

NORTHERN ROCK PLC
INTERIM RESULTS
6 MONTHS ENDED 30 JUNE 2005

NORTHERN ROCK GROUP INTERIM RESULTS

THIS PAGE LEFT INTENTIONALLY BLANK

NORTHERN ROCK GROUP INTERIM RESULTS

Contents	Page
Introduction	3
Highlights	4
<u>Statutory Accounts</u>	
Operational Review	6
Financial Highlights - Statutory	20
Statutory Consolidated Income Statement	22
Statutory Consolidated Balance Sheet	23
Statutory Consolidated Cashflow Statement	24
Statutory Consolidated Statement of Changes in Equity	26
Notes to the Statutory Results	28
Significant Accounting Policies	42
Reconciliations Between IFRS and UK GAAP	52
Independent Review Report	75
<u>Proforma Accounts</u>	
Financial Highlights – Proforma	78
Proforma Consolidated Income Statement	80
Proforma Consolidated Balance Sheet	81
Proforma Consolidated Statement of Changes in Equity	82
Notes to the Proforma Results	85
Reconciliations Between Proforma IFRS and UK GAAP	99

NORTHERN ROCK GROUP INTERIM RESULTS

Introduction

Statutory Results

The 2005 Interim Results have been prepared using International Financial Reporting Standards (“IFRS”) as approved by the International Accounting Standards Board that are effective or available for early adoption at the Group’s first reporting date, 31 December 2005. Certain of these IFRS are only effective from 1 January 2005, and therefore the revised 2004 statutory based results (“statutory”) only include certain of the IFRS used in the preparation of the 2005 results. The results included on pages 18 to 74 represent the statutory results of the Group for the six months ended 30 June 2005 and include the statutory comparatives reflecting only those standards which permit or require retrospective adoption, reflecting the voluntary exemptions of IFRS1.

Proforma Results

In order to aid comparability of the 2005 results with those of 2004, 2004 results have also been prepared on a proforma basis, incorporating the impact of IFRS where it is possible to determine what the impact would have been if the accounting changes had been effective in 2004. The proforma results include the impacts of changes to accounting rules relating to effective interest rate and the reclassification of certain financial instruments from debt to equity.

Underlying Results

The 2005 statutory results include the full effects of the introduction of fair value and hedge accounting following the adoption of IAS 32 and 39 with effect from 1 January 2005. Where appropriate, certain aspects of the results for 2005 are presented to reflect management’s view of the underlying results for 2005 excluding the effects of fair value volatility and hedge ineffectiveness to provide a clearer representation of the underlying performance of the Group.

NORTHERN ROCK GROUP INTERIM RESULTS

28 July 2005

Northern Rock plc today issued its Interim Results for the six months ended 30 June 2005.

HIGHLIGHTS

Operating Performance

- Total assets of £72.5 billion - an increase of 26.9% from June 2004 assets of £57.1 billion
- Record H1 gross lending of £11.5 billion - an increase of 14.8%, with record H1 net lending of £6.0 billion - an increase of 17.2%
- Share of UK net mortgage lending of 14.2% - up from 11.2% in the 2004 full year
- 1 July 2005 total lending pipeline of £6.5 billion - up 26% from 1 January 2005
- 0.35% (31 December 2004 - 0.37%) of mortgage accounts 3 months or more in arrears - under half of industry average
- Record retail savings intake of £1.7 billion - nearly twice the total for all of 2004

Profits

- Pre tax profits up by 45.4% to £294.0 million from June 2004, an increase of 39.2% compared with June 2004 proforma pre tax profits
- Underlying pre tax profits of £239.2 million, up by 13.3% compared with 2004 proforma
- Underlying attributable profits of £149.4 million, up by 10.6% compared with 2004 proforma

Costs

- Cost to asset ratio improved to 0.35% (from 0.37% in 2004)
- Cost to income ratio improved to 28.3%. On an underlying basis it is 30.1%, compared with a proforma ratio of 29.9% for all of 2004

Shareholder Value

- Return on equity of 24.6%, being 25.9% on a proforma basis and 20.6% on an underlying basis
- EPS of 45.5p - an increase of 30.7%. On a proforma basis the increase is 39.1% and on an underlying basis EPS of 36.1p represents an increase of 10.4%
- Interim dividend per share of 9.4p - an increase of 10.6%

Social Responsibility

- The Northern Rock Foundation - supporting charitable causes - to receive £14.7 million

Note

The basis of preparation of statutory, proforma and underlying figures is detailed on page 3

NORTHERN ROCK GROUP INTERIM RESULTS

Adam J Applegarth, Chief Executive, said:

“Northern Rock has again demonstrated in the first half of 2005 its ability to grow through strong volumes of high quality residential mortgage lending, despite a slow down in the UK housing market. Total balance sheet assets have grown to £72.5 billion, an increase of 27% compared with 30 June 2004.

Although the introduction of IFRS defers income for a growth company like Northern Rock the volatility from fair value adjustments and hedge accounting has been introduced and so, reported profit before tax is up 45%, with underlying attributable profit up 10.6%. In future years, as our asset growth trends to the mid-point of our strategic targets, I expect to see the gap between underlying attributable profit growth and asset growth narrow noticeably.

With the introduction of IFRS there have been some additional costs - mainly to do with pension funding and employee share benefits. We’ve incorporated these and have still seen an improvement in our cost to asset ratio and our cost to income ratio remains broadly stable on an underlying basis. Therefore, once comparable figures are available, I expect our relative cost advantage to have improved.”

Note

The basis of preparation of statutory, proforma and underlying figures is detailed on page 3

NORTHERN ROCK GROUP INTERIM RESULTS

OPERATIONAL REVIEW

Introduction

The 2005 Interim Results have been prepared using International Financial Reporting Standards ("IFRS") which differ significantly to UK GAAP used in the preparation of previously reported financial statements.

Analysis of the results is complicated as a result of certain IFRS only being effective from 1 January 2005. This means that the revised 2004 statutory results only include certain of the IFRS used in the preparation of the 2005 results. As a consequence we have included, on pages 76 to 112, 2004 results prepared on a proforma basis, incorporating the impact of IFRS where it can be determined what the impact would have been if the accounting changes had been effective in 2004. This particularly relates to the treatment of interest income and fees and the reclassification of certain funding instruments from debt to non shareholders' equity but excludes the effects of hedge accounting under IFRS which differs from that applied under UK GAAP.

Full reconciliations of the effect of the introduction of IFRS are included in the statutory and proforma sections of the Interim Results together with full details of the accounting policies for 2005.

As a consequence of the introduction of IFRS the balance sheet and income statement are subject to a certain amount of volatility particularly from the accounting for hedges deemed under IFRS rules to be ineffective, plus volatility arising from fair value movements on derivatives taken out in respect of certain financial liabilities and instruments included in non shareholders' equity which themselves are not subject to fair value treatment. Where appropriate, such volatility is separately identified in the review of financial and operating results to enable underlying performance to be separately identified.

Overview

Strong lending volumes continued in the first half of 2005 resulting in total assets of £72.5 billion, an increase of 26.9% compared with 30 June 2004. Residential net lending market share at 14.2% to the end of May 2005, exceeded the 11.2% share achieved in 2004, further demonstrating Northern Rock's ability to achieve growth targets even in a slowing and competitive mortgage market. Asset quality also remained robust across all loan portfolios.

Underlying profit before tax growth compared with the proforma results for 2004 was 13.3%, with growth in underlying earnings per share on an equivalent basis of 10.4%, in line with expectations. Underlying return on equity at 20.6% remained within the top half of our strategic target range.

The strong performance of our retail funding seen in 2004 continued in the first half of 2005 with net inflows of £1,716 million. Two successful securitisation issues raised £8,558 million and contributed further to our capital management.

Lending

During the first half of 2005 Northern Rock has again achieved record levels of total lending. Total gross lending was £11,543 million, an increase of 14.8% (30 June 2004 - £10,055 million), with total net lending of £5,965 million, an increase of 17.2% (30 June 2004 - £5,091 million). Prospects for the remainder of 2005 are good, with a pipeline of £6,453 million some 26% higher than at the beginning of the year (1 January 2005 - £5,105 million). The residential lending pipeline at £5,987 million is also 26% higher than at the beginning of the year (1 January 2005 - £4,755 million).

Note

The basis of preparation of statutory, proforma and underlying figures is detailed on page 3

NORTHERN ROCK GROUP INTERIM RESULTS

Lending (continued)

The composition of our lending portfolios has continued to be low risk. At 30 June 2005 89% of our loans to customers were residential (30 June 2004 - 89%), 3% commercial secured loans (30 June 2004 - 3%) and 8% (30 June 2004 - 8%) within our personal unsecured portfolios. This mix is not expected to change significantly going forward.

An analysis of lending by portfolio is set out in the following table:

£ millions	Residential	Commercial	Unsecured	Total
2005 First Half				
Gross	10,224	218	1,101	11,543
Net	5,610	31	324	5,965
2004 First Half				
Gross	8,512	212	1,331	10,055
Net	4,367	63	661	5,091
2004 Full Year				
Gross	20,051	499	2,792	23,342
Net	11,383	182	1,367	12,932

Residential

The UK residential lending market was weaker in the first half of 2005 compared with the equivalent period in 2004, as a result of falling consumer confidence and a slow down in the housing transaction market, with gross lending down by 14% and net lending down 25% in the first 5 months of the year. Estimated gross lending, however, remains on track to reach around £260 billion for the full year, compared with £291 billion last year. Net lending is forecast to be around £80 billion for the year which would represent a 21% reduction from the £101 billion seen in 2004. UK house prices remained static in the first half of the year, but there remains little evidence of widespread house price reductions, a situation we expect to continue. With the level of housing transactions at the lower end of long term trends and house price inflation likely to be limited for the time being, gross lending continues to be underpinned by sustained levels of remortgage activity which accounted for approximately 46% of gross lending so far this year. The gross market remains key to Northern Rock achieving its growth targets, and economic conditions remain supportive with low inflation, relatively low unemployment, low interest rates and consequently good affordability.

Against this background we achieved gross residential lending of £10,224 million (30 June 2004 - £8,512 million) and net residential lending of £5,610 million (30 June 2004 - £4,367 million), representing increases of 20.1% and 28.5% respectively. Our share of UK gross residential lending for the first five months of 2005 was 8.1% and our market share of net residential lending for the same period was 14.2%. This compares with 5.8% and 8.2% respectively for the first half of 2004, and 6.8% and 11.2% for 2004 in total. Our share of redemptions in the first five months of the year was 5.2%, again lower than our closing share of mortgage stock of around 6.0%. This reflects the continued success of our pro-active customer retention process and our fair and transparent policy of allowing existing customers, subject to contractual terms, to transfer their loan to any product available to new borrowers.

Note

The basis of preparation of statutory, proforma and underlying figures is detailed on page 3

NORTHERN ROCK GROUP INTERIM RESULTS

Lending (continued)

The low risk profile of our new lending has continued despite strong growth in volumes. The proportion of lending to first time buyers remains low at 21% (2004 - 21%) with 79% of new customers having a proven payment track record. The average Loan to Value ratio ("LTV") of new lending in 2005 so far remained similar to 2004 at around 75% and new lending below 90% LTV was 71% (2004 - 75%) of completions. The average indexed LTV of our mortgage book is now 57% (31 December 2004 - 53%) providing strong cover in the event of default. The slight increase in indexed LTV reflects the slow down in house price inflation. We have minimal exposure to large loans with only around 3.5% of new loans over £500,000 (2004 - 3.5%) and we maintained an excellent geographic spread of lending.

We offer customers a wide range of innovative and attractive products including lifestyle products and traditional price-led products. Our lifestyle products comprise our "together" family of products, Lifetime and residential Buy to Let mortgages. The "together" products combine a secured and unsecured loan at one interest rate and one monthly payment. Gross lending of "together" products amounted to £2.5 billion of which £2.2 billion were advances secured on residential property representing 23.5% of new residential lending, excluding further advances. Outstanding balances of "together" mortgages remained around one fifth of our mortgage portfolio.

Our Lifetime range is aimed at homeowners aged over 60 who wish to utilise equity in their homes to enhance their lifestyle. Such lending accounted for 1.4% of gross new residential lending (2004 - 1.8%), with outstanding Lifetime balances representing 3.0% (31 December 2004 - 3.1%) of our mortgage balances.

Residential Buy to Let lending is focussed on lending to private investors secured on good quality residential properties with low LTVs. Such lending accounted for 4.8% of our mortgage portfolio at 30 June 2005 (31 December 2004 - 4.0%) and for 8.6% (H2 2004 - 7.3%) of gross new residential lending. This type of lending is likely to remain a niche part of our overall portfolio of lending and the professional part of the market is likely to be supported by demand following changes in pension legislation allowing rental properties to be included within investors' pension plans.

In total our lifestyle products, which are margin enhancing, represented 33.5% (2004 - 28.9%) of our gross new residential lending and 26.4% of mortgage balances at 30 June 2005 (31 December 2004 - 25.3%).

Of our traditional price-led mortgage products, fixed rate mortgages remained the most popular with 30.2% (2004 - 46.4%) of total new lending accounted for by short term fixed products up to two years, and 25.6% (2004 - 7.5%) by longer term fixes normally up to a maximum of seven years. The increased demand for longer term fixed rate products reflected attractive pricing as longer term swap rates have fallen.

Unsecured

Our personal unsecured credit portfolios comprise the unsecured element of "together" lending and standalone unsecured loans not linked to a residential mortgage. An analysis of lending volumes on the separate elements of our unsecured portfolios is shown in the following table:

Note

The basis of preparation of statutory, proforma and underlying figures is detailed on page 3

NORTHERN ROCK GROUP INTERIM RESULTS

Lending (continued)

£ millions	Standalone Unsecured	Together Unsecured	Total
2005 First Half			
Gross	761	340	1,101
Net	174	150	324
2004 First Half			
Gross	950	381	1,331
Net	505	156	661
2004 Full Year			
Gross	2,068	724	2,792
Net	1,104	263	1,367

Standalone gross lending has slowed in line with consumer spending and our risk appetite. Net lending has shown further reduction as the portfolio matures and redemptions and repayments increase.

Volumes of “together” unsecured lending remained similar to levels seen in each of the previous half year periods. At 30 June 2005 our unsecured lending balances were £4,997 million (31 December 2004 - £4,660 million) of which 40.6% (31 December 2004 - 40.3%) represented “together” unsecured advances.

Commercial

Competition in the commercial secured lending market has remained strong in the first half of 2005 with certain lenders being particularly aggressive on price and LTV levels at which they are prepared to lend. We have continued to grow our commercial lending portfolio gradually, maintaining our emphasis on quality rather than volume of lending. Gross lending in the first half amounted to £218 million (30 June 2004 - £212 million) with net lending of £31 million (30 June 2004 - £63 million).

Arrears and Possessions

The arrears position of each of our personal lending portfolios based upon accounts three months or more in arrears is set out in the following table:

	Residential	Standalone Unsecured	“Together” Unsecured
30 June 2005	0.35%	1.02%	0.82%
31 December 2004	0.37%	1.04%	0.78%
30 June 2004	0.39%	0.94%	0.80%

The absolute increase in number of residential accounts three months or more in arrears was only 20 cases, less than a 1% movement, compared with a 5% increase in number of accounts. The 0.35% remains well below half the industry average of 0.87% at 30 June 2005 (31 December 2004 - 0.80%). The “together” secured advances performance remained consistent, with three months plus arrears stable at 0.79% at 30 June 2005 (31 December 2004 - 0.77%). At 30 June 2005, 310 properties, representing only 0.05% of all accounts, were in possession compared with 181 (0.03%) at the end of 2004.

Note

The basis of preparation of statutory, proforma and underlying figures is detailed on page 3

NORTHERN ROCK GROUP INTERIM RESULTS

Arrears and Possessions (continued)

Standalone personal unsecured loan arrears remain significantly better than industry average, reflecting our policy of attracting high quality lending and use of our bespoke scorecard to avoid lower quality lending. Unsecured loans within the “together” brand continued to perform in line with the “together” secured advances and better than traditional personal unsecured loans.

At 30 June 2005 only 14 of our commercial loans (0.58% of accounts) with balances outstanding of £5.0 million were three months or more in arrears compared with 8 accounts (0.31%) with outstanding balances of £6.3 million at 31 December 2004.

Funding

Northern Rock has established 4 distinct funding arms enabling it to attract funds from a wide range of customers and counterparties on a global basis. Flows of new funding and closing balances are shown in the following table:

£ millions	Retail	Non-Retail	Securitisation	Covered Bonds
2005 First Half				
Net flow	1,716	(2,245)	6,138	1,025
Closing balances	19,008	17,520	27,706	2,430
2004 First Half				
Net flow	(163)	(1,916)	5,425	1,341
Closing balances	16,232	15,060	20,283	1,339
2004 Full Year				
Net flow	896	2,770	7,234	1,341
Closing balances	17,290	19,740	22,090	1,339

Note: Closing balances at 30 June 2005 are stated including IAS39 fair value adjustments. Net flows in 2005 represent net cashflows excluding fair value adjustments.

Retail

Retail funding comprised a net inflow of funds of £1,457 million plus interest credited of £259 million and builds on the successful funding in the second half of 2004 of over £1.0 billion, again demonstrating the strength and diversity of our retail franchise.

Funding during the six months was largely into our Silver Savings account launched in September 2004 for the over 50s. Fixed rate bonds also remained popular. Balances in our Ireland based operation rose to £804 million (31 December 2004 - £628 million), with £1,812 million (31 December 2004 - £1,871 million) in our Guernsey based off-shore vehicle.

Non-Retail

Our non-retail funding provides a balanced mixture of short and medium term funding with increasing diversification of our global investor base. During the first half we were able to repay £2.2 billion, mainly short term funds, following the successful securitisation issues.

Note

The basis of preparation of statutory, proforma and underlying figures is detailed on page 3

NORTHERN ROCK GROUP INTERIM RESULTS

Non-Retail (continued)

During the first half we raised £1.4 billion medium term wholesale funds, from a variety of sources located globally, with specific emphasis on the US and Europe. This included a US\$1.75 billion Extendible Quarterly Securities issue sold to domestic US investors.

With regards to short term funding, key developments included the establishment of a CAD\$2 billion Canadian Commercial Paper programme which provides access to domestic Canadian investors. This programme had outstanding balances of CAD\$1.0 billion at 30 June 2005.

Securitisation

Funding through securitisation has remained an integral part of Northern Rock's funding strategy. During the first half of 2005 two residential mortgage issues were completed raising £8.6 billion through our Granite vehicles. Diversification of our investor base continued with over 75% of the securitised bonds being issued in US dollars or euros. Further issuance is planned in the second half of 2005, with a second commercial mortgage securitisation raising £600 million already having completed since the half year. The characteristics of the mortgages securitised, in terms of product type, LTV and geographic distribution remain similar to those of our non-securitised mortgages.

The two Granite issues in 2005 were at the lowest spread we have ever achieved and noticeably (around 8 bps) cheaper than the maturing issues they are in part replacing.

At 30 June 2005 advances to customers subject to securitisation amounted to £29.2 billion (31 December 2004 - £21.9 billion), representing 48% (31 December 2004 - 40%) of our total lending portfolios.

Covered Bond

In the first half of 2005 we raised €1.5 billion (£1.03 billion) from a second issue from our €10 billion programme established in 2004. This provided further diversification of the investor base as around 40% of the participants were new to Northern Rock. The covered bond is secured by a pool of ring-fenced residential mortgages which remain on-balance sheet as Northern Rock retains substantially all the risks and rewards associated with the loans.

Assets

Total assets on a statutory and underlying basis (excluding fair value adjustments) are set out in the following table:

£ millions	30 June 2005	30 June 2004	31 December 2004
Statutory	72,460	57,092	64,881
Underlying	71,198	57,092	64,881

On a statutory basis total assets are 11.7% higher than at the previous year end and 26.9% higher than 12 months ago. On an underlying basis growth in total assets was 9.7% and 24.7% respectively.

Treasury

Our Treasury operation continues to raise wholesale funds, manage interest rate and currency risks, and manage a portfolio of investments primarily for liquidity purposes. It is not a separate profit centre and does not operate trading portfolios. At 30 June 2005, 97% (31 December 2004 - 96%) of our Treasury investment portfolios comprised assets which are rated single A or better. We continue to have no exposure to emerging markets or non-investment grade debt.

Note

The basis of preparation of statutory, proforma and underlying figures is detailed on page 3

NORTHERN ROCK GROUP INTERIM RESULTS

Total Income and Margins

The introduction of IFRS in 2005 results in significant changes in the presentation and reporting of interest and non-interest income. Upfront lending fees are now spread over the expected life of a loan and included in interest income resulting in a deferral of reported income. Introducer fees are also now recognised within interest income and spread over the expected life of a loan, rather than the life of the customer relationship, resulting in an acceleration of the recognition of the cost. Mortgage incentives continue to be offset against interest income but are now spread over the expected life of a loan rather than over the early repayment charge period. In addition, following the re-classification of certain instruments from debt to equity, the coupon payable on these instruments is now excluded from interest expense. As these accounting changes were introduced on a statutory basis with effect from 1 January 2005 we have prepared proforma 2004 figures on a comparable basis as well as on the statutory basis.

The following tables show net interest income and total income on a statutory and proforma basis for 2004 and on a statutory and underlying basis (see notes 3 and 4) for 2005.

Statutory basis	6 months ended		Year ended
£ millions	30 June 2005	30 June 2004	31 December 2004
Net interest income	369.3	227.0	466.9
Other income	50.5	113.9	252.3
Total income	419.8	340.9	719.2
Underlying / Proforma basis	6 months ended		Year ended
£ millions	30 June 2005	30 June 2004	31 December 2004
Net interest income	345.0	299.3	612.7
Other income	50.5	50.4	111.8
Total income	395.5	349.7	724.5

On a statutory basis total income in the first half of 2005 amounted to £419.8 million representing an increase of 23.1% over total income in the first half of 2004. On this basis the ratio of total income to mean total assets at 1.22% in the first half compares with the 2004 full year and half year ratios of 1.23% and 1.25%. Total income as a proportion of mean risk weighted assets at 3.59% compares with the 2004 full year and half year ratios of 3.37% and 3.43%.

On an underlying basis total income in the first half of 2005 amounted to £395.5 million representing an increase of 13.1% over proforma total income in the first half of 2004. On this basis the ratio of total income to underlying mean total assets at 1.16% in the first half compares with the 2004 full year and half year ratios of 1.24% and 1.29%. Total income as a proportion of mean risk weighted assets at 3.41% compares with the 2004 full year and half year ratios of 3.43% and 3.56%.

Underlying interest margin at 1.00% in the first half compares with the 2004 full year and half year ratios of 0.82% and 0.85% on a statutory basis and 1.07% and 1.12% on a proforma basis. The proforma basis is considered to be a more appropriate comparator as it is calculated on the same basis as the 2005 figures, including the impact of effective interest rate changes under IFRS. On this basis, interest margin is 7bps lower than the full year in 2004 but only 3bps lower than in the second half last year. During the first half of 2005, 3 month Libor has remained on average 15bps higher than Bank Base Rate compared with 20bps in the second half of 2004 and so has continued to adversely affect the price of our securitisation and non-retail funding. Towards the end of the first half, 3 month Libor, together with swap rates, started to fall such that a positive differential between Bank Base Rate and

Note

The basis of preparation of statutory, proforma and underlying figures is detailed on page 3

NORTHERN ROCK GROUP INTERIM RESULTS

Total Income and Margins (continued)

funding rates currently exists. If this continues in the second half of 2005 this will support spreads as and when the relevant funding re-prices.

At 30 June 2005 the net value of fees deferred to future periods amounts to £268.7 million, compared with £238.2 million at 31 December 2004 and £203.0 million at 30 June 2004 on a proforma basis.

Other income primarily comprises insurance commission generated on sales of building and contents and payment protection insurance together with administration fees not included within interest margin.

Expenses

Total operating expenses amounted to £118.9 million representing an increase of 17.1% over statutory operating expenses of £101.5 million and 18.0% over proforma operating expenses of £100.8 million for the first half of 2004. The increase of 18.0% compares with an increase in underlying assets of 24.7% over the twelve months and a rise in underlying total income of 13.1% on a proforma basis, resulting in a cost to asset ratio of 0.35% (30 June 2004 statutory - 0.37%, proforma - 0.37%) and cost to underlying income ratio of 30.1% (30 June 2004 statutory - 29.8%, proforma - 28.8%). Our performance is in line with achieving around the mid point of our strategic target of cost growth being 1/2 to 2/3rds the rate of growth of assets by the year end.

Included in the 2005 operating expenses are £4.9 million recurring incremental costs in relation to increased regulatory requirements out of an anticipated £10 million for the full year. The first half results also include additional pension scheme and share based costs of £2.3 million arising from the introduction of IFRS.

Social Responsibility - The Northern Rock Foundation

Northern Rock donates 5% of pre tax profit to The Northern Rock Foundation under a deed of covenant. Such donations are used to support community and charitable causes mainly in the North East of England and Cumbria. The covenant from 2005 first half profits amounts to £14.7 million (30 June 2004 - £10.0 million), resulting in over £130 million having been donated since its inception in 1997 as an integral part of Northern Rock's conversion to a plc.

Loan Loss Impairment

Although there are similarities between the bases for making loan loss impairment under UK GAAP and IFRS, the latter is more prescriptive. During the first half of 2005 we have enhanced our loan loss impairment methodologies incorporating risk and performance data captured in and generated by our Basel II capital systems. Following the introduction of the improved methodologies a reassessment of loan loss impairment provisions has been made to closer match the risk profile of our loan portfolios. Following this one-off reassessment, loan loss impairment provisions were reduced by £10.3 million for the residential portfolio and by £9.8 million in our commercial lending portfolio and increased by £20.1 million in respect of our unsecured loans.

Note

The basis of preparation of statutory, proforma and underlying figures is detailed on page 3

NORTHERN ROCK GROUP INTERIM RESULTS

Loan Loss Impairment (continued)

The charge for loan loss impairment amounted to £25.5 million for the first half (30 June 2004 - £26.5 million) representing 0.09% of mean advances to customers (30 June 2004 - 0.12%). The combination of high quality lending, low interest rates, low arrears and continued strong average LTV of the portfolio have continued to contain the levels of loan loss impairment provisions required for residential mortgages. Provisions for the commercial secured lending portfolio have been rebased to levels consistent with portfolio performance and expected economic conditions for this sector.

The growth in loan loss impairment provision balances against our personal credit portfolios reflects growth in balances and the maturing nature of the portfolios. As a result, total loan loss impairment provision balances for these portfolios have increased to £92.7 million with total cover of 1.86% (31 December 2004 - 1.68%).

Hedge Ineffectiveness

Following the introduction of IFRS all derivatives entered into by Northern Rock, which under UK GAAP were held off balance sheet, are now recorded on the balance sheet with any fair value movements being taken to the income statement. Where effective 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 fair value of the underlying instrument being hedged. Any ineffectiveness arising from different movements in fair value will trend to zero over time and so any recorded ineffectiveness in any accounting period is excluded from underlying results in that accounting period.

In addition, Northern Rock enters into certain derivative contracts, which although efficient economically, cannot be included in effective hedge accounting relationships. Consequently, although the implicit interest cost of the underlying instrument and associated derivative are included in net interest income in the income statement, future fair value movements on such derivatives are recorded in "Net hedge ineffectiveness and other fair value gains and losses" on the face of the income statement and are excluded from underlying results as these fair value movements will not be realised in cash terms. The same treatment also applies to the revaluation at each balance sheet date of economically hedged foreign currency liabilities.

The over-riding objective of the presentation of underlying results is to show the true interest income / cost of hedged instruments and to exclude future fair value adjustments from current performance measurement.

In the first half of 2005 the income statement shows "Net hedge ineffectiveness and other fair value gains and losses" as a positive figure of £33.3 million. This increases to £57.6 million positive after the cost of interest implicit in forward exchange contracts is transferred to underlying net interest income.

Having taken powers at the Annual General Meeting to issue preference shares, we are considering the issue of a nominal amount of such shares. This would enable the Upper Tier 2 instruments currently included in equity to be re-classified as liabilities. This would then enable the economic hedges we hold in respect of these instruments to be included in hedge accounting relationships thereby eliminating a significant amount of the hedge volatility recorded in the income statement.

Taxation

The effective tax rate for the first half was 29.3% (30 June 2004 - 28.9%). We continue to anticipate, with a corporation tax rate of 30%, the ongoing effective tax rate will trend towards 30.0% in the medium term.

Note

The basis of preparation of statutory, proforma and underlying figures is detailed on page 3

NORTHERN ROCK GROUP INTERIM RESULTS

Profits and EPS

To aid comparison of the 2005 results with those of 2004 we have prepared 2004 comparatives on a statutory basis and on a proforma basis. In addition, the underlying 2005 results are determined after excluding the effect of hedge accounting ineffectiveness. Details of profit before tax, profit attributable to shareholders and earnings per share on these bases are set out in the following tables:

Statutory basis	6 months ended		Year ended
	30 June 2005	30 June 2004	31 December 2004
PBT £m	294.0	202.2	435.3
Attributable profit £m	188.2	143.7	309.5
EPS p/share	45.5	34.8	74.9
Proforma basis	6 months ended		Year ended
	30 June 2005	30 June 2004	31 December 2004
PBT £m	294.0	211.2	441.5
Attributable profit £m	188.2	135.1	271.2
EPS p/share	45.5	32.7	65.7
Underlying basis	6 months ended		Year ended
	30 June 2005	30 June 2004	31 December 2004
PBT £m	239.2	211.2	441.5
Attributable profit £m	149.4	135.1	271.2
EPS p/share	36.1	32.7	65.7

The reconciliation of 2005 underlying results is set out in note 2 of the Interim Results (page 28 statutory results, page 85 proforma results).

Statutory profit before tax of £294.0 million for the six months ended 30 June 2005 represents an increase of 45.4% over the equivalent statutory figure for 2004 and an increase of 39.2% over the equivalent proforma figure. Statutory profit attributable to shareholders for the first half of 2005 was £188.2 million, an increase of 31.0% over the 2004 statutory result for the same period and 39.3% over the proforma result. Compared with the 2004 first half proforma results, the underlying 2005 profit before tax of £239.2 million represents an increase of 13.3%, with underlying attributable profit rising by 10.6% to £149.4 million.

Return on equity for the first half of 2005 was 24.6% on a statutory basis and 20.6% on an underlying basis compared with 21.1% in the first half of 2004 on a statutory basis and 21.6% on a proforma basis.

Dividends

The proposed interim dividend is 9.4p per share payable on 27 October 2005 to shareholders on the register on 29 September 2005, a 10.6% increase over the 2004 interim dividend of 8.5p.

Note

The basis of preparation of statutory, proforma and underlying figures is detailed on page 3

NORTHERN ROCK GROUP INTERIM RESULTS

Capital

At 30 June 2005 total capital amounted to £3,033 million resulting in a total capital ratio of 12.8%, comfortably above regulatory and internal requirements. Tier 1 capital was £1,953 million and the Tier 1 ratio 8.2%. The restated equivalent ratios at 31 December 2004 on a statutory basis were 14.0% and 8.7% and on a proforma basis were 13.5% and 8.0% respectively.

We intend to be among the first wave of applicants seeking waiver from the FSA enabling us to adopt the Retail Internal Ratings Based approach to Basel II currently anticipated to commence on 1 January 2007. We intend to initially adopt the Standardised Approach to Operational Risk.

Our low risk balance sheet means that we expect to achieve significant reductions to the levels of our total regulatory risk weighted assets for credit exposures compared to current levels. This should result in future capital efficiencies subject to consultation with the FSA and credit rating agencies. We recognise, however, that delays to the approval of relevant European Union legislation could result in delays to the introduction of Basel II.

Within securitisation, whilst there has been transference of risk on a non-recourse basis, we have continued to hold a first loss position. After consultation, we intend this autumn, subject to market conditions, to substantially sell-on (on a non-recourse and on-going basis) the majority of the first loss position. This will substantially further strengthen our capital position.

Outlook

The strong performance in the first half of 2005 together with prospects for the remainder of the year mean that we remain on track to achieve our strategic targets in 2005. Asset growth will be at the top end of our 20% + / - 5% target and underlying attributable profit growth will be at the lower end of our targeted 15% + / - 5% range due to the impacts of IFRS. In the medium term we expect asset and profit growth to trend to the mid points of our strategic targets.

Lending will continue to be focussed on low risk residential lending supplemented by commercial secured and personal credit where returns and risk are appropriate. All our funding portfolios will be further developed helping to ensure we have a secure and diversified funding platform.

The range of attributable profit expectations for 2005, excluding any fair value and hedge accounting gains or losses, as provided by 17 of the major bank research analysts, is £290 million to £312 million, with a mean of £298 million, growth of 10% compared to the 2004 proforma figure. Northern Rock remains comfortable with this consensus mean.

Note

The basis of preparation of statutory, proforma and underlying figures is detailed on page 3

NORTHERN ROCK GROUP INTERIM RESULTS

THIS PAGE LEFT INTENTIONALLY BLANK