1.58%	3,127	20.82%	36.29%	1,135
High	3.46%	2,897	22.33%	61.07%	1,769
In Arrears	26.39%	3,940	21.96%	102.39%	4,034
Default	100.00%	1,653	33.70%	165.18%	2,730
Total		<u>70,939</u>			<u>14,622</u>

#### 2007

PD Band	LRA PD	Exposure (£m)	Downturn LGD	RWA%	RWA (£m)
Very low	0.17%	71,443	16.02%	6.08%	4,347
Low	1.01%	5,704	19.32%	25.84%	1,474
Medium	1.57%	3,073	19.73%	35.08%	1,078
High	3.73%	2,950	19.50%	56.76%	1,674
In Arrears	17.66%	2,060	19.62%	87.99%	1,813
Default	100.00%	572	37.72%	435.70%	2,492
Total		<u>85,802</u>			<u>12,878</u>

### Other retail exposures

#### 2008

PD Band	LRA PD	Exposure (£m)	Downturn LGD	RWA%	RWA (£m)
Very Low	0.33%	2,418	66.01%	41.54%	1,005
Low	1.37%	1,004	50.89%	61.07%	613
Medium	4.04%	1,062	53.70%	80.45%	854
High	16.13%	620	64.88%	136.82%	849
In Arrears	55.81%	212	50.70%	113.23%	240
Default	100.00%	470	76.23%	383.33%	1,801
Total		<u>5,786</u>			<u>5,361</u>

**2007**

PD Band	LRA PD	Exposure (£m)	Downturn LGD	RWA%	RWA (£m)
Very Low	0.36%	2,145	85.91%	53.50%	1,148
Low	1.47%	3,058	58.46%	73.00%	2,233
Medium	6.46%	1,003	61.52%	99.12%	994
High	24.21%	362	49.41%	125.53%	454
In Arrears	58.16%	167	57.65%	142.46%	237
Default	100.00%	287	83.95%	351.16%	1,007
Total		<u>7,022</u>			<u>6,073</u>

**Foundation IRB exposures****2008**

	Central governments & central banks	Institutions	Corporates
PD band	£m	£m	£m
0%	9,397.0	-	-
0%-0.03%	-	3,532.1	-
0.03%-0.05%	-	7,593.8	-
0.05%-0.20%	-	84.7	64.1
0.20%-0.30%	-	90.2	-
0.30%-0.40%	-	18.8	-
0.40%-0.80%	-	68.8	-
0.80%-0.90%	-	-	-
In default	-	21.8	-
	<u>9,397.0</u>	<u>11,409.6</u>	<u>64.1</u>

**2007**

	Central governments & central banks	Institutions	Corporates
PD band	£m	£m	£m
0%	1,723.4	-	-
0%-0.03%	-	2,810.2	-
0.03%-0.05%	-	1,523.8	75.4
0.05%-0.20%	-	86.8	41.3
0.20%-0.30%	-	-	-
0.30%-0.40%	-	12.0	-
0.40%-0.80%	-	40.1	-
0.80%-0.90%	-	35.2	-
>.90%	-	0.8	-
	<u>1,723.4</u>	<u>4,508.9</u>	<u>116.7</u>

**Impairment charges by exposure type**

This table shows the impairment charges made in 2008 and 2007 by Basel exposure class, and includes impairment charges for exposure classes under the standardised approach.

	Valuation adjustment, £m	
	2008	2007
Retail exposures secured by real estate collateral	421.1	62.3
Other retail exposures	473.3	177.4
Securitisation positions	321.0	410.5
	<u>1,215.4</u>	<u>650.2</u>

## **11. Credit Risk Mitigation**

### **Retail exposures**

Of the Group's retail exposures at 31 December 2008, 92.5% (2007 92.5%) were secured on real estate – 92.4% (2007 92.2%) on residential property and 0.01% (2007 0.3%) on commercial property. The personal unsecured portfolio made up the remaining 7.5% (2007 7.5%) of retail exposures. The indexed average loan to value ratio of the mortgage book at the end of 2008 was 73% (2007 60%). The collateral held against mortgage exposures was valued at £99.7 billion (2007 £164.6 billion). Of this, £931.1 million (2007 £138.0 million) was held against impaired loans with a book value of £925.1 million (2007 £152.9 million).

### **Treasury exposures**

Credit Support Annexes (CSAs) exist for collateralising derivative transactions with counterparties to which the Group has its largest derivative exposures in order to mitigate the risk of loss on default. The CSAs allow margin calls to be made on the net mark to market value of derivative exposures with a particular counterparty. All collateral held or paid under the CSAs is in the form of cash. Although these CSAs are taken into consideration when setting the internal credit risk limits for derivative counterparties, the Group has not recognised the risk mitigating effect of these CSAs in its Pillar 1 capital calculations. At 31 December 2008, cash collateral of £4,239.9 m (2007 £482.5 m) was held in relation to CSAs.