Equity Release Funding (No. 2) plc

Directors' Report and Financial Statements

Year ended: 31 December 2004

Registered Number: 4414548

Contents

Directors and other information

Directors:

M McDermott
J Fairrie
SPV Management Limited

Secretary:

SPV Management Limited

Bankers:

Barclays Bank PLC
London Corporate Banking Centre
54 Lombard Street
London
EC3P 3AH

Solicitors:

Slaughter and May
1 Bunhill Row
London
EC1Y 8YY

Auditors:

Ernst & Young LLP
1 More London Place
London
SE1 2AF

Registered Office:

C/O SPV Management Ltd
Tower 42 (Level 11)
International Financial Centre
25 Old Broad Street
London
EC2N 1HQ

Registered in England No. 4414548

Directors' Report

The directors present their report and financial statements for the year ended 31 December 2004.

Principal activities, review of business and future developments

The principal activity of the company is investment in Equity Release mortgage loans secured by first charges over properties within the United Kingdom and to raise/borrow money and to grant security over its assets. The directors do not anticipate any material changes to the nature or volume of the business in the foreseeable future.

The profit and loss account for the year ended 31 December 2004 is set out on page 7 and in the related notes. The Directors do not recommend the payment of a dividend.

Directors and secretary and their interests

Directors who served during the period were as follows :-

M McDermott
SPV Management Limited
J Fairrie

During the year J Fairrie and Equity Release Holdings Limited jointly held one share in the company. SPV Management Limited jointly held one share with M McDermott and also held one fully paid share in the parent company, Equity Release Holdings Limited. M McDermott jointly held one share in Equity Release Funding (No. 1) plc. J Fairrie jointly held one share in Equity Release Funding (No. 3) plc. The directors had no other interest in the share capital or loan stock of the company or group companies during the year.

Statement of directors' responsibilities

Company law requires the directors to prepare financial statements for each financial period which give a true and fair view of the state of affairs of the company and of the profit and loss for that period. In preparing those financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards 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 proper accounting records which disclose with reasonable accuracy at any time the financial position of the company and which enable them to ensure that the financial statements comply with the Companies Act 1985. 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.

Policy on payment of creditors

The company is responsible for the agreement of terms and conditions under which business transactions with suppliers are conducted. It is the company's policy that payments to suppliers are made in accordance with these terms, normally between 30 and 60 days, provided that the supplier is also complying with all relevant terms and conditions. There were no trade creditors as at 31 December 2004.

Directors' Report

Financial instruments

The company's financial instruments comprise mortgages, borrowings, cash and liquid resources and other sundry instruments such as debtors and creditors arising directly from the company's operations. The company also entered into an interest rate swap agreement for the purposes of managing the interest rate risk associated with the company's operations and to provide liquidity. No trading in financial instruments has been undertaken during the period. The main risks arising from the company's financial instruments held are credit risk, interest rate risk and liquidity/reinvestment risk. The company's management reviews and agrees policies for managing each of these risks and they are, broadly, as follows:

Credit Risk

Credit risk is the risk that borrowers or his/her estate will not be able to meet their obligations as they fall due. The lending criteria for the mortgages include low initial loan to value ratios reducing the risk of credit losses. Due to the limited recourse nature of the structure, the directors consider that there is no net credit risk to the members of the Company. The company also has the benefit of an insurance policy with Norwich Union Life & Pensions Ltd which insures any undischarged portion of a loan where a sale has occurred as a result of death or the need for long term care of the relevant borrower.

Interest rate risk

Interest rate risk exists when assets and liabilities attract interest rates set according to different bases or which are reset at different times. The company minimises its exposure to interest rate risk by ensuring that the interest rate characteristics of its assets and liabilities are similar. Where this is not possible, interest rate swaps are utilised to mitigate any residual interest rate risk.

Liquidity risk

Liquidity risk is the risk that the company will encounter difficulty in raising funds to meet commitments associated with financial instruments, if the cashflows from the mortgages differs from that expected. The company minimises its exposure to liquidity risk by modelling its cashflows using multiple state modelling. The remaining risk is managed by the liquidity provided through the facility agreement (see note 16) and the swap agreement (see note 14).

Auditors

In accordance with section 385 of the Companies Act, 1985, Ernst & Young LLP have indicated their willingness to continue in office and the directors will place a resolution before the annual general meeting to re-appoint them as auditors for the ensuing year.

On behalf of the board

28 June 2005

Auditors' report to the members of Equity Release Funding (No.2) plc

Independent auditors' report to the members of Equity Release Funding (No.2) plc

We have audited the Company's financial statements for the year ended 31 December 2004 which comprise the profit and loss account, balance sheet and the related notes 1 to 16. These financial statements have been prepared on the basis of the accounting policies set out therein.

This report is made solely to the Company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

As described in the statement of directors' responsibilities the Company's directors are responsible for the preparation of the financial statements in accordance with applicable United Kingdom law and accounting standards.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and United Kingdom Auditing Standards.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the directors' report is not consistent with the financial statements, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and transactions with the Company is not disclosed.

We read the directors' report and consider the implications for our report if we become aware of any apparent misstatements within it.

Basis of audit opinion

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

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

Opinion

In our opinion the financial statements give a true and fair view of the state of affairs of the Company as at 31 December 2004 and of its profit for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

Ernst + Young LLP

Ernst & Young LLP
Registered Auditor
London
1st July 2005

Profit and loss account
for the year ended 31 December 2004

	Note	**Year Ended 31 December 2004**	Year Ended 31 December 2003
		£	£
Interest receivable and similar income	*2*	**25,985,641**	25,379,311
Interest payable and similar charges	*3*	**(19,798,462)**	(19,457,332)
Net income		**6,187,179**	5,921,979
Other operating expenses		**(6,184,921)**	(5,919,755)
Profit on ordinary activities before taxation	*4*	**2,258**	2,224
Tax on profit on ordinary activities	*6*	**(375)**	(201)
Profit for the financial year		**1,883**	2,023

Statement of total recognised gains and losses
for the year ended 31 December 2004

The Company has no recognised gains or losses other than those included in the results above. Accordingly, a statement of total recognised gains and losses is not given.

Reconciliation of movements in shareholders' funds
for the year ended 31 December 2004

	Year Ended 31 December 2004	Year Ended 31 December 2003
	£	£
Profit for the financial year	**1,883**	2,023
Net increase in shareholders' funds	**1,883**	2,023
Opening shareholders' funds	**15,737**	13,714
Closing shareholders' funds	**17,620**	15,737

The notes on pages 9 to 17 form an integral part of these financial statements.

Balance sheet
at 31 December 2004

	Note	As at 31 December 2004 £	As at 31 December 2003 £
Current assets			
Mortgage advances	*7*	**290,098,524**	287,132,893
Debtors	*8*	**331,222**	275,454
Cash at bank and in hand		**25,116,754**	24,968,339
		315,546,500	312,376,686
Creditors: amounts falling due within one year	*9*	**(2,338,384)**	(2,294,978)
Net current assets		**313,208,116**	310,081,708
Total assets less current liabilities		**313,208,116**	310,081,708
Creditors: amounts falling due after one year	*10*	**(313,190,496)**	(310,065,971)
Net Assets		**17,620**	15,737
Capital and reserves			
Called up share capital	*13*	**12,502**	12,502
Profit and loss account		**5,118**	3,235
Shareholders' funds – equity		**17,620**	15,737

The financial statements on pages 7 to 17 were approved by the Board on 28 June 2005 and were signed on its behalf by:

SPV Management Limited
Director

The notes on pages 9 to 17 form an integral part of these financial statements.

Notes to the financial statements

1. Statement of accounting policies

The following accounting policies have been applied consistently in dealing with items which are considered material in relation to the company's financial statements.

Basis of preparation

The financial statements have been prepared in accordance with generally accepted accounting principles under the historical cost convention and comply with financial reporting standards of the Accounting Standards Board. The financial statements are denominated in sterling.

Cash flow statement and Related Party Disclosure

The directors have taken advantage of the exemption as per Financial Reporting Standard 1 (Revised 1996) for any company whose ultimate parent undertaking prepares and files consolidated financial statements, incorporating the results of the company including a consolidated cash flow statement in the required format. Accordingly no cash flow statement is presented. The directors have also taken advantage of the exemption in paragraph 3 © of Financial Reporting Standard 8 from disclosing transactions with related parties that are part of the same group.

Taxation

The tax charge in the profit and loss account is based on the taxable profits for the year, after any adjustments in respect of prior years. Tax, including tax relief for losses if applicable, is allocated over profits on ordinary activities and amounts charged or credited to reserves as appropriate. Provision is made for deferred tax liabilities, on all material timing differences. Deferred taxation is calculated at the rates at which it is expected that the tax will arise. And discounted to take into account the likely timing of payments and pattern of expected realisation of investments. The discount rates used are the post-tax yields to maturity that could be obtained at the balance sheet date on government bonds with maturity dates and in currencies similar to those of the deferred tax assets or liabilities.

Interest rate swaps

The company hedges its exposure to gains and losses from interest rate movements by using interest rate swaps. The swaps are used for hedging and liquidity and are, therefore, not marked to market. Swaps are accounted for by reference to the aim of the arrangement. That element of the swap, which acts as a hedge, is accounted for on an accruals basis equivalent to that used for the underlying transaction. That element of the swap, which provides liquidity, is accounted for as a loan on an accruals basis. The interest on the loan is accrued based on the outstanding amount at a fixed interest rate. The fixed interest rate is the implied fixed rate cost calculated with reference to that element of the cash flow of the swaps, which represents a loan.

Income and expense recognition

Interest income and expenses are recognised on an accruals basis. Expenses are, in general, charged to the profit and loss account as accrued. However, initial costs incurred in arranging funding facilities are amortised over the expected life of the underlying security based on the expected repayment profile of the security. Unamortised initial costs are deducted from the associated liability in accordance with Financial Reporting Standard No. 4 ('Capital Instruments') and costs amortised in the period are included in Other operating expenses.

Deferred consideration

Under the terms of the agreement for the purchase of the mortgage loans the company has a liability to pay deferred consideration when surplus funds become available under the priority of payments. Provision has been made to pay deferred consideration in any period, in which surplus income accrues, which will ultimately be paid out by way of deferred consideration.

Premiums and Discounts

Premiums and discounts on the purchase of mortgage advances or issue of loan notes are amortised or accreted based on the expected repayment profile of the underlying transaction. Associated issue costs which occurred at the start of the transaction are being amortised over the expected redemption profile of the loan notes. The discount on substitution which has occurred during the year has been capitalised and is being accreted over the average expected lifetime of the mortgages.

Mortgage Advances

The mortgages are shown in the financial statements at the lower of cost and net realisable value.

Mortgage Backed Loan Notes

The mortgage backed loan notes are shown in the financial statements at net issue proceeds.

	Year Ended 31 December 2004	Year Ended 31 December 2003
	£	£
2 Interest receivable and similar income		
Mortgage interest receivable	**22,497,641**	22,428,192
Amounts receivable from swap counterparties	**2,037,003**	1,610,134
Bank interest receivable	**1,069,520**	870,250
Other income	**381,477**	470,735
	25,985,641	25,379,311

All of the company's revenues arose in the United Kingdom.

	Year Ended 31 December 2004	Year Ended 31 December 2003
	£	£
3 Interest payable and similar charges		
Loan notes interest payable	**17,038,988**	16,839,900
Amounts payable to swap counterparties	**2,487,068**	2,487,068
Amounts payable to swap counterparties (loan element)	**272,406**	130,364
	19,798,462	19,457,332

Notes to the financial statements

		Year Ended 31 December 2004	Year Ended 31 December 2003
		£	£
4	**Operating profit on ordinary activities**		
	Profit on ordinary activities is stated after charging		
	Auditors' remuneration – audit fee	**7,638**	7,950
	Deferred consideration	**4,996,676**	4,738,017
	Amortisation of initial funding costs	**174,412**	174,412
	Accretion of mortgage discount	**407,520**	420,985
	Accretion of substitution discount	**13,149**	-
	Accretion of A2 notes discount	**31,826**	31,826

The company has no employees and services required are contracted from third parties.

5 Directors Emoluments

SPV Management Limited received fees of £16,335 (Year ended 2003: £14,304) including VAT during the year to 31 December 2004, in respect of structuring and management services.

		Year Ended 31 December 2004	Year Ended 31 December 2003
		£	£
6	**a) Tax on profit on ordinary activities**		
	UK Corporation Tax	**375**	201
	Tax charged in the profit & loss account	**375**	201
	b) Factors affecting current tax charge for the year		
	The tax assessed in the profit and loss account is the same as the standard UK corporation tax rate.		
	Profit on ordinary activities before tax	**2,258**	2,224
	Current tax charge at standard UK corporation tax rate of 19% (2003: 19%)	**429**	423
	Non allowable expenses	**346**	213
	Small companies' relief	**(400)**	(435)
	Current tax charge for the year	**375**	201

c) Factors that may affect future tax charges

Formation costs are amortised through the profit & loss account and are non-allowable for tax purposes. The balance of namortized costs was £18,088 at 31 December 2004 (2003: £19,209).

Notes to the financial statements

7 Mortgage Advances

On 11 June 2002, the company purchased £276m of mortgage assets at market value from Norwich Union Equity Release Limited, a wholly owned subsidiary of Norwich Union Life & Pensions Limited. These assets are a portfolio of UK Equity Release fixed rate residential mortgages, wholly secured on properties in the UK. In order to fund the purchase of these mortgage assets, the company issued a series of mortgage backed notes. Under the terms of this arrangement, the rights of the providers of the finance for this transaction are limited to the mortgage assets purchased and any related income generated by the portfolio, and are without recourse to Norwich Union Equity Release Limited.

Norwich Union Equity Release Limited is not obliged to support any losses, which may arise in respect of the mortgage assets. During the term of this transaction, any amounts realised from the mortgage portfolio in excess of that due to the providers of the funding, less any related administrative costs, will be payable to Norwich Union Equity Release Limited in the form of deferred consideration.

Norwich Union Equity Release Limited administers the mortgage portfolio.

	2004 Mortgage Advances £	2003 Mortgage Advances £
At start of year	**287,132,893**	280,936,258
Amounts redeemed	**(19,532,010)**	(16,231,557)
Interest	**22,497,641**	22,428,192
At end of year	**290,098,524**	287,132,893

8 Debtors

	Year Ended 31 December 2004 £	Year Ended 31 December 2003 £
Interest receivable	**309,418**	251,293
Reinsurance rebates	**13,277**	14,585
Amounts owed by Group companies	**-**	591
Prepayments	**8,527**	8,985
	331,222	275,454

All amounts (excluding amounts owed by Group companies) fall due within one year.

Notes to the financial statements

		Year Ended 31 December 2004	Year Ended 31 December 2003
		£	£
9	**Creditors: amounts falling due within one year**		
	Accruals and deferred income	**19,972**	19,972
	Unaccreted mortgage discount (note 11)	**425,330**	407,520
	Unaccreted substitution discount (note 12)	**19,226**	-
	Interest payable	**1,873,374**	1,867,486
	Corporation Tax	**482**	-
		2,338,384	2,294,978

		Year Ended 31 December 2004	Year Ended 31 December 2003
		£	£
10	**Creditors: amounts falling due after one year**		
	Deferred consideration	**12,175,800**	7,179,124
	Mortgage backed loan notes	**293,096,417**	297,524,092
	Less: namortized element of initial funding costs	**(2,813,308)**	(2,987,720)
	Swap – loan element	**6,014,715**	3,502,740
	Unaccreted mortgage discount (note 11)	**4,422,405**	4,847,735
	Unaccreted substitution discount (note 12)	**294,467**	-
		313,190,496	310,065,971

On 11 June 2002, the company issued £300m of mortgage backed loan notes (A1 and A2 notes) in order to fund the purchase of a mortgage portfolio. The balance of these notes at 31 December 2004 is shown net of the namortized portion of initial funding costs incurred in arranging the transaction, which are being written off over the expected life of the transaction.

The loan notes are secured over a portfolio of mortgage loans secured by first charges over residential properties in the UK. The mortgages were purchased from Norwich Union Equity Release Limited, which is a wholly owned subsidiary of Norwich Union Life & Pensions Limited.

The A1 were issued at par and the A2 notes were issued at 99.724%. This discount is amortised over the expected life of the A2 notes based on the scheduled repayment profile. The balance on the notes is shown net of the namortized portion of the A2 discount.

Interest on the notes is payable quarterly in arrears, at the following rates, unpaid interest is capitalised quarterly:

The notes are listed on the London Stock Exchange.

Notes to the financial statements

10 Creditors: amounts falling due after one year cont

£300 m Mortgage Backed Loan Notes	**Capital Balance Outstanding At End of Year**	**Up to May 2012**	**From May 2012**
Class A1 (£45 m)	£38,718,000	LIBOR + 0.44%	LIBOR + 1.50%
Class A2 (255 m)	£255,000,000	5.88%	5.88%

The A1 and A2 notes ('the senior notes') rank pari passu in point of payment and security without preference or priority amongst themselves. A1 notes are to be redeemed as funds become available. Liquidity has been provided through the swap agreement (see note 14) and borrowing facility (see note 16) with the intention that the A1 notes will be redeemed in full in May 2012, unless redeemed prior to this date. A2 notes are to be redeemed according to a redemption schedule commencing in August 2016, although the company will be obliged to redeem (in full or in part) if certain early redemption conditions are satisfied.

Unless previously redeemed in full, each class of notes will mature at its principal amounts outstanding on the interest payment date falling in:

A1 Notes	May 2027
A2 Notes	May 2032

The company may, at its option, redeem all (but not some only) of the notes at their principal amounts outstanding in the event of certain tax changes affecting the notes or the swap agreement (see note 14).

11 Unaccreted mortgage discount	**Year Ended 31 December 2004**	Year Ended 31 December 2003
	£	£
Mortgage discount		
At start of year	**(5,255,255)**	(5,676,242)
Accretion in during the year	**407,520**	420,987
At end of year	**(4,847,735)**	(5,255,255)
Amounts due within one year	**(425,330)**	(407,520)
Amounts due after more than one year	**(4,422,405)**	(4,847,735)
	(4,847,735)	(5,255,255)

The difference in value between the market price of mortgages paid for on purchase and their book value is amortised over the expected life of the mortgages based on their expected repayment profile.

Notes to the financial statements

12 Unaccreted substitution discount

	Year Ended 31 December 2004	Year Ended 31 December 2003
	£	£
At start of year	223,534	-
Accretion during the year	(13,149)	-
At end of year	210,385	-
Amounts due within one year	19,226	-
Amounts due after one year	294,467	-
Total	313,693	-

The difference in value between the mortgages being substituted out of the company and the replacement mortgages being substituted back into the company from Norwich Union Equity Release Limited is being amortised over the average expected life of the mortgages. There was no amortisation in 2003 as it was not considered material to the financial statements.

13 Called up share capital

	Year Ended 31 December 2004	Year Ended 31 December 2003
	£	£
Authorised		
Ordinary shares of £1 each	50,000	50,000
Allotted, called up and fully paid		
Ordinary shares of £1 each	2	2
Allotted, called up and partly paid		
Ordinary shares of £1 each (25p paid per share)	12,500	12,500
	12,502	12,502

14 Commitments

In June 2002 the company entered into an interest rate swap agreement, the purpose of which is to protect the company from interest rate risk in respect of the floating rate notes and to provide liquidity to the company. The notional amount outstanding as at 31 December 2004 was £45m and the swap had an expiry date of May 2027. Under the terms of the swap the company receives an amount of three month LIBOR and pays an amount of 0.55%, of the notional amount quarterly. In addition to the 0.55% interest payments the company is committed to make a series of scheduled payments under the swap arrangement totalling £140.8m commencing in May 2028. The company may terminate the swap prior to expiry and receive an early termination payment. The market value of this early termination payment has been hedged by the company through a second 'termination swap'.

15 Ultimate parent undertaking

The company is a wholly owned subsidiary of Equity Release Holdings Limited, a company incorporated in the UK. A copy of the consolidated group accounts and annual report may be obtained from its registered office at C/O SPV Management, Tower 42 (Level 11), International Financial Centre, 25 Old Broad Street, London, EC2N 1HQ.

Notes to the financial statements

16 Derivatives and other financial instruments

The company's policies with regard to derivatives and other financial instruments have been outlined in the directors' report.

Interest rate repricing
The interest rate profile of the Group's assets and liabilities at 31 December 2004 was:

	Weighted Average Interest Rate	Floating Rate £	Fixed Rate £	Non interest Bearing £	Total Book Value £	Fair Value of financial assets / liabilities £
Assets						
Mortgage advances (*)	8.13%	-	290,098,524	-	290,098,524	322,909,994
Unaccreted discount	-	-	-	(4,847,736)	(4,847,736)	
Interest Receivable	-	-	-	309,418	309,418	309,418
Cash	4.65%	25,116,754	-	-	25,116,754	25,116,754
Liabilities						
Deferred consideration	-	-	-	12,175,800	12,175,800	4,425,284
Mortgage backed notes	5.71%	38,718,000	255,000,000	(621,583)	293,096,417	326,111,426
Interest payable	-	-	-	1,873,373	1,873,373	1,873,373
Loans	5.53%	-	6,014,715	-	6,014,715	8,623,402
Off Balance Sheet Items						
Interest rate swaps	-	(45,000,000)	45,000,000	-	-	(1,841,222)

Fair value of financial assets and liabilities
Set out above is a comparison by category of book values and fair values of the Group. Fair values have been determined by discounting cash flows at prevailing rates.

* The Fair Value of Mortgage advances incorporates the unaccreted discount.

The interest rate of floating rate assets and liabilities is determined with reference to the London Inter-Bank Offering Rate.

Maturity profile (for all fixed and floating rate items)
The maturity of the fixed rate mortgage backed loan notes and other loans is more than five years. In the opinion of the directors the maturity profile of the mortgage advances, and accordingly the floating rate mortgage backed notes cannot be stated with sufficient certainty as it is not known exactly when a mortgage will redeem. (See note 11 for redemption details of the mortgage backed notes).

Borrowing facilities
At 31 December 2004, the group had a committed but undrawn 364 day borrowing facility of £70m.

Notes to the financial statements

Foreign currency
The company has not entered into transactions in any currency other than sterling throughout the period.

Credit Risk
The lending criteria for the mortgages include low initial loan to value ratios reducing the risk of credit losses. Due to the limited recourse nature of the structure, the directors consider that there is no net credit risk to the members of the Company. The company also has the benefit of an insurance policy with Norwich Union Life & Pensions Ltd which insures any undischarged portion of a loan where a sale has occurred as a result of death or the need for long term care of the relevant borrower.