

AIRE VALLEY MORTGAGES 2007-2 PLC

Directors' Report and Financial Statements

Registered number: 6374633

31 December 2011

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Directors' Report and Financial Statements

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Company Information

Directors

Phillip Alexander McLelland
SFM Directors Limited
SFM Directors (No 2) Limited

Company Secretary

SFM Corporate Services Limited

Registered Office

35 Great St Helen's
London
EC3A 6AP

Independent auditors

PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Benson House
33 Wellington Street
Leeds
LS1 4JP

Directors' Report for the year ended 31 December 2011**Registered number** 6374633

The Directors present their Report and the audited Financial Statements for the year to 31 December 2011

Ownership and control

Aire Valley Mortgages 2007-2 plc (the Company) is a public limited liability company incorporated and domiciled in the United Kingdom. The Company is a subsidiary of Aire Valley Holdings Limited, a private limited liability company incorporated and domiciled in the United Kingdom.

Aire Valley Holdings Limited holds one £1 fully paid share and 49,998 quarter paid up ordinary shares in the Company. One £1 ordinary fully paid share is held by SFM Nominees for the benefit of Aire Valley Holdings Limited.

On 1 October 2010 UK Asset Resolution Limited ('UKAR') was established as the holding company for Northern Rock (Asset Management) plc ('NRAM') and Bradford & Bingley plc ('B&B'), bringing together the two brands under shared management and a common Board of Directors.

Principal activities

The Company's principal activity is to issue debt securities and to enter into financial arrangements to fund the activities of certain subsidiaries of Aire Valley Holdings Limited and ultimately UKAR by means of intercompany loans. The debt securities were originally issued in Euros and Sterling and are secured on a beneficial interest in a portfolio of mortgage loans originated by the B&B Group and held under a Master Trust arrangement by Aire Valley Trustee Limited. These mortgage loans are secured on residential property in the UK. Details are set out in the offering circular pertinent to this issuance. In November 2007, £1,156.3m of loan notes denominated in Euros and Sterling were issued to purchase a £1,156.3m share in the Master Trust. £175.8m loan notes were redeemed in October 2008 and a total of £11.8m notes were redeemed in 2009. In October 2010, £2.4m loans were redeemed, £7.3m were redeemed in January 2010, £6m in April 2010, and a further £7m were redeemed in January 2011, £6m were redeemed in April 2011, £6m in July 2011 and £7m in October 2011. At the exchange rates at issue as at 31 December 2011, £940.3m (2010: £966.3m) loan notes in. Subsequent to the year end, a further £200m loan notes were redeemed in April.

In September 2009, as a result of (i) the rate of early redemption of the loans in the mortgage pool being lower than had been anticipated at the time of issue of the loan notes and (ii) the occurrence of the step-up event, amounts due and payable under certain series of notes that fell to be redeemed in accordance with specified controlled amortisation schedules began to be repaid on a pass-through basis (such notes being the 'Affected Controlled Amortisation Notes'). This Company has no Affected Controlled Amortisation Notes.

Business review

The profits of the Company are pre-determined under the terms of the issue documentation. The results for the year are shown in the Statement of Comprehensive Income on page 9. The loss after taxation was £772,000 (2010: profit £1,604,000). Fair value movements of a loss of £968,000 (2010: £2,017,000 gain) arose due to the movements in interest rates and exchange rates over the course of the year. This fair value loss is a timing effect only, which will reverse, and does not have cash implications. The Company has met all its obligations under the terms of the issue documentation.

In April 2011, all of the Company's remaining Euro-denominated floating rate notes were redenominated into sterling at their original exchange rate, and all of the Company's derivatives were transferred at nil value to B&B, the holder of the redenominated notes. The Company made no material net profit or loss on the combined transaction.

As described in note 16, on 10 May 2012 a non-asset trigger event occurred. This will affect the timing of future redemptions of the loan notes in issue.

Key performance indicators

The key performance indicators used by management in assessing the performance of the Company are actual cash flows against planned cash flows and the credit ratings assigned to the loan notes. The performance of the Company is addressed in the monthly trustee reports to investors. Certain of the Company's debt securities in issue were downgraded during the year and subsequent to the year end.

Some of the key performance indicators of the mortgage pool of the Master Trust are:

		2011	2010
Number of outstanding mortgage loans	No.	87,771	90,841
Outstanding mortgage loans	£bn	10.9	11.3
Number of mortgage loans 3 months or more in arrears	No.	1,578	2,553
Principal value of mortgage loans 3 months or more in arrears	£m	234.2	385.9
Arrears value of mortgage loans 3 months or more in arrears	£m	6.4	12.0
Mortgage loans in repossession	No.	98	136
Mortgage loans in repossession	£m	15.5	19.1
Weighted average indexed current LTV	%	84.6	83.8

Future developments

The Directors expect that during 2012 the Company will continue to meet the interest payments on the notes. At the present time the Directors do not foresee any changes in the Company's activities.

As described in note 16, on 10 May 2012 a non-asset trigger event occurred. This will affect the timing of future redemptions of the loan notes in issue.

Dividend

No dividends were paid during the year (2010: £nil), and the Directors do not recommend the payment of a final dividend for the year (2010: £nil).

Payment policy

Standard terms provide for payment of all invoices within 30 days of invoice date, except where different arrangements have been agreed with suppliers. It is the policy of the Company to abide by the agreed payment terms.

Directors' Report for the year ended 31 December 2011 (continued)

Registered number 6374633

Directors

The Directors who served during the year and up to the date of signing the Financial Statements were as follows

Phillip Alexander McLelland
SFM Directors Limited
SFM Directors (No 2) Limited

Mr McLelland, SFM Directors Ltd and SFM Directors (No 2) Limited are also directors of Aire Valley Holdings Limited. None of the Directors had any interest in the share capital of Aire Valley Holdings Ltd during the year. None of the Directors had an interest in the share or loan capital of B&B or in any of its subsidiary undertakings. Mr McLelland is a director of B&B.

Disclosure of information to auditors

The Directors who held office at the date of approval of this Directors' Report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditors are unaware, and each Director has taken all the steps that he ought to have taken as a Director to make himself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions section of the Companies Act 2006.

Risk management and control

In the ordinary course of business the Company is exposed to and manages, a variety of risks, with credit risk, liquidity risk, currency risk and interest rate risk being of particular significance. The Directors have responsibility for the overall system of internal control and for reviewing its effectiveness. In general, when a transaction or group of transactions is entered into, derivative instruments are taken out to manage the associated risks. The effectiveness of the risk management is then monitored on an ongoing basis. Details of the Company's risks and their management and control are provided in note 11, and further discussion in the context of the B&B Group as a whole is provided on pages 10-13 of the B&B Group's 2011 Annual Report & Accounts, which do not form part of this Report and Financial Statements.

The Company has entered into contracts with a number of third parties to provide operational support including corporate service providers, paying agents and swap providers. B&B acts as bank account and cash manager. The Company's operations are subject to periodic review by the B&B internal audit department.

The issue documentation also sets out a number of business risks through a number of asset and non asset trigger events. The occurrence of trigger events could lead to early redemption of the floating rate notes.

As described in note 16, on 10 May 2012 a non-asset trigger event occurred. This will affect the timing of future redemptions of the loan notes in issue.

Corporate governance

The Directors have been charged with governance in accordance with the transaction documents describing the structure and operation of the transaction. The structure of the Company is such that the key policies have been predetermined at the time of issuance and the operational roles have been assigned to third parties with their roles strictly governed by the transaction documents.

The transaction documents provide for procedures that have been designed for safeguarding assets against unauthorised use or disposition, for maintaining proper accounting records, and for the reliability and usefulness of financial information used within the business or for publication. Such procedures are designed to manage rather than eliminate the risk of failure to achieve business objectives whilst enabling them to comply with the regulatory obligations.

Due to the nature of the securities which have been issued, the Company is exempt from the requirements of Disclosure and Transparency Rules 7.1 audit committees and 7.2 Corporate governance statements, which would otherwise require the Company respectively to have an audit committee in place and include a corporate governance statement in the Directors' Report. The Directors are therefore satisfied that there is no requirement for an audit committee or a supervisory body entrusted to carry out the functions of an audit committee or to publish a corporate governance statement.

Political and charitable contributions

During the year no political or charitable contributions were made (2010: £nil).

Directors' Report for the year ended 31 December 2011 (continued)

Registered number 6374633

Third party indemnities

Qualifying third party indemnity provision for the benefit of the Directors was in force during the year under review and remains in force as at the date of approval of the Directors' Report and Financial Statements

Independent auditors

During the year KPMG Audit Plc resigned as auditor to the Company, and the Directors have appointed PricewaterhouseCoopers LLP ('PwC')

In accordance with the Companies Act 2006 a resolution for the re-appointment of PwC as auditor of the Company will be proposed at the forthcoming Annual General Meeting

By order of the Board



Helena Whitaker
per pro SFM Corporate Services Limited
Company Secretary

25 June 2012

Statement of Directors' Responsibilities in respect of the Directors' Report and Financial Statements

The Directors are responsible for preparing the Directors' Report and the Financial Statements in accordance with applicable law and regulations

Company law requires the Directors to prepare Financial Statements for each financial year. Under that law the Directors have prepared the Financial Statements in accordance with International Financial Reporting Standards ('IFRS') as adopted by the European Union ('EU'). Under company law the Directors must not approve the Financial Statements unless they are satisfied that they give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing these Financial Statements, the Directors are required to

- select suitable accounting policies and then apply them consistently,
- make judgements and accounting estimates that are reasonable and prudent,
- state whether applicable IFRS as adopted by the EU have been followed, subject to any material departures disclosed and explained in the Financial Statements,
- prepare the Financial Statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the Financial Statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Independent Auditor's Report to the members of Aire Valley Mortgages 2007-2 plc

We have audited the Financial Statements of Aire Valley Mortgages 2007-2 plc for the year ended 31 December 2011 which comprise the Statement of Comprehensive Income, the Balance Sheet, the Statement of Changes in Equity, the Cash Flow Statement and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRS) as adopted by the European Union.

Respective responsibilities of directors and auditors

As explained more fully in the Statement of Directors' Responsibilities set out on page 7, the Directors are responsible for the preparation of the Financial Statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the Financial Statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Company's members as a body in accordance with Chapter 3 of part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the audit of the Financial Statements

An audit involves obtaining evidence about the amounts and disclosures in the Financial Statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the Company's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates made by the Directors, and the overall presentation of the Financial Statements. In addition, we read all the financial and non-financial information in the Directors' Report to identify material inconsistencies with the audited Financial Statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on the Financial Statements

In our opinion the Financial Statements

- give a true and fair view of the state of the Company's affairs as at 31 December 2011 and of its loss and cash flows for the year then ended,
- have been properly prepared in accordance with IFRS as adopted by the European Union, and
- have been prepared in accordance with the requirements of the Companies Act 2006

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the Financial Statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us, or
- the Financial Statements are not in agreement with the accounting records and returns, or
- certain disclosures of Directors' remuneration specified by law are not made, or
- we have not received all the information and explanations we require for our audit.



Mark Hannam (Senior Statutory Auditor)

For and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors

Leeds

25th June 2012

Statement of Comprehensive Income for the year ended 31 December

	<i>Note</i>	2011 £000	2010 £000
Interest receivable and similar income	2	18,203	16,234
Interest expense and similar charges	3	(18,160)	(16,198)
Net interest income		<u>43</u>	<u>36</u>
Operating expenses	4	(41)	(33)
Fair value movements	11(e)	(968)	2,017
(Loss)/profit before taxation		<u>(966)</u>	<u>2,020</u>
Taxation	5	194	(416)
(Loss)/profit for the financial year		<u>(772)</u>	<u>1,604</u>
Other comprehensive income for the financial year		-	-
Total comprehensive (expense)/income for the financial year		<u>(772)</u>	<u>1,604</u>

The Company's business and operations comprise one single activity in the United Kingdom, and the Company has only one operating segment for the purpose of IFRS 8 'Operating Segments'. The results above arise from continuing activities and are attributable to the equity shareholder.

The notes on pages 13 to 26 form an integral part of these Financial Statements

Balance Sheet as at 31 December**Registered number: 6374633**

	<i>Note</i>	2011 £000	2010 £000
Assets			
Loans to Group undertakings	8	944,121	969,640
Derivative financial instruments	11(e)	-	73,923
Total non-current assets		944,121	1,043,563
Cash and cash equivalents		14	14
Current tax assets		2	3
Total current assets		16	17
Total assets		944,137	1,043,580
Liabilities			
Deferred tax liabilities	5	-	194
Interest-bearing loans and borrowings	7	940,293	1,038,728
Total non-current liabilities		940,293	1,038,922
Interest-bearing loans and borrowings	7	3,819	3,861
Total current liabilities		3,819	3,861
Total liabilities		944,112	1,042,783
Equity			
Capital and reserves attributable to equity holders			
Share capital	12	13	13
Retained earnings		12	784
Total attributable equity		25	797
Total equity and liabilities		944,137	1,043,580

The notes on pages 13 to 26 form an integral part of these Financial Statements

The Financial Statements were approved by the Board of Directors and authorised for issue on 25 June 2012 and signed on its behalf by


Helena Whitaker
 per pro SFM Directors Limited
 As Director

25 June 2012

Statement of Changes in Equity for the year ended 31 December

	Share capital £000	Retained earnings £000	Total equity £000
At 1 January 2011	13	784	797
Total comprehensive expense for the financial year	-	(772)	(772)
At 31 December 2011	<u>13</u>	<u>12</u>	<u>25</u>

	Share capital £000	Retained earnings £000	Total equity £000
At 1 January 2010	13	(820)	(807)
Total comprehensive income for the financial year	-	1,604	1,604
At 31 December 2010	<u>13</u>	<u>784</u>	<u>797</u>

Cash Flow Statement for the year ended 31 December

	2011 £000	2010 £000
Cash flows from operating activities		
(Loss)/ profit before tax	(966)	2,020
<i>Adjustments for</i>		
Interest on loans to Group undertakings	(18,203)	(16,234)
Interest on floating rate notes	18,163	16,017
Swap interest	(134)	(122)
Fair value movements	968	(2,017)
Amortisation of issue costs	131	303
Cash flows used in operating activities before changes in operating assets and liabilities	(41)	(33)
<i>Net decrease in operating assets</i>		
Loans to Group undertakings	25,519	1,486
Cash generated by operations	25,478	1,453
Taxation received/(paid)	1	(2)
Net cash generated from operating activities	25,479	1,451
<i>Cash flows from financing activities</i>		
Interest received on loans to Group undertakings	18,203	16,234
Interest paid on floating rate notes	(18,205)	(15,064)
Swap interest received/(paid)	527	(199)
Repayment of floating rate notes	(26,004)	(2,422)
Net cash used in financing activities	(25,479)	(1,451)
Net movement in cash and cash equivalents	-	-
Cash and cash equivalents at beginning of year	14	14
Cash and cash equivalents at end of year	14	14
Cash at bank	14	14

All cash is deposited with a third party bank with a credit rating of A or above

Notes to the Financial Statements for the year ended 31 December 2011**1 Principal accounting policies**

Aire Valley Mortgages 2007-2 plc ('the Company') is a public limited liability company incorporated and domiciled in the United Kingdom

(a) Statement of Compliance

The Company's Financial Statements have been prepared and approved by the Directors in accordance with International Financial Reporting Standards as adopted by the EU ('adopted IFRS')

For these 2011 Financial Statements, including the 2010 comparative financial information where applicable, the Company has adopted for the first time the following statements

- The November 2009 amendments to IAS 24 'Related Party Disclosures', which clarified the disclosure requirements for Government-related entities and was effective from 1 January 2011
- The October 2010 amendments to IFRS 7 'Financial Instruments Disclosures' regarding enhancement of disclosures of transfers of financial assets

For these 2011 Financial Statements the Company has not adopted the following statements

- IFRS 9 'Financial Instruments', sections of which have been issued as part of the International Accounting Standard Board's ('IASB's') project to replace IAS 39 'Financial Instruments Recognition and Measurement', and the associated amendments to IFRS 7. These statements are expected to be mandatory for 2015 Financial Statements, with 2014 comparative information, but have not yet been adopted for use in the EU
- IFRS 13 'Fair Value Measurement'. This statement is expected to be mandatory for 2013 Financial Statements, with 2012 comparative information, but has not yet been adopted for use in the EU
- The December 2010 amendments to IAS 12 'Income Taxes' relating to 'Deferred Tax Recovery of Underlying Assets'. This amendment is expected to be mandatory for 2012 Financial Statements, with 2011 comparative information, but has not yet been adopted for use in the EU
- The June 2011 amendments to IAS 1 'Presentation of Financial Statements' relating to 'Presentation of Items of Other Comprehensive Income'. This statement is expected to be mandatory for 2013 Financial Statements, with 2012 comparative information, but has not yet been adopted for use in the EU
- The December 2011 amendments to IFRS 7 and IAS 32 'Financial Instruments Presentation' relating to the offsetting of financial assets and financial liabilities. This statement is expected to be mandatory for 2013 Financial Statements, with 2012 comparative information, but has not been adopted for use in the EU

All other new standards, amendments to standards and interpretations are not considered relevant to and have no impact upon the Financial Statements of the Company

(b) Basis of preparation

The Financial Statements are presented in pounds sterling, which is the currency of the Company's primary operating environment, and on a going concern basis. The Financial Statements are prepared on the historical cost basis except for financial instruments classified as 'at fair value through profit or loss'.

The Directors consider that the accounting policies set out in this note are the most appropriate to the Company's circumstances, have been consistently applied to the Company in dealing with items which are considered material and are supported by reasonable and prudent estimates and judgements.

Judgements made by the Directors in the application of these accounting policies that have a significant effect on the Financial Statements and estimates with a significant risk of material adjustment in the next year are discussed in note 10.

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

The Financial Statements have been prepared in accordance with EU adopted IFRS, IFRIC interpretations issued by the IFRS Interpretations Committee (formerly the International Financial Reporting Interpretations Committee) and with those parts of the Companies Act 2006 applicable to companies reporting under IFRS. A summary of accounting policies is set out below. The preparation of the Financial Statements in conformity with these accounting policies and generally accepted accounting principles requires the use of estimates and assumptions that affect the reported values of assets and liabilities at the date of the Financial Statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management's best knowledge of the amounts, event or actions, actual results ultimately may differ from those estimates (see note 10).

Notes to the Financial Statements for the year ended 31 December 2011 (continued)**I Principal accounting policies (continued)****(c) Interest income and expense**

For all interest-bearing financial instruments except derivatives interest income and expense are recognised in the Statement of Comprehensive Income on an Effective Interest Rate ('EIR') basis

The EIR method calculates the amortised cost of a financial asset or financial liability and spreads the resulting interest income or interest expense on a level yield basis over the expected life of the instrument. The EIR is the rate which at the inception of the instrument exactly discounts expected future cash flows over the expected life of the instrument to the initial carrying amount. When calculating the EIR, future cash flows are estimated, considering all contractual terms of the instrument (for example prepayment options), but potential future credit losses are not considered. The calculation includes all directly attributable incremental fees and costs, premia on acquisition of mortgage portfolios and all other premia and discounts as well as interest.

When a financial asset or a group of similar financial assets is written down as a result of an impairment loss interest income continues to be recognised by applying the applicable EIR to the reduced balance

(d) Taxation**(i) Current tax**

The charge for taxation is based on the result for the year and takes into account taxation deferred or accelerated arising from temporary differences between the carrying amounts of certain items for taxation and for accounting purposes. Tax relating to items which are taken directly to reserves is also taken directly to reserves.

(ii) Deferred tax

Deferred tax is calculated using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the Financial Statements. Deferred tax is determined using tax rates and laws that have been enacted or substantively enacted by the Balance Sheet date and are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled. The principal temporary differences arise from unrealised fair value movements.

Deferred tax assets are recognised only when it is probable that future taxable profits will be available against which these temporary differences can be utilised.

(e) Cash and cash equivalents

For the purposes of the Cash Flow Statement, cash and cash equivalents comprise balances which had an original maturity of three months or less.

(f) Floating rate notes

On initial recognition, debt issued is measured at its fair value net of directly attributable transaction costs and discounts. Subsequent measurement is at amortised cost using the Effective Interest Rate ('EIR') method to amortise incremental attributable issue and transaction costs, premia and discounts over the life of the instrument. These costs are charged along with interest on the debt to 'interest expense and similar charges'. Unamortised amounts are added to or deducted from the carrying value of the instrument. The carrying value of floating rate notes which are effectively hedged is adjusted by the change in fair value of the hedged risk.

(g) Classification of financial instruments

In accordance with IAS 39 each financial asset is classified at initial recognition into one of four categories:

- (i) Financial assets at fair value through profit or loss,
- (ii) Held-to-maturity investments,
- (iii) Loans and receivables, or
- (iv) Available-for-sale,

and each financial liability into one of two categories:

- (v) Financial liabilities at fair value through profit or loss, or
- (vi) Other liabilities

Measurement of financial instruments is either at amortised cost (categories (ii), (iii) and (vi) above) or at fair value (categories (i), (iv) and (v) above), depending on the category of financial instrument.

Notes to the Financial Statements for the year ended 31 December 2011 (continued)**1 Principal accounting policies (continued)****(g) Classification of financial instruments (continued)**

The company does not carry any assets at fair value other than derivative financial instruments

Amortised cost is the amount measured at initial recognition, adjusted for subsequent principal and other payments, less cumulative amortisation calculated using the EIR method, the amortisation is taken to interest income or expense depending on whether the instrument is an asset or liability. The amortised cost balance is reduced where appropriate by an allowance for amounts which are considered to be impaired or uncollectable.

Fair value is the amount for which an asset can be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Where a market exists, fair values are based on quoted prices or lead manager prices. For instruments which do not have active markets, fair value is calculated using present value models which take individual cash flows together with assumptions based on market conditions and credit spreads, and are consistent with accepted economic methodologies for pricing financial instruments. Any net movements in fair value are included in the Statement of Comprehensive Income as 'fair value movements'.

(h) Derivative financial instruments

All derivatives are carried at fair value in the Balance Sheet, as assets when the fair value is positive and as liabilities when the fair value is negative. Changes in the fair value of derivatives are reflected immediately in the Statement of Comprehensive Income as 'fair value movements'.

(i) Foreign currencies

Foreign currency transactions, assets and liabilities are accounted for in accordance with IAS 21 'The Effects of Changes in Foreign Exchange Rates'. The presentational and functional currency of the Company is pounds sterling. Transactions which are not denominated in pounds sterling are translated into sterling at the spot rate of exchange on the date of the transaction. Monetary assets and liabilities which are not denominated in pounds sterling are translated into sterling at the closing rate of exchange at the Balance Sheet date.

Foreign exchange gains and losses resulting from the restatement and settlement of such transactions are recognised in the Statement of Comprehensive Income in 'fair value movements'.

(j) Hedge accounting

The Company applies fair value hedge accounting to its floating rate notes. Provided that the hedge arrangement meets the requirements of IAS 39 to be classed as 'highly effective' the hedged item is carried on the Balance Sheet at fair value in respect of the hedged risk, with any gain or loss in that fair value being included in the Statement of Comprehensive Income as 'fair value movements'.

Notes to the Financial Statements for the year ended 31 December 2011 (continued)

2. Interest receivable and similar income

	2011	2010
	£000	£000
Interest on loans to Group undertakings	18,203	16,234
	<u>18,203</u>	<u>16,234</u>

Interest income for the year on impaired assets was £nil (2010 £nil) as no financial asset is impaired

3. Interest expense and similar charges

	2011	2010
	£000	£000
Interest on floating rate notes	18,163	16,017
Amortisation of issue costs	131	303
Swap interest payable	(134)	(122)
	<u>18,160</u>	<u>16,198</u>

4 Operating expenses

	2011	2010
	£000	£000
Legal and professional fees	41	33

Auditors' remuneration of £3,650 (2010 £4,080) was borne by B&B

5. Taxation

	2011	2010
	£000	£000
Current taxation charge		
UK corporation tax on (loss)/profit for the year	-	2
Deferred taxation temporary differences (see below)	(194)	424
Change in rate effective 1 April 2011 on deferred tax items	-	(10)
Total taxation (credit)/charge per the Statement of Comprehensive Income	<u>(194)</u>	<u>416</u>
(Loss)/profit before taxation	<u>(966)</u>	<u>2,020</u>
UK corporation tax at 26.5% (2010 21%)	<u>(256)</u>	<u>424</u>
Change in rate effective 1 April 2011 on deferred tax items	-	(10)
Effects of other tax rates	62	-
Adjustments in respect of previous years	-	2
Total taxation (credit)/charge per the Statement of Comprehensive Income	<u>(194)</u>	<u>416</u>

The deferred tax liability is attributable to the following

	Recognised in income 2011 £000	As at 31 December 2011 £000	Recognised in income 2010 £000	As at 31 December 2010 £000
Fair value movements	194	-	414	(194)
	<u>194</u>	<u>-</u>	<u>414</u>	<u>(194)</u>

The standard rate of Corporation Tax in the UK changed from 28% to 26% with effect from 1 April 2011. Accordingly, the Company's profits for this accounting period are taxed at an effective rate of 26.5%.

The carrying amount of deferred tax relating to fair value movements has been reassessed as nil because it is not expected to result in an actual future tax payment or receipt.

Notes to the Financial Statements for the year ended 31 December 2011 (continued)

6. Employees and Directors' emoluments

There were no employees during the year and preceding year none of the Directors received emoluments in respect of their services to the Company. A corporate service fee is paid to Structured Finance Management Limited in connection with its supply of corporate management services including the provision of directors (see note 9)

7. Interest-bearing loans and borrowings

Interest-bearing loans and borrowings comprise floating rate notes issued on 14 November 2007

In April 2011, the A2 Euro-denominated floating rate notes were redenominated into sterling at their original exchange rate, and all of the Company's derivatives were transferred at nil value to B&B, the holder of the redenominated notes. The Company made no material net profit or loss on the combined transaction.

Under the terms of the Notes, any shortfalls arising on the redemption of the Loan to Group undertaking, over which the Noteholders have a charge, may result in a reduction in the liability under the Notes, due to their limited recourse nature. Such shortfall on the redemption of the Loan to Group undertaking may arise if the underlying mortgage pool against which the Loan to Group undertaking is secured does not generate sufficient cash to repay the Loan to Group undertaking and the credit enhancement in the structure is not sufficient to cover such shortfall.

Class	Maturity	31 December		31 December	
		In currency 31 December 2011	In currency 31 December 2010	2011 £000	2010 £000
A1	Oct 2066	£297,933,098	£311,181,633	297,933	311,182
A2	Oct 2066	£285,402,621	€ 428,297,623	285,403	369,193
A3	Apr 2030	£200,000,000	£200,000,000	200,000	200,000
B	Oct 2066	£73,000,000	£73,000,000	73,000	73,000
C	Oct 2066	£84,000,000	£84,000,000	84,000	84,000
				940,336	1,037,375
Issue costs				(43)	(174)
Hedge adjustments				-	1,527
				940,293	1,038,728
Accrued interest - current				3,819	3,861
				944,112	1,042,589

Subject to their scheduled redemption dates, the Class A notes rank, irrespective of series, without preference or priority amongst themselves. Subject to the relevant scheduled and/or, as applicable, permitted redemption dates or other payment conditions of the issuer notes, payments of principal and interest due and payable on the Class A notes will rank ahead of payments of principal and interest due and payable on the Class B notes and the Class C notes, subject to the terms and conditions of the notes, the issuer cash management agreement, the issuer deed of charge and the other issuer transaction documents. Similarly, payments of principal and interest due and payable on the Class B notes will rank ahead of payments of principal and interest due and payable on the Class C notes.

The notes are now in 'pass through', and will be partially redeemed on each quarterly interest payment date to the extent that funds are available, in accordance with the terms set out in the Offering Circular. The timing of future redemptions will be dependent on the availability of funds, and cannot be reliably forecast and hence the notes have all been described as non current liabilities.

As described in note 16, on 10 May 2012 a non-asset trigger event occurred. This will affect the timing of future redemptions of the loan notes in issue.

Notes to the Financial Statements for the year ended 31 December 2011 (continued)

7. Interest-bearing loans and borrowings (continued)

Interest is payable on the Class A, Class B and Class C notes at a variable rate based on three month sterling LIBOR

The Company's obligations to noteholders and to other secured creditors are secured under a deed of charge which grants security over all its assets in favour of the security trustee. The principal assets of the Company are loans made by it to Aire Valley Funding 1 Limited, a fellow subsidiary undertaking of Aire Valley Holdings Limited, whose obligations in respect of these loans are secured pursuant to a deed of charge which grants security over all its assets, primarily consisting of its beneficial interest in a portfolio of residential mortgage loans, in favour of the security trustee.

The security trustee holds this security for the benefit of all secured creditors of Aire Valley Funding 1 Limited, including the Company.

8 Loans to Group undertakings

Loans to Group undertakings comprise a single loan to Aire Valley Funding 1 Limited, denominated in Sterling and at a variable rate of interest. This loan has ultimately been secured against a beneficial interest in a mortgage portfolio held in trust on behalf of the Aire Valley Holdings Limited Group.

The ability of Aire Valley Funding 1 Limited to pay amounts due on the intercompany loan will depend mainly upon it receiving sufficient revenue receipts and principal on the trust property from Aire Valley Trustee Limited, receiving the required funds from the swap provider and amounts available in the reserve funds. The repayment of the intercompany loan will coincide with the repayment of the floating rate notes as they become due for payment.

The repayment of the intercompany loans will coincide with the repayment of the floating rate notes as they become due for payment only to the extent these are available and hence the loans have all been described as non-current assets.

9. Related party disclosures

The Company is a special purpose vehicle controlled by its Board of Directors, which comprises three Directors. Two of the Company's three Directors are Corporate Directors provided by Structured Finance Management Limited and the third is a director of B&B. The Company pays a corporate services fee to Structured Finance Management Limited in connection with its supply of corporate management services, including the provision of directors. The fee amounted to £12,408 (2010: £9,758).

The Company undertook the following transactions with companies in the B&B Group and the Aire Valley Holdings Limited Group.

	Aire Valley Holdings Limited and subsidiaries 2011 £000	Aire Valley Holdings Limited and subsidiaries 2010 £000
Interest receivable and similar income		
Interest on loans to Group undertakings	18,203	16,234
Non-current assets		
Loans to Group undertakings	944,121	969,640

Notes to the Financial Statements for the year ended 31 December 2011 (continued)

9. Related party disclosures (continued)

Auditors' remuneration of £3,650 (2010 £4,080) was borne by B&B

At 31 December 2011 B&B held £740,366,000 (2010 £468,181,683) and £nil (2010 €428,297,623) of the Company's floating rate notes and earned £16,366,000 (2010 £16,015,771) interest on them during the year

10. Critical accounting judgements and estimates

In preparation of the Company's Financial Statements, estimates and assumptions are made which affect the reported amounts of assets and liabilities, estimates and assumptions are kept under continuous evaluation. Estimates and judgements are based on historical experience, expectations of future events and other factors.

Effective interest rate

Certain financial instruments are accounted for on an effective interest rate basis, under which the income or expense associated with the instruments is spread over the instrument's expected life. On a quarterly basis, models are reviewed to re-assess expected life.

Fair values of financial instruments

Certain financial instruments are carried at fair value. Where a market exists, fair values are based on quoted market prices. For instruments which do not have an active market, fair value is calculated using expected future cash flows for which assumptions are made.

Qualifying hedge relationships

In designating a financial instrument as part of a qualifying hedge relationship, the Company has determined that the hedge is expected to be highly effective over the life of the hedging instrument, considering the maturity and terms of the hedged item and hedging instrument.

Notes to the Financial Statements for the year ended 31 December 2011 (continued)

11 Financial instruments

a) Categories of financial assets and financial liabilities: carrying value compared to fair value
At 31 December 2011

Financial assets	Assets at fair value through profit or loss - on initial recognition £000	Loans and receivables £000	Total carrying value £000	Fair value £000	If fair values increased by 1% £000
Loans to Group undertakings	-	944,121	944,121	944,121	9,441
Derivative financial instruments	-	-	-	-	-
Cash and cash equivalents	-	14	14	14	-
Total financial assets	-	944,135	944,135	944,135	9,441

Financial liabilities	Liabilities at fair value through profit or loss - on initial recognition £000	Liabilities at amortised cost £000	Total carrying value £000	Fair value £000	If fair values increased by 1% £000
Interest-bearing loans and borrowings	-	944,112	944,112	944,112	9,441
Total financial liabilities	-	944,112	944,112	944,112	9,441

At 31 December 2010

Financial assets	Assets at fair value through profit or loss - on initial recognition £000	Loans and receivables £000	Total carrying value £000	Fair value £000	If fair values increased by 1% £000
Loans to Group undertakings	-	969,640	969,640	236,638	2,366
Derivative financial instruments	73,923	-	73,923	73,923	739
Cash and cash equivalents	-	14	14	14	-
Total financial assets	73,923	969,654	1,043,577	310,575	3,105

Financial liabilities	Liabilities at fair value through profit or loss - on initial recognition £000	Liabilities at amortised cost £000	Total carrying value £000	Fair value £000	If fair values increased by 1% £000
Interest-bearing loans and borrowings	-	1,042,589	1,042,589	309,587	3,096
Total financial liabilities	-	1,042,589	1,042,589	309,587	3,096

Notes to the Financial Statements for the year ended 31 December 2011 (continued)

11 Financial instruments (continued)

a) Categories of financial assets and financial liabilities: carrying value compared to fair value (continued)

No financial assets were reclassified during the year between amortised cost and fair value categories

The fair value of loans to Group undertakings has been adjusted to reflect the market yields implied by the floating rate notes valuations

The fair value of interest-bearing loans and borrowings and amounts due to Group undertakings takes into account the timing and extent of future cash flows based on expectations and known circumstances. The fair value of derivatives is their carrying amount

b) Interest income and expense on financial instruments that are not at fair value through profit or loss

	2011	2011	2010	2010
	Income	Expense	Income	Expense
	£000	£000	£000	£000
Interest on loans to Group undertakings	18,203	-	16,234	-
Interest on floating rate notes	-	18,163	-	16,017
Amortisation of issue costs	-	131	-	303

Interest income for the year on impaired assets was £nil (2010: £nil) as no financial asset is impaired

c) Nature and extent of risks arising from financial instruments

The Company's exposure to risk on financial instruments and the management of this risk is established at the commencement of the securitisation transactions, with the Company's activities and the roles of other parties defined in the programme documentation. Financial instruments used by the Company for risk management purposes include derivative instruments. Such instruments are used for commercial hedging purposes only, not for trading or speculative purposes, to hedge interest rate and currency risk arising as part of the securitisation transaction. The principal derivative instruments used by the Company in managing its risk are cross currency swaps. The duration of derivative instruments is generally short to medium term and their maturity profile reflects the nature of exposures arising from underlying business activities. All the Company's derivatives activity is contracted with financial institutions.

Credit risk

Credit risk reflects the risk that a counterparty of the Company will be unable or unwilling to meet a contractual commitment to the Company. The Company is exposed to credit risk via amounts due from the loan to Group undertakings, derivative counterparties and deposits with third party banks.

The Company's ability to meet payments under the floating rate notes relies on the receipt of funds on the loan to Group undertakings, which is in turn dependent on receipt of payments on the mortgage portfolio held in trust. To minimise risk, any mortgage included in the portfolio is required to meet a number of criteria as determined in the transaction document. Credit risk also exists on the derivative contracts entered into. The swap counterparties are required to have minimum credit ratings as outlined in the transaction documentation.

The exposure to credit risk is represented by the carrying amount of each financial asset, as set out in the table in note 11c(i).

Notes to the Financial Statements for the year ended 31 December 2011 (continued)**11 Financial instruments (continued)****c) Nature and extent of risks arising from financial instruments (continued)***Liquidity risk*

Liquidity risk is the risk that the Company is not able to meet its financial obligations as they fall due. The Company's policy is to maintain sufficient funds in a liquid form at all times to ensure that the Company can meet its liabilities as they fall due. The Company's ability to meet payments under the floating rate notes relies on the receipt of funds on the loan to Group undertakings, which is in turn dependent on receipt of payments on the mortgage portfolio held in Trust (note 11c(ii)).

Currency risk

During the year the Company had floating rate notes in issue denominated in Euros. The Company's policy is to eliminate all exposures arising from movements in exchange rates by the use of cross currency swaps to hedge payments of interest and principal on the notes. All other assets, liabilities and transactions are denominated in Sterling. The table in note 11c(iii) summarises the Company's assets and liabilities denominated in foreign currencies.

Interest rate risk

Interest rate risk exists where assets and liabilities have interest rates set under a different basis or which reset at different times. To minimise exposure to interest rate risk the Company ensures that the interest rate profile of the loans to Group undertakings and interest-bearing loans and borrowings are similar. Where this is not possible, derivative financial instruments are used to reduce any residual interest rate risk. If LIBOR for three month-Sterling deposits was 1% higher or lower, with all other variables held constant, the effect on the Company's net interest income would be immaterial due to movements on interest on the loan to Group undertakings being offset by movements on interest on the loan notes. This would also apply if EURIBOR for three-month Euro deposits was 1% higher or lower, with all other variables held constant, as movements in interest on foreign currency loan notes would be offset by a corresponding movement in interest on the currency swaps and on loans to Group undertakings.

Other market risks

At the year end the Company had no other material exposure to market risks.

Notes to the Financial Statements for the year ended 31 December 2011 (continued)

11 Financial instruments (continued)

c) Nature and extent of risks arising from financial instruments (continued)

(i) Credit risk

Before taking account of any collateral the exposure to credit risk at 31 December was

	2011 £000	2010 £000
Loans to Group undertakings	944,121	969,640
Derivative financial instruments	-	73,923
Cash and cash equivalents	14	14
Total on-Balance Sheet and maximum exposure to credit risk	944,135	1,043,577

No impairment has been recognised in respect of any financial asset, and no financial assets were past due

Further information regarding the number and credit quality of loans in the mortgage pool is provided in the Key Performance Indicators on page 4

(ii) Liquidity risk

The contractual undiscounted cash flows associated with financial liabilities were as follows

	On demand £000	In not more than three months £000	In more than three months but not more than one year £000	In more than one year but not more than five years £000	In more than five years £000	Total £000
At 31 December 2011						
Interest-bearing loans and borrowings	-	13,248	239,567	418,350	351,048	1,022,213
Total	-	13,248	239,567	418,350	351,048	1,022,213

	On demand £000	In not more than three months £000	In more than three months but not more than one year £000	In more than one year but not more than five years £000	In more than five years £000	Total £000
At 31 December 2010						
Interest-bearing loans and borrowings	-	11,774	33,610	577,090	515,907	1,138,381
Total	-	11,774	33,610	577,090	515,907	1,138,381

The cash flows above assume that the loan notes are redeemed on the earliest possible date that the Company could be compelled to redeem them

As described in note 16 on 10 May 2012 a non-asset trigger event occurred. This will affect the timing of future redemptions of the loan notes in issue.

Notes to the Financial Statements for the year ended 31 December 2011 (continued)

11 Financial instruments (continued)

c) Nature and extent of risks arising from financial instruments (continued)

(iii) Currency risk

The Group's policy is to hedge all material foreign currency exposures. In April 2011 all of the Company's remaining foreign currency denominated assets and liabilities were redenominated into sterling or disposed of. Consequently the Company no longer has any exposure to foreign currencies.

The sterling equivalent amounts of the Company's financial assets and liabilities denominated in foreign currencies as at 31 December 2010 are set out in the table below, excluding the nominal value of cross currency interest rate swaps.

	Euro £000
At 31 December 2010	
Financial assets	
Loans to Group undertakings	-
Derivative financial instruments	370,690
Cash and cash equivalents	-
Total financial assets	370,690
Financial liabilities	
Interest-bearing loans and borrowings	370,690
Other liabilities	-
Total financial liabilities	(370,690)
Net currency gap	-

d) Concentrations of risk

The Company operates primarily in the UK, and adverse changes to the UK economy could impact on all areas of the Company's business. The loan to Group undertakings is due from one entity, Aire Valley Funding 1 Limited, and represents an interest in a portfolio of mortgage loans secured on residential properties in England, Scotland and Wales. In turn the ability of Aire Valley Funding 1 Limited to meet its loan obligations to the Company is based upon its cash receipts from its interest in the portfolio.

e) Derivatives and hedging

The Company had the following types of derivatives and hedges

	Nominal amounts £000	Fair value hedges £000	Total derivatives £000
At 31 December 2011			
Cross-currency interest rate swaps	-	-	-
Total asset balances	-	-	-

The fair value movements in the Statement of Comprehensive Income comprised the following

	2011 £000
Net losses on hedging swaps	(73,531)
Net gains on hedged items due to exchange rate movements	71,035
Net losses on hedging items due to interest rate movements	1,528
	(968)

	Nominal amounts £000	Fair value hedges £000	Total derivatives £000
At 31 December 2010			
Cross-currency interest rate swaps	430,000	73,923	73,923
Total asset balances	430,000	73,923	73,923

The fair value movements in the Statement of Comprehensive Income comprised the following

	2010 £000
Net losses on hedging swaps	(9,498)
Net gains on hedged items due to exchange rate movements	11,590
Net losses on hedging items due to interest rate movements	(75)
	2,017

Notes to the Financial Statements for the year ended 31 December 2011 (continued)

11 Financial instruments (continued)

f) Fair value measurement

Financial assets and liabilities carried at fair value are valued on the following bases

	Level 1 £'000	Level 2 £'000	Level 3 £'000	Total £'000
At 31 December 2011				
Financial assets				
Derivative financial instruments	-	-	-	-
At 31 December 2010				
Financial assets				
Derivative financial instruments	-	-	73,923	73,923

Level 1 Quoted prices (unadjusted) in active markets for identical assets or liabilities

Level 2 Inputs other than quoted prices that are observable for the asset or liability, either directly (i.e. as price) or indirectly (i.e. derived from the implications of prices)

Level 3 Inputs for the asset or liability that are not based on observable market data or have significant unobservable inputs

These definitions have been taken from the March 2009 amendment to IFRS 7 'Improving Disclosures about Financial Instruments'

	Financial assets Derivative financial instruments £'000	Financial liabilities Derivative financial instruments £'000	Total £'000
At 1 January 2011	73,923	-	73,923
Total losses in the Statement of Comprehensive Income	(73,923)	-	(73,923)
Transfers from assets to liabilities	-	-	-
At 31 December 2011	-	-	-

	Financial assets Derivative financial instruments £'000	Financial liabilities Derivative financial instruments £'000	Total £'000
At 1 January 2010	83,101	-	83,101
Total losses in the Statement of Comprehensive Income	(9,178)	-	(9,178)
Transfers from assets to liabilities	-	-	-
At 31 December 2010	73,923	-	73,923

12 Share capital

	2011 Number	2011 £	2010 Number	2010 £
Authorised				
Ordinary shares of £1 each	100,000	100,000	100,000	100,000
At 1 January and 31 December	100,000	100,000	100,000	100,000
Issued				
Issued on incorporation				
Ordinary shares of £1 each fully paid	2	2	2	2
Ordinary shares of £1 each 25p paid	49,998	12,500	49,998	12,500
At 1 January and 31 December	50,000	12,502	50,000	12,502

These shares rank equally in respect of rights attaching to voting, dividends and in the event of a winding up

Notes to the Financial Statements for the year ended 31 December 2011 (continued)

13 Capital structure

The Company's capital is represented by the capital and reserves attributable to equity holders. The Company is not subject to externally imposed capital requirements other than the minimum share capital required by the Companies Act, with which it complies. The Company manages its capital and reserves in order that there is sufficient capital to meet the needs of the Company in its operations.

14 Ultimate parent undertaking

The Company's immediate parent undertaking is Aire Valley Holdings Limited, a limited liability company incorporated and domiciled in the United Kingdom.

The Company's ultimate parent undertaking is SFM Corporate Services Limited, a limited liability company incorporated and domiciled in the United Kingdom, which holds the shares of Aire Valley Holdings Limited on a discretionary trust basis for charitable purposes. Copies of the financial statements of Aire Valley Holdings Limited and SFM Corporate Services Limited may be obtained from the Company Secretary at 35 Great St. Helen's, London EC3A 6AP.

As a result of The Bradford & Bingley plc Transfer of Securities and Property etc. Order 2008, which transferred all shares in B&B to the Treasury Solicitor as nominee for HM Treasury on 29 September 2008, the Company considered Her Majesty's Government to be its ultimate controlling party from that date. On 1 October 2010 all shares in B&B were acquired via a share-for-share exchange by UK Asset Resolution Limited, a private limited company incorporated and domiciled in the United Kingdom, which is wholly owned by the Treasury Solicitor as nominee for HM Treasury.

The Company considers Her Majesty's Government to remain its ultimate controlling party. UKAR heads the largest group of companies into which the Financial Statements of the Company are consolidated. Copies of the financial statements of UKAR may be obtained from the Company Secretary at Croft Road, Crossflatts, Bingley, West Yorkshire BD16 2UA.

15 Operations of the Company

B&B, the originator of the mortgage loans in the Master Trust pool, carries the pool mortgages on its balance sheet. The cash receipts in respect of the mortgage loans in the pool are collected by B&B and paid to the Trustee. On a monthly basis the Trustee allocates this cash between Aire Valley Funding 1 Limited, the other funding companies in the Master Trust structure and to B&B (which holds a share of the pool mortgages) according to the rules of the structure. On a monthly basis Aire Valley Funding 1 Limited allocates this cash between the Company and the other issuing companies in the Aire Valley Funding 1 Limited structure. The Company uses its cash receipts to service its loan notes in accordance with their terms.

As described in note 16, on 10 May 2012 a non-asset trigger event occurred. This will affect the timing of future redemptions of the loan notes in issue.

16 Events after the reporting period

On 10 May 2012 a Non-Asset Trigger Event occurred within the structure of the Master Trust, due to the aggregate Current Balance of Loans comprising the Trust Property falling below the minimum trust size of £10.7 billion. The impact of this event is to change the order of priority of the Funding 1 Available Principal Receipts as set out on pages 145 to 154 of the Company's Offering Circular. As a result of the Non-Asset Trigger Event, all principal is allocated to Funding 1 and will continue to be so allocated until all holders of Aire Valley residential mortgage-backed securities have been repaid in full if sufficient funds are available. The principal is then passed to the Issuers based on their respective notes outstanding. Each Issuer then utilises this principal to pay down pro rata and sequentially by Class of Note. The timing of future redemptions will be dependent on the availability of funds, and cannot be reliably forecast.