

NORTHERN ROCK PLC
PRELIMINARY RESULTS
YEAR ENDED 31 DECEMBER 2005

NORTHERN ROCK GROUP ANNUAL RESULTS

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Introduction

Statutory Results

The 2005 Preliminary Results have been prepared using International Financial Reporting Standards (“IFRS”) as approved by the International Accounting Standards Board that, under European Regulations, are effective or available for early adoption at the Group’s first reporting date under IFRS, 31 December 2005. Certain of these IFRS are only effective from 1 January 2005, and therefore have not been used to restate the 2004 statutory based results. The results included on pages 22 to 38 represent the statutory results of the Group for the year ended 31 December 2005 and include the statutory comparatives reflecting only those standards which permit or require retrospective adoption, reflecting the voluntary exemptions of IFRS1.

Proforma Results

As a result of some IFRS not being required to be implemented until 1 January 2005, 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, included on pages 44 to 57, include the impacts of changes to accounting rules relating to effective interest rate and the reclassification of certain financial instruments from debt to equity, but exclude the effects of hedge accounting under IFRS which differs from that applied under UK GAAP.

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, in addition to the statutory results.

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25 January 2006

Northern Rock plc today issued its Preliminary Results for the year ended 31 December 2005.

HIGHLIGHTS

Operating Performance

- Total underlying assets of £81.1 billion - an increase of 24.9% from December 2004 assets of £64.9 billion. Risk weighted assets grew by 14.2%
- Record gross lending of £26.9 billion - an increase of 15.2%, with record net lending of £14.6 billion - an increase of 12.6%
- Share of UK gross mortgage lending of 8.1% - up from 6.8% in 2004; net share of 14.4% - up from 11.2% in 2004
- 0.39% (31 December 2004 - 0.37%) of mortgage accounts 3 months or more in arrears - under half of industry average
- Record retail savings net intake of £2.8 billion (2004 - £0.9 billion) - over 3 times the total for 2004

Profits

- Underlying pre tax profits of £504.6 million, up by 14.3% compared with 2004 proforma
- Underlying profit attributable to shareholders of £308.1 million, up by 13.6% compared with 2004 proforma
- Statutory pre tax profits (including hedge ineffectiveness) up by 13.5% to £494.2 million

Costs

- Cost to asset ratio improved to 0.34% (from 0.37% in 2004)
- Cost to underlying income ratio improved to 29.8% (from 29.9% proforma in 2004)

Pension Fund

- IAS 19 pension fund deficit substantially eliminated by special contributions made in December 2005 and January 2006 amounting in total to £65.0 million

Shareholder Value

- Underlying return on equity of 20.8% and 19.3% on a statutory basis
- Underlying EPS of 74.3p - an increase of 13.1%
- Final dividend per share of 20.7p - giving a total dividend per share of 30.1p, an increase of 13.6%

Social Responsibility

- The Northern Rock Foundation - supporting charitable causes - to receive £24.7 million

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Adam J Applegarth, Chief Executive, said:

“In 2005, Northern Rock continued to achieve its strategic targets and is well placed to continue to do so. Lending, dominated by low risk residential mortgages, has been strong resulting in underlying total balance sheet assets growing to £81.1 billion, an increase of 24.9%. Underlying pre tax profits rose by 14.3% to £504.6 million, attributable profit grew by 13.6% to £308.1 million and return on equity on the same basis was 20.8%. All this was achieved in a year when income was deferred and cost write-off accelerated under IFRS, meaning 2005 was a year of very good performance.

We do not expect to see a significant deterioration in credit quality going forward. We have low levels of arrears, strong credit risk management and a low risk balance sheet. We have continued to provide, prudently, for loan losses using our Basle II based impairment models.

Capital efficiency and risk management have been enhanced following our innovative Whinstone transaction resulting in the sale of the majority of first loss positions previously held in respect of our pre 2005 securitisations. We expect similar transactions going forward which will mitigate the risk of credit default and enable a closer alignment of regulatory and credit rating levels of capital as Basle II is introduced.

Northern Rock submitted its waiver application for IRB approval before the year end and is well positioned to take advantage of the introduction of Basle II. Our business model remains extremely robust and continues to deliver good shareholder value.”

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OPERATIONAL REVIEW

Introduction

The 2005 Preliminary Results have been prepared using International Financial Reporting Standards ("IFRS") as approved by the International Accounting Standards Board that, under European Regulations, are effective or available for early adoption at the Group's first reporting date under IFRS, 31 December 2005 and 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 having been applied from 1 January 2005. This means that the revised 2004 statutory results only include the impact of certain of the IFRS used in the preparation of the 2005 results. As a consequence we have included, on pages 44 to 57, 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 impact includes 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 accounting for derivatives under IFRS which differs from that applied under UK GAAP.

Full reconciliations of the effect of the introduction of IFRS together with full details of the accounting policies for 2005 will be included in the full 2005 Annual Financial Statements and were included in the Interim Results released on 28 July 2005. The Interim Results are available on the Company's website www.northernrock.co.uk.

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 management's view of underlying performance to be separately identified. Further detail is given on page 14.

Overview

Strong lending volumes continued throughout 2005 resulting in underlying total assets of £81.1 billion at the year end, an increase of 24.9% compared with 31 December 2004. Estimated residential net lending market share at 14.4% for the full year, exceeded both the 11.2% share achieved in 2004 and the 13.5% achieved in the first half of 2005, confirming Northern Rock's ability to achieve growth targets in a competitive mortgage market. Commercial lending and standalone personal unsecured lending grew more slowly reflecting our low appetite for risk. Asset quality also remained robust across all loan portfolios.

The strong performance of our retail funding seen in 2004 and the first half of 2005 continued, resulting in net inflows for the year of £2.8 billion. Our successful securitisation issues raised a net £8.8 billion and contributed further to our capital management. Capital efficiency has also been enhanced by the sale of a significant part of our securitisation vehicles' retained first loss risk in the Whinstone transaction, following which our senior unsecured credit rating outlook was changed from neutral to positive by Standard & Poor's

Profit before tax (underlying) rose by 14.3% and profit attributable to shareholders (underlying) rose by 13.6% from last year - ahead of consensus. Underlying return on equity at 20.8% remained well within our strategic target range of 19% to 22%.

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Lending

During 2005 Northern Rock again achieved record levels of total lending. Total gross lending was £26,879 million, an increase of 15.2% (2004 - £23,342 million), with total net lending of £14,555 million, an increase of 12.6% (2004 - £12,932 million). Prospects for 2006 are good, with a total opening pipeline of £5,300 million (1 January 2005 - £5,105 million) including a residential lending pipeline of £5,005 million (1 January 2005 - £4,891 million). The 2006 opening pipeline reflects a 6% improvement in the time applications remain in the lending pipeline. Improved customer retention reduces the need to grow gross lending significantly as we move towards achieving the centre of our asset growth target range.

The composition of our lending portfolios has continued to be low risk. At 31 December 2005, 90% of our loans to customers were residential secured loans (31 December 2004 - 89%), 2% commercial secured loans (31 December 2004 - 3%) and 8% (31 December 2004 - 8%) within our personal unsecured portfolios. This mix is not expected to change significantly going forward.

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

£ millions	Residential	Commercial	Unsecured	Total
2005				
Gross	23,618	408	2,853	26,879
Net	13,350	5	1,200	14,555
2004				
Gross	20,051	499	2,792	23,342
Net	11,383	182	1,367	12,932

Residential – UK market

The UK residential lending market improved in the second half of 2005 resulting in estimated gross lending for the year of £287 billion, broadly unchanged from the £291 billion recorded in 2004. Gross lending associated with housing transactions and equity withdrawal represents around 55% of lending with 45% driven by remortgage activity. Whilst the former will vary with volumes of home moving transactions and house price inflation, the latter does not due to increased market liquidity following the removal of overhanging early repayment charges. The two components will continue to provide a substantial and robust gross lending market for us to be able to achieve our lending targets. The slow down in the housing transaction market during 2005 has, however, resulted in estimated net lending being down 9% at £92 billion (2004 - £101 billion). UK house prices remained stable throughout 2005. Although the latter part of 2005 saw an increase in housing transactions, we expect 2006 transactions to be similar to those achieved in 2005, with low single digit house price appreciation, in line with the growth in average earnings.

Residential – Northern Rock performance

Against this background, we achieved gross residential lending of £23,618 million (2004 - £20,051 million) and net residential lending of £13,350 million (2004 - £11,383 million), representing increases of 17.8% and 17.3% respectively. Our estimated share of UK gross residential lending for 2005 was 8.1% and our market share of net residential lending was 14.4%. This compares with 8.0% and 13.5% respectively for the first half of 2005, and 6.8% and 11.2% for 2004 in total. Our share of redemptions for the year was 5.2% (2004 - 4.5%), again lower than our closing share of mortgage stock of around 6.4% (31 December 2004 - 5.5%). This reflects the continued success and strengthening of our proactive customer retention process and our fair and transparent policy of allowing existing customers, subject to their contractual terms, to transfer their loan to any product available to new borrowers.

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Lending (continued)

In 2005, 90% of our gross residential lending was originated via the indirect market (2004 - 88%). This reflects the increasing importance of mortgage clubs and networks, with whom we are even more closely aligned following the introduction of statutory mortgage regulation in the last quarter of 2004, and improvements in service levels and access through our on-line trading platform.

The profile of our new lending has remained low risk despite strong growth in volumes. There was a slight increase in the proportion of lending to first time buyers to 24% (2004 - 21%) reflected in increased volumes of “together” lending. 76% (2004 - 79%) of new customers continued to have a proven payment track record. The impact of this trend has been to increase the average Loan to Value ratio (“LTV”) of new lending in 2005 to 78% compared with 76% in 2004. Similarly new lending at or below 90% LTV was 70% (2004 - 77%) of completions. The average indexed LTV of our mortgage book is now 58% (31 December 2004 - 53%) which continues to provide strong cover in the event of default. We have minimal exposure to large loans with only 3.4% of new loans over £500,000 (2004 - 3.5%) and have a good spread of geographic risk.

We offer customers a wide range of innovative and attractive products including lifestyle products and traditional price-led products. Most of our products also have inbuilt flexibility giving customers the opportunity to overpay, make redraws and subject to advance agreement and after a qualifying period, take payment holidays. 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 £7.0 billion of which £6.1 billion were advances secured on residential property representing 28.7% of new residential lending, excluding further advances. Outstanding balances of “together” mortgages have increased to 20.6% of our mortgage portfolio (31 December 2004 - 18.2%).

Our Lifetime range is aimed at homeowners aged 60 and over 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 4.9% of our mortgage portfolio at 31 December 2005 (31 December 2004 - 4.0%) and for 7.1% (2004 - 6.4%) of gross new residential lending.

In total our family of lifestyle products, which are margin enhancing, represented 37.2% (2004 - 28.9%) of our gross new residential lending and 28.5% of mortgage balances at 31 December 2005 (31 December 2004 - 25.3%).

Of our traditional price-led mortgage products, fixed rate mortgages remained the most popular with 25.3% (2004 - 46.4%) of total new lending accounted for by short term fixed rate products up to two years, and 28.8% (2004 - 7.5%) by longer term fixes, normally up to five years. The increased demand for longer term fixed rate products reflected competitive pricing led by attractive longer term swap rates.

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Lending (continued)

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:

£ millions	Standalone Unsecured	Together Unsecured	Total
2005			
Gross	1,970	883	2,853
Net	744	456	1,200
2004			
Gross	2,068	724	2,792
Net	1,104	263	1,367

Standalone unsecured gross lending has slowed in line with the number of borrowers who satisfy our credit score and our risk appetite. Net lending has shown a further reduction as the portfolio matures and redemptions and repayments naturally increase.

Volumes of new “together” unsecured lending increased below the rate of growth of “together” mortgage lending due to the cap of £30,000 on the value of the unsecured element of “together” loans. At 31 December 2005, our unsecured lending balances were £5,789 million (31 December 2004 - £4,581 million) of which 40.0% (31 December 2004 - 40.3%) represented “together” unsecured advances.

Commercial

Competition in the commercial secured lending market remained strong throughout 2005 with certain lenders being particularly aggressive on price and LTV levels at which they are prepared to lend. Both gross and net lending within our commercial lending portfolio slowed as a result of maintaining our emphasis on quality rather than volume of lending. Gross lending in the year amounted to £408 million (2004 - £499 million) with net lending of £5 million (2004 - £182 million).

Arrears and Possessions

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

	Residential	Standalone Unsecured	Together Unsecured	CML Residential Average
31 December 2005	0.39%	0.98%	0.84%	0.87%
31 December 2004	0.37%	1.04%	0.78%	0.80%

Note: CML Residential Average arrears shown at 30 June 2005 and 31 December 2004. Source: Council of Mortgage Lenders.

Residential accounts three months or more in arrears at 0.39% remained well below half the CML residential average of 0.87% at 30 June 2005 (31 December 2004 - 0.80%) and only marginally ahead of the equivalent figure of 0.37% at the end of 2004. The “together” secured three months plus arrears

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Arrears and Possessions (continued)

increased to 0.84% at 31 December 2005 (31 December 2004 - 0.77%) but remained around the CML average for residential lending.

At 31 December 2005, properties in possession had increased to 576, representing only 0.09% of all accounts compared with 181 (0.03%) at the end of 2004 in line with our policy of rapid movement towards recovery where it is clear the borrower is unwilling to maintain payments and where we have higher risk.

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. Three months plus arrears finished the year at 0.98%, below that reported at the half year and at the end of December 2004, although greater collections activity was required compared with 2004. On an industry-wide view indebtedness of customers seems to have stabilised. In our loan portfolios indebtedness has begun to decline and collection activity in the last quarter became a little easier.

At 31 December 2005 only 10 of our commercial loans (0.42% of accounts) with balances outstanding of £5.8 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 four 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				
Net flow	2,809	2,317	8,831	2,378
Closing balances	20,104	22,253	31,156	3,830
2004				
Net flow	896	2,770	7,234	1,341
Closing balances	17,290	19,740	22,090	1,339

Note: Net flow in 2005 represents net cashflows excluding fair value adjustments. Closing balances at 31 December 2005 are stated including fair value adjustments.

Retail

Retail funding comprised a total inflow of funds of £2,809 million, including interest credited of £565 million and builds on the successful funding in the first half of 2005 of £1,716 million, again demonstrating the strength and diversity of our retail franchise. 2005's net inflow represents over three times the net inflow of £896 million achieved in 2004.

Funding during the year was largely into our Silver Savings account for the over 50s, launched in September 2004 and supplemented in 2005 by the introduction of a 30 day notice account. Balances in our Ireland based operation rose 63% to £1,026 million (31 December 2004 - £628 million), with £1,940 million (31 December 2004 - £1,871 million) in our Guernsey based off-shore vehicle.

Closing balances of £20.1 billion represent 65.8% of our non-securitised lending portfolios (31 December 2004 - 52.6%).

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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 repaid net £2.2 billion, mainly short term funds, following securitisation issues. In the second half we raised a net £4.5 billion, leaving a full year net funding of £2.3 billion.

During the year, we raised £2.6 billion medium term wholesale funds from a variety of globally spread sources, with specific emphasis on the US, Europe and Asia. This included a US\$1.75 billion Extendible Quarterly Securities issue sold to domestic US investors and a US\$1.5 billion Floating Rate Notes issue sold in Asia and Europe. In January 2006, we have raised a further US\$2.0 billion Extendible Securities, with over 60% of funds raised from investors new to the Northern Rock Extendible programme.

Key developments in short term funding 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\$850 million at 31 December 2005.

Securitisation

Funding through securitisation has remained an integral part of Northern Rock's funding strategy. During 2005 four residential mortgage-backed issues were completed raising £12.9 billion through our Granite vehicles. The characteristics of the mortgages securitised, in terms of product type, LTV and geographic distribution remain similar to those of our non-securitised mortgages. We continue to diversify our investor base aided by comprehensive global investor roadshows. A second commercial mortgage securitisation (Dolerite) raising £600 million was also completed.

The last Granite issue of 2005 (a £3.75 billion deal) was priced at the lowest spread we have ever achieved, even tighter than previous deals completed in the year and significantly below the cost of older deals being replaced.

Already in 2006 we have completed a £6.0 billion residential mortgage-backed securitisation issue, which was heavily oversubscribed. (Details are set out in a separate Stock Exchange announcement released today - 25 January 2006.)

At 31 December 2005 advances to customers subject to securitisation amounted to £39.1 billion (31 December 2004 - £21.9 billion), representing 56% (31 December 2004 - 40%) of our total lending portfolios.

Covered Bonds

In 2005 we raised €3.5 billion (£2.4 billion) from two further issues from our €10 billion covered bond programme established in 2004. This provided further ongoing diversification of the investor base. The second transaction raised funds with a maturity of 15 years priced at mid swaps plus 11bps helping to lower the average cost of new funding. The covered bonds are secured by a pool of ring-fenced residential mortgages. The credit risks associated with these loans have subsequently been transferred into the capital markets by means of synthetic securitisation transactions (Graphite) providing further capital benefits.

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Assets

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

£ millions	31 December 2005	31 December 2004
Statutory	82,709	64,881
Underlying	81,057	64,881

On an underlying basis total assets are 24.9% higher than at the previous year end and on a statutory basis have increased by 27.5%.

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 31 December 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.

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 comparable 2004 figures on a proforma basis as well as on the statutory basis.

The following table shows net interest income and total income on a statutory and proforma basis for 2004 and on a statutory (excluding hedge ineffectiveness) and underlying basis (see notes 3 and 4) for 2005.

£ millions	Statutory 2005	Underlying 2005	Statutory 2004	Proforma 2004
Net interest income	752.3	706.8	466.9	612.7
Other income	129.0	129.0	252.3	111.8
Total income	881.3	835.8	719.2	724.5

On a statutory basis, total income in 2005 amounted to £881.3 million (excluding hedge ineffectiveness) representing an increase of 22.5% over statutory total income in 2004. On this basis the ratio of total income to mean total assets at 1.19% compares with the 2004 ratio of 1.23%. Total income as a proportion of mean risk weighted assets at 3.34% compares with the 2004 ratio of 3.37%.

On an underlying basis total income in 2005 amounted to £835.8 million representing an increase of 15.4% over proforma total income in 2004. On this basis, the ratio of total income to underlying mean total assets at 1.15% compares with the 2004 ratio of 1.24%. Total income as a proportion of mean risk weighted assets at 3.41% compares with the 2004 ratio of 3.43%.

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Total Income and Margins (continued)

Underlying interest margin at 0.97% compares with the 2004 ratio of 0.82% on a statutory basis and 1.07% 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 for 2005 is 10bps lower than the full year in 2004 but only 3bps lower than in the first half of 2005. During 2004, 3 month Libor was on average 26bps higher than Bank Base Rate. Although this differential reduced to 11bps on average during 2005, there continued to be an adverse effect on the price of our Libor related funding.

At 31 December 2005, the net value of fees deferred to future periods amounted to £292.0 million, compared with £238.2 million at 31 December 2004 on a proforma basis. This deferred income returns to the income statement over the life of loans, reducing the future dependence of income growth on volume growth.

Other income primarily comprises commission generated on sales of third party products such as building and contents and payment protection insurance together with administration fees not included within interest margin. During 2005, we improved our product range and sales process for payment protection insurance. By offering a wider range of products which better match customer needs and by lowering prices we have arranged better protection to more customers.

Expenses

Total operating expenses amounted to £249.4 million representing an increase of 14.2% over statutory operating expenses of £218.3 million and 15.0% over proforma operating expenses of £216.9 million for 2004. The increase of 15.0% compares with an increase in underlying assets of 24.9% over the year and a rise in underlying total income of 15.4%, resulting in a cost to asset ratio of 0.34% (2004 statutory - 0.37%, proforma - 0.37%) and a cost to underlying income ratio of 29.8% (2004 statutory - 30.4%, proforma - 29.9%).

At the half year stage the cost to underlying income ratio had risen to 30.1% as a result of incremental regulatory costs being incurred in the first half of 2005 with no corresponding cost in the equivalent period in 2004. In the second half of 2005, underlying income growth of 17.5%, compared with the second half of 2004, exceeded cost growth of only 12.4%, resulting in a 2005 second half cost to underlying income ratio of 29.6%.

Included in the 2005 operating expenses are approximately £10 million of recurring incremental costs (2004 - £3.6 million) in relation to the full year impact of increased regulatory requirements. These have been absorbed in our cost base and so going forward we expect the rate of cost growth to slow, cost growth to be at the bottom end of the one half to two thirds of asset growth range and income growth to exceed cost growth.

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 profits amounts to £24.7 million (31 December 2004 - £21.6 million), resulting in approximately £145 million having been donated since its inception in 1997 as an integral part of Northern Rock's conversion to a plc.

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Loan Loss Impairment

Although there are similarities between the bases for determining loan loss impairment provisions under UK GAAP and IFRS, the latter is more prescriptive. In 2005, we enhanced our loan loss impairment methodologies incorporating risk and performance data captured in and generated by our Basle II capital systems. As stated at the half year stage, following the introduction of the improved methodologies, a reassessment of loan loss impairment provisions was made to reflect more accurately 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.

The 2005 charge for loan loss impairment amounted to £56.6 million (2004 - £48.5 million) representing 0.09% of mean advances to customers (2004 - 0.10%). 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 are consistent with portfolio performance and economic conditions for this sector.

The growth in loan loss impairment provision balances against our personal unsecured 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 £87.1 million (31 December 2004 - £78.4 million) with total cover of 1.48% (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 at full fair value 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 the 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, fair value movements of future cashflows on such derivatives are recorded in "Net hedge ineffectiveness and other unrealised fair value gains and losses" on the face of the income statement and are excluded from underlying results as these fair value adjustments are not realised in the current accounting period. 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 underlying interest income / expense of hedged instruments and to exclude future fair value adjustments from current performance measurement.

In 2005, the income statement shows "Net hedge ineffectiveness and other unrealised fair value gains and losses" as a negative figure of £56.4 million. This reduces to £10.9 million negative after the cost of interest implicit in forward exchange contracts is transferred to underlying net interest income. At 30 June 2005 the equivalent figures were £33.3 million positive and £57.6 million positive respectively.

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Taxation

The effective tax rate in 2005 was 29.3% (2004 - 28.9%). We continue to anticipate, with a corporation tax rate of 30% and HMRC's stance on tax planning, that the ongoing effective tax rate will trend towards 30.0% in the medium term.

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, management's view of the underlying 2005 results is also presented. Details of profit before tax, profit attributable to shareholders and earnings per share on these bases are set out in the following table:

	Statutory 2005	Underlying 2005	Statutory 2004	Proforma 2004
PBT £m	494.2	504.6	435.3	441.5
Attributable profit £m	300.7	308.1	309.5	271.2
EPS p/share	72.5	74.3	74.9	65.7

The reconciliation between 2005 statutory and underlying results is set out in note 2 of the Preliminary Results (page 28 statutory results, page 48 proforma results).

Underlying 2005 profit before tax of £504.6 million represents an increase of 14.3% over 2004 proforma profit before tax, with underlying attributable profit rising by 13.6% to £308.1 million. Compared with the 2004 statutory results, 2005 statutory profit before tax of £494.2 million represents an increase of 13.5% over the equivalent figure for 2004 and an increase of 11.9% over the 2004 proforma figure

Return on equity for 2005 was 20.8% on an underlying basis and 19.3% on a statutory basis compared with 20.9% in 2004 on a proforma basis and 21.6% on a statutory basis.

Whinstone Transaction

In November 2005, Northern Rock completed its first Whinstone transaction transferring around 80% of the reserve fund risk relating to pre 2005 Granite residential mortgage securitisations to third party investors, therefore reducing the potential exposure to downturn credit risk. The transaction reduces the level of core capital required under credit rating assessments of required capital as well as the regulatory capital deduction in respect of the reserve funds, thereby enhancing capital efficiency and more closely aligning regulatory and credit rating capital; an important step in advance of Basle II. By retaining a small portion of the first loss, Northern Rock continues to align the interests of securitisation investors and the Company and demonstrates its confidence in the credit performance of the mortgage portfolios.

Net interest income, total income and pre tax profits were affected by the interest cost of this transaction for two months in 2005 and will be affected on a full year basis thereafter. This additional cost will be largely offset by savings in appropriations due to not having to raise subordinated debt to support securitisation capital deductions. Underlying attributable profits will therefore not be significantly affected by this transaction.

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Whinstone Transaction (continued)

Following the announcement of the transaction Standard & Poor's changed the Northern Rock senior unsecured credit rating outlook from neutral to positive. The £423 million transaction, included within securitised notes in issue, is by far the largest transaction of its type ever completed in the international markets and has been awarded European Securitisation deal of the year by IFR magazine. It is our intention to continue to utilise this type of transaction on an ongoing basis.

Dividends

In line with our dividend policy of a payout ratio of approximately 40% of sustainable underlying attributable profits, cover of 2.5 times, the proposed final dividend is 20.7p per share payable on 26 May 2006 to shareholders on the register on 28 April 2006. This, combined with the interim dividend of 9.4p, results in a total dividend for 2005 of 30.1p per share, an increase of 13.6% over the 2004 total dividend of 26.5 pence per share.

Capital

At 31 December 2005, total capital amounted to £3,224 million resulting in a total capital ratio of 12.3%, comfortably above regulatory and internal requirements. Tier 1 capital was £2,033 million and the Tier 1 ratio 7.7%. 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.

In December 2005, we submitted our application seeking waiver from the FSA to permit us to adopt the Retail Internal Ratings Based approach to Basle II, which is planned 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 in the levels of our total regulatory risk weighted assets for credit exposures compared to current levels. This should result, subject to consultation with the FSA and credit rating agencies, in future capital efficiencies. In the first three years of the operation of Basle II, transitional arrangements will apply such that any capital relief will be introduced gradually with a potential maximum 20% reduction in capital by the end of the transition period.

Pension Fund

Whilst almost fully funded on an actuarial basis, the average deficit of the Northern Rock Pension Fund throughout 2005 using the IAS19 basis of calculation was £65.0 million. At the end of 2005, this deficit would have grown to around £74.4 million without corrective action, reflecting in particular volatility arising from the use of point in time assumptions about return on assets and discount rates. The defined benefit element of the fund is a closed fund, and as we get closer to the end of the fund's life, the IAS19 deficit will become realised. Consequently, we have decided to eliminate the average 2005 deficit. This has been achieved by an initial additional contribution of £20.0 million in December 2005, with the balance of £45.0 million paid in January 2006.

As a result of the above, the IAS 19 deficit at 31 December 2005 is £54.4 million, which reduces by £45.0 million to £9.4 million after the payments made in January 2006. The impact of these contributions will be minimal on the Group's earnings but will reduce the risk of significant increases in pension cost in the future.

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Outlook

We expect UK gross residential lending in 2006 to be similar to 2005 at around £300 billion, underpinned by a stable housing market and sustained remortgage activity. Economic conditions will remain fundamentally supportive, with interest rates remaining low during 2006.

Following two years of growth of assets at the top of our strategic range of 20% +/- 5% we intend that over the next two to three years the rate of growth of assets will move to the centre of the range, assisting both operational and capital efficiency. Also as income deferred under IFRS is recognised in the income statement and margins stabilise we expect to see underlying earnings growth move back to at least the centre of our strategic range of 15% +/- 5%. Our strategic target for return on equity of 19% to 22% is also confirmed.

Cost efficiency ratios should continue to improve as cost growth returns to below income growth and at the lower end of the target of one half to two thirds of asset growth despite continuing our usual policy of investing in new infrastructure for the future.

Risk management and credit quality remains paramount to Northern Rock's business, which will remain dominated by good quality prime residential mortgages. Whilst the extremely benign credit conditions of the last few years are unlikely to continue they are not expected to deteriorate significantly. This, together with increased focus on arrears management and sound provisioning policies, should ensure that loan loss impairment provisions will not increase markedly.

Capital efficiency will continue to benefit from further sales of securitisation reserve fund risk and in the future by the reduction in capital risk weightings under Basle II.

Our business model remains on track to deliver all of our strategic targets in terms of asset and profit growth, returns on equity and cost efficiency. This will benefit employees, customers and shareholders.