

# **AIRE VALLEY MORTGAGES 2004 - 1 PLC**

Directors' Report and Financial Statements

Registered number: 5154235

31 December 2006

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**Directors' Report and Financial Statements**

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**Company Information**

**Directors**

SFM Directors Limited  
SFM Directors (No 2) Limited  
Christopher Patrick Willford (Appointed 9 January 2007)

**Company Secretary**

SFM Corporate Services Limited

**Registered Office**

35 Great St Helen's  
London  
EC3A 6AP

**Auditor**

KPMG Audit Plc  
1 The Embankment  
Neville Street  
Leeds  
LS1 4DW

**Directors' Report for the year ended 31 December 2006**

The Directors present their Report and Financial Statements for the year ended 31 December 2006

**Principal activities and business review**

Aire Valley Mortgages 2004 - 1 plc ("the Company") is a limited company incorporated in the United Kingdom under the Companies Act 1985 and registered in England and Wales

Aire Valley Holdings Ltd holds 49,998 £1 quarter paid shares and one £1 fully paid share, and SFM Nominees Ltd (the share nominee) holds one £1 fully paid share in the Company

The Company's principal activity is to issue floating and/or fixed rate debt securities and to enter into financial arrangements to fund the activities of certain subsidiaries of Aire Valley Holdings Limited by means of intercompany loans. The debt securities are issued in US Dollars, Euros and Sterling and are secured on a beneficial interest in a portfolio of mortgage loans held by Aire Valley Trustee Limited, under a Master Trust arrangement. These mortgage loans, which are originated by Bradford & Bingley plc, are secured on residential property in the UK. Details are set out in the offering circular pertinent to this Issue. The Company issued £2bn floating rate notes to the market on 5 October 2004. As at 31 December 2006 £1.775bn remains in issue. £225m was repaid in 2005 in accordance with the terms of its contractual agreements.

Interest expense has reduced to £91m in the year (2005: £99m) due to the note repayments in 2005, interest receivable has also reduced accordingly (page 8).

The profits of the Company are pre-determined under the terms of the issue documentation. The results for the year are shown in the Income Statement on page 8. The profit after taxation was £9,157 (2005: £6,952).

The Company has met all its obligations under the terms of the issue documentation.

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, and there have been no changes in the credit ratings of the notes in the period.

**Future developments**

The Directors expect that during 2007 the Company will continue to meet the interest payments on the notes.

**Dividend**

The Directors do not recommend the payment of a final dividend for the year (2005: £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 and their interests**

The Directors who served during the year were as follows:

SFM Directors Limited

SFM Directors (No. 2) Limited

Christopher Donald Gillespie

(Resigned 9 January 2007)

Christopher Gillespie, SFM Directors Limited and SFM Directors (No. 2) Limited are, or have been, Directors of Aire Valley Holdings Limited during the year. No Director had any interest in the share or loan capital of the Company at any time during the year.

**Directors' Report for the year ended 31 December 2006 (continued)**

**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

**International Financial Reporting Standards**

The Company adopted International Financial Reporting Standards (IFRS) with effect from 1 January 2005

**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 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 12, and further discussion in the context of the Bradford & Bingley Group as a whole is provided on pages 18-21 of that Group's 2006 Annual Report which does not form part of this report and Financial Statements

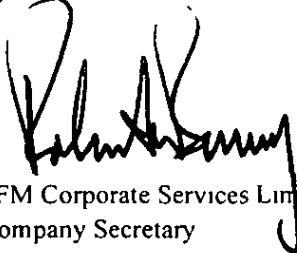
**Political and charitable contributions**

During the year no political or charitable contributions were made (2005 £nil)

**Auditor**

In accordance with Section 384 of the Companies Act 1985 a resolution for the re-appointment of KPMG Audit Plc as auditor of the Company is to be proposed at the forthcoming Annual General Meeting

By order of the Board



SFM Corporate Services Limited  
Company Secretary  
28 June 2007

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

The Directors are responsible for preparing the Directors' Report and 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 elected to prepare the Financial Statements in accordance with IFRS as adopted by the EU and applicable laws.

The Financial Statements are required by law to present fairly the financial position and the performance of the Company. The Companies Act 1985 provides in relation to such Financial Statements that references in the relevant part of that Act to Financial Statements giving a true and fair view are references to their achieving a fair presentation.

In preparing these 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 the Financial Statements have been prepared in accordance with IFRS as adopted by the EU, and
- # 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 that 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 have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Company and to prevent and detect fraud and other irregularities.

**Independent Auditor's Report to the members of Aire Valley Mortgages 2004 - 1 plc**

We have audited the Financial Statements of Aire Valley Mortgages 2004 - 1 plc for the year ended 31 December 2006 which comprise the Income Statement, the Balance Sheet, the Statement of Changes in Equity, the Cash Flow Statement and the related notes. These Financial Statements have been prepared under 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 auditor's 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 auditor**

The Directors' responsibilities for preparing the Financial Statements in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted by the EU are set out in the Statement of Directors' Responsibilities on page 6.

Our responsibility is to audit the Financial Statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

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 whether in our opinion the information given in the Directors' Report is consistent with the Financial Statements.

In addition we report to you if, in our opinion, 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 other transactions 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 International Standards on Auditing (UK and Ireland) 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, in accordance with IFRS as adopted by the EU, of the state of the Company's affairs as at 31 December 2006 and of its profit for the year then ended,
- the Financial Statements have been properly prepared in accordance with the Companies Act 1985, and
- the information given in the Directors' Report is consistent with the Financial Statements.



**KPMG Audit Plc**  
Chartered Accountants  
Registered Auditor  
28 June 2007

1 The Embankment  
Neville Street  
Leeds  
LS1 4DW

**Income Statement for the year ended 31 December**

	<i>Note</i>	<b>2006</b> <b>£000</b>	2005 £000
Interest receivable and similar income	2	<b>90,742</b>	99,439
Interest expense and similar charges	3	<b>(90,693)</b>	(99,388)
<b>Net interest income</b>		<u><b>49</b></u>	<u>51</u>
Operating expenses	4	<b>(40)</b>	(41)
<b>Profit before taxation</b>		<u><b>9</b></u>	<u>10</u>
Taxation	5	-	(3)
<b>Profit for the financial year</b>		<u><u><b>9</b></u></u>	<u><u>7</u></u>

The notes on pages 12 to 23 form part of these Financial Statements

The results above arise from the Company's single continuing activity and are attributable to the equity shareholders

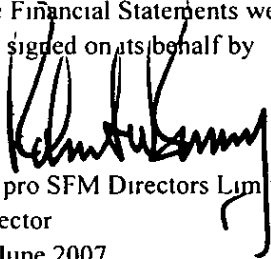


**Balance Sheet as at 31 December**

	<i>Note</i>	<b>2006</b> <b>£000</b>	2005 £000
<b>Assets</b>			
Loans to Group undertakings due after one year	9	<b>1,775,000</b>	1,775,000
<b>Total non-current assets</b>		<b>1,775,000</b>	1,775,000
Cash and cash equivalents		<b>252</b>	249
Loans to Group undertakings due within one year	9	<b>2,951</b>	2,503
Debt securities	7	-	31,127
Derivative financial instruments		-	9,022
Prepayments and accrued income		<b>8</b>	6
<b>Total current assets</b>		<b>3,211</b>	42,907
<b>Total assets</b>		<b>1,778,211</b>	1,817,907
<b>Equity</b>			
Capital and reserves attributable to equity holders			
Share capital	13	<b>13</b>	13
Retained earnings		<b>18</b>	9
<b>Total attributable equity</b>		<b>31</b>	22
<b>Liabilities</b>			
Interest bearing loans and borrowings	8	<b>1,738,288</b>	1,815,712
<b>Total non-current liabilities</b>		<b>1,738,288</b>	1,815,712
Interest-bearing loans and borrowings	8	<b>2,761</b>	2,170
Derivative financial instruments		<b>37,131</b>	-
Current tax liabilities		-	3
<b>Total current liabilities</b>		<b>39,892</b>	2,173
<b>Total liabilities</b>		<b>1,778,180</b>	1,817,885
<b>Total equity and liabilities</b>		<b>1,778,211</b>	1,817,907

The notes on pages 12 to 23 form part of these Financial Statements

The Financial Statements were approved by the Board of Directors and authorised for issue on 28 June 2007 and signed on its behalf by

  
per pro SFM Directors Limited  
Director  
28 June 2007

**Statement of Changes in Equity for the year ended 31 December**

	<b>Share capital £000</b>	<b>Retained earnings £000</b>	<b>Total equity £000</b>
<b>As at 1 January 2006</b>	<b>13</b>	<b>9</b>	<b>22</b>
<b>Profit for the year</b>	<b>-</b>	<b>9</b>	<b>9</b>
<b>As at 31 December 2006</b>	<b><u>13</u></b>	<b><u>18</u></b>	<b><u>31</u></b>
As at 1 January 2005	13	2	15
Profit for the year	-	7	7
As at 31 December 2005	<u>13</u>	<u>9</u>	<u>22</u>

**Cash Flow Statement for the year ended 31 December**

	2006 £000	2005 £000
<b>Cash flows from operating activities</b>		
<b>Profit for the financial year</b>	<b>9</b>	<b>7</b>
<i>Adjustments for</i>		
Interest on floating rate notes	<b>72,449</b>	66 216
Income tax expense	<b>-</b>	<b>3</b>
<b>Cash flows from operating activities before changes in operating assets and liabilities</b>	<b>72,458</b>	66,226
<i>Net (increase)/decrease in operating assets</i>		
Loans to Group undertakings	<b>(448)</b>	225,874
Debt securities	<b>31,127</b>	(3,439)
Prepayments and accrued income	<b>(2)</b>	(6)
Other current assets	<b>-</b>	1,175
Derivative financial instruments	<b>9,022</b>	(9,022)
<i>Net increase/(decrease) in operating liabilities</i>		
Derivative financial instruments	<b>37,131</b>	-
Other non-cash items	<b>46,297</b>	9,656
<b>Cash generated from/(absorbed by) operations</b>	<b>195,585</b>	290,464
Taxation paid	<b>(3)</b>	(1)
<b>Net cash from/(to) operating activities</b>	<b>195,582</b>	290,463
<i>Cash flows from financing activities</i>		
Interest paid on floating rate notes	<b>(73,040)</b>	(72,866)
Repayment of floating rate notes	<b>-</b>	(225,000)
Issue of subordinated liabilities	<b>-</b>	3,439
Repayment of subordinated liabilities	<b>(31,127)</b>	-
<b>Net cash from financing activities</b>	<b>(104,167)</b>	(294,427)
<b>Net (decrease)/increase in cash and cash equivalents</b>	<b>91,415</b>	(3,964)
Cash and cash equivalents at beginning of year	<b>249</b>	4,213
<b>Cash and cash equivalents at end of year</b>	<b>91,664</b>	249

**Notes to the Financial Statements for the year ended 31 December 2006****1. Significant accounting policies**

Aire Valley Mortgages 2004 - 1 plc (the "Company") is a company incorporated in the UK under the Companies Act 1985 and registered in England and Wales

**(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"). The Company has not adopted the following two statements issued by the IASB in August 2005 and mandatory for 2007 financial statements

The Capital Disclosures amendment to IAS 1 "Presentation of Financial Statements", and  
IFRS 7 "Financial Instruments Disclosures"

These two statements relate to disclosures only and adoption of them would have no impact on the Company's Income Statement, Balance Sheet or Cash Flow Statement

The Financial Statements also comply with the relevant provisions of Part VII of the Companies Act 1985, as amended by the Companies Act 1985 (International Accounting Standards and other Accounting Amendments) Regulations 2004

**(b) Basis of preparation**

The Financial Statements are prepared on the historical cost basis, except for derivative financial instruments, which are carried at fair value, and floating rate notes, where a hedge adjustment is applied as described in paragraph 1(k). The Financial Statements are presented in pounds sterling, which is the currency of the Company's primary operating environment. The Directors consider that the accounting policies set out below are the most appropriate to the Company's circumstances and have been consistently applied

**(c) Interest income and expense**

For all financial instruments measured at amortised cost (including loans to Group undertakings and floating rate notes) interest income and expense are recognised in the Income Statement on an Effective Interest Rate ("EIR") basis

The EIR basis spreads the interest income or interest expense over the expected life of the instrument. The EIR is the rate that at the inception of the instrument exactly discounts expected future cash payments and receipts through the expected life of the instrument back 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 and all other premia and discounts as well as interest

**(d) Taxation**

The charge for taxation is based on the profit for the period 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. Deferred taxation is provided for in full at the tax rate at the Balance Sheet date in accordance with IAS 12 "Income Taxes", including on tax losses carried forward, and is not discounted to take account of the expected timing of realisation. Deferred taxation assets are recognised only to the extent that it is probable that future taxable profits will be available against which the taxable differences can be utilised

**Notes to the Financial Statements for the year ended 31 December 2006 (continued)****1. Significant accounting policies (continued)****(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) 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) At amortised cost, or
- (vi) At fair value through profit or loss

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

The Company does not carry any financial instruments 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

Any profit or loss on sale of an instrument carried at amortised cost is recognised immediately in the Income Statement in interest income or expense depending on whether the instrument is an asset or a liability

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 market 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 that occur will be included in the Income Statement as "fair value movements on financial instruments"

**(g) Floating rate notes and subordinated liabilities**

On initial recognition, debt issued is measured at its fair value net of directly attributable transaction costs and discounts, in accordance with IAS 39 "Financial Instruments: Recognition and Measurement". Subsequent measurement is at amortised cost using the 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.

**Notes to the Financial Statements for the year ended 31 December 2006 (continued)****1. Significant accounting policies (continued)****(h) Derivative financial instruments**

Derivative financial instruments are carried at fair value in the Balance Sheet in accordance with IAS 39, as assets when the fair value is positive and as liabilities when the fair value is negative. Changes in fair value of derivatives are taken to the Income Statement as "fair value movements on financial instruments".

**(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.

Any foreign exchange gains or losses arising from settlement of transactions at rates different from those at the date of the transaction, and any unrealised foreign currency exchange gains and losses on unsettled foreign currency monetary assets and liabilities, are included in the Income Statement in "interest receivable and similar income" or "interest expense and similar charges" depending on whether the underlying instrument is an asset or a liability.

**(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 Income Statement as "fair value movements on financial instruments".

**2. Interest receivable and similar income**

	2006 £000	2005 £000
Interest on loans to Group undertakings	90,729	99,321
Bank interest	<u>13</u>	<u>118</u>
	<u>90,742</u>	<u>99,439</u>

The interest income for the year on impaired assets was £nil (2005: £nil)

**3. Interest expense and similar charges**

	2006 £000	2005 £000
Interest on floating rate notes	72,449	66,216
Swap interest	<u>18,244</u>	<u>33,172</u>
	<u>90,693</u>	<u>99,388</u>

**Notes to the Financial Statements for the year ended 31 December 2006 (continued)****4. Operating expenses**

	<b>2006</b>	2005
	<b>£000</b>	£000
Legal and professional fees	<u>40</u>	<u>41</u>

Auditors' remuneration of £3,000 (2005 £3,000) was borne by Bradford & Bingley plc

**5. Taxation**

	<b>2006</b>	2005
	<b>£000</b>	£000
Current taxation expense		
UK corporation tax on profit for the year	2	3
Adjustments in respect of previous years	<u>(2)</u>	<u>-</u>
Total taxation expense per the Income Statement	<u>-</u>	<u>3</u>
Profit before taxation	<u>9</u>	<u>10</u>
UK corporation tax at 30%	3	3
Effects of		
Small companies rate	(1)	-
Adjustments in respect of previous years	<u>(2)</u>	<u>-</u>
	<u>-</u>	<u>3</u>

There was no deferred tax provided or unprovided during the year or the previous year

**6. Employees and Directors' emoluments**

There were no employees during the year (2005 none) and 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 10)

**7. Debt securities**

During the year the debt securities which represented collateral provided by Credit Suisse First Boston International (CSFB) to provide security for the currency swaps held with the Company were repaid. As at 31 December 2005 this amounted to £31.1m. These amounts were held by CSFB on behalf of the Company as a contingency against any default on the swap agreement.

**Notes to the Financial Statements for the year ended 31 December 2006 (continued)****8. Interest-bearing loans and borrowings**

	2006	2005
	£000	£000
Floating rate notes	1,741,049	1,786,755
Subordinated liabilities	-	31,127
	<u>1,741,049</u>	<u>1,817,882</u>

Accrued interest on the loan notes is included within the floating rate note balance. In 2005 this was presented separately as accruals and deferred income.

The subordinated liabilities related to the swap collateral deposited by CSFB (see note 7).

The floating rate notes were issued on 5 October 2004. Under the terms of the notes any shortfalls arising on the redemption or repossession of the mortgage assets held in trust on behalf of Aire Valley Funding 1 Limited over which the note holders have a floating charge, may result in a reduction in the liability under the notes. Shortfalls are allocated against the notes in reverse order to the seniority of the class of the note, resulting in such reductions being first allocated against Class D notes.

Class	Maturity	31 December 2006	31 December 2005
		£000	£000
Series 2 A1	Sep 2034	250,000	250,000
Series 2 A2	Sep 2034	550,000	550,000
Series 2 A3	Sep 2034	200,000	200,000
Series 2 B1	Sep 2066	20,000	20,000
Series 2 B2	Sep 2066	44,900	44,900
Series 2 C1	Sep 2066	20,000	20,000
Series 2 C2	Sep 2066	51,800	51,800
Series 3 A1	Sep 2066	215,000	215,000
Series 3 A2	Sep 2066	315,000	315,000
Series 3 B1	Sep 2066	20,000	20,000
Series 3 B2	Sep 2066	17,000	17,000
Series 3 C1	Sep 2066	20,000	20,000
Series 3 C2	Sep 2066	21,300	21,300
Series 3 D1	Sep 2066	15,000	15,000
Series 3 D2	Sep 2066	15,000	15,000
		<u>1,775,000</u>	<u>1,775,000</u>
Less issue costs		(107)	(170)
Less fair value adjustment		(36,605)	9,755
Total non-current liabilities		<u>1,738,288</u>	<u>1,784,585</u>
Accrued interest - current		2,761	2,170
Floating rate notes		<u>1,741,049</u>	<u>1,786,755</u>



**Notes to the Financial Statements for the year ended 31 December 2006 (continued)****8. Interest-bearing loans and borrowings (continued)**

The floating rate notes are denominated in the following currencies

	£000
Sterling	560,000
US Dollars	200,000
Euros	1,015,000
	<u>1,775,000</u>

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 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, C and D 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 and D notes, and payments of principal and interest due and payable on the Class C notes will rank ahead of payments of principal and interest due and payable on the Class D notes.

Interest is payable on the Series 2 Class A3 notes at a variable rate based on three month US Dollar LIBOR. Interest is payable on the Series 2 Class A2, Series 2 Class B2, Series 2 Class C2, Series 3 Class A2, Series 3 Class B2, Series 3 Class C2 and Series 3 Class D2 notes at variable rates based upon three month EURIBOR. Interest is payable on Series 2 Class A1, Series 2 Class B1, Series 2 Class C1, Series 3 Class A1, Series 3 Class B1, Series 3 Class C1 and Series 3 Class D1 notes at variable rates based upon 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 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.

The estimated market value of the floating rate notes based on the mid-market price on 31 December 2006 was £1,744,937,000 (2005 £1,778,087,000).

**9. Loans to Group undertakings**

The intercompany loan to Aire Valley Funding 1 Limited is denominated in Sterling and is 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.

Aire Valley Funding 1 Limited's ability to pay amounts due on the intercompany loan will depend mainly upon it receiving sufficient revenue 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.

**Notes to the Financial Statements for the year ended 31 December 2006 (continued)****10. Related parties 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 provided by SFM Directors Limited and SFM Directors (No 2) Limited and the third director is an employee of Bradford & Bingley plc (the mortgage loan administrator). 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 £11,914 (2005 £8,936).

The loans to Group undertakings consist of the Company's beneficial interest in the mortgages held by Aire Valley Funding 1 Limited. Interest received by the Company is based on income received by Aire Valley Funding 1 Limited from these mortgage loans.

The Company undertook the following transactions with companies in the Bradford & Bingley plc Group and the Aire Valley Holdings Ltd Group

	<b>Bradford &amp; Bingley plc and subsidiaries</b>	<b>Aire Valley Holdings Ltd and subsidiaries</b>	<b>Bradford &amp; Bingley plc and subsidiaries</b>	<b>Aire Valley Holdings Ltd and subsidiaries</b>
	<b>2006</b>	<b>2006</b>	<b>2005</b>	<b>2005</b>
	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>
<b>Interest receivable and similar income</b>				
Interest on loans to Group undertakings	-	90,729	-	99,321
<b>Non-current assets</b>				
Loans to Group undertakings due after one year	-	1,775,000	-	1,775,000
<b>Current assets</b>				
Loans to Group undertakings due within one year	-	2,951	-	2,503

Auditors' remuneration of £3,000 (2005 £3,000) was borne by Bradford & Bingley plc

**11. Key sources of estimation uncertainty and judgements in application of accounting policies**

In preparation of the Company's accounts 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 instrument 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 present value models.

## Notes to the Financial Statements for the year ended 31 December 2006 (continued)

## 12. Financial instruments

## (a) Fair values of financial assets and financial liabilities

2006	Carrying value £000	Fair value £000
Financial assets		
Loans to Group undertakings due after one year	1,775,000	1,775,000
Loans to Group undertakings due within one year	2,951	2,951
Cash and cash equivalents	252	252
Total financial assets	<u>1,778,203</u>	<u>1,778,203</u>
Financial liabilities		
Interest-bearing loans and borrowings	1,741,049	1,744,937
Derivative financial instruments	37,131	37,131
Total financial liabilities	<u>1,778,180</u>	<u>1,782,068</u>
2005		
Financial assets		
Loans to Group undertakings due after one year	1,775,000	1,775,000
Loans to Group undertakings due within one year	2,503	2,503
Cash and cash equivalents	249	249
Debt securities	31,127	31,127
Derivative financial instruments	9,022	9,022
Total financial assets	<u>1,817,901</u>	<u>1,817,901</u>
Financial liabilities		
Interest-bearing loans and borrowings	1,817,882	1,809,214
Total financial liabilities	<u>1,817,882</u>	<u>1,809,214</u>

No financial instruments were reclassified during the year or previous year between amortised cost and fair value categories

The derivative financial instruments were categorised as "at fair value through profit or loss" throughout the year and previous year

## (b) Nature and extent of risks arising from financial instruments

The main financial risks arising from the Company's activities are credit risk, liquidity risk, currency risk and interest rate risk. Financial instruments used by the Company for risk management purposes include derivative instruments. Such instruments are used only for commercial hedging purposes, not for trading or speculative purposes. The principal derivative instruments used by the Company in managing its risks 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. Substantially all of the Company's derivatives activity is contracted with Group undertakings.

**Notes to the Financial Statements for the year ended 31 December 2006 (continued)****12. Financial instruments (continued)****(b) Nature and extent of risks arising from financial instruments (continued)***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 arising from the loans to Group undertakings, debt security issuers, derivative counterparties and deposits with third party banks. The exposure to credit risk is represented by the carrying amount of each financial asset, as set out in the table in note 12b(i).

*Liquidity risk*

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, and to minimise mismatches between maturing assets and liabilities.

*Currency risk*

The Company has debt securities in issue denominated in US Dollars and 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 securities. All other assets, liabilities and transactions are denominated in Sterling.

*Interest rate risk*

The Company is exposed to movements in interest rates due to mismatches between the dates on which interest receivable on assets and interest payable on liabilities are next reset, or maturity if earlier. The table in note 12b(iii) summarises interest repricing mismatches as at 31 December 2006 and 31 December 2005. The Company takes out derivative instruments to manage interest rate mismatches.

*Other market risks*

At the year end the Company had no other material exposure to market risks (2005: £nil).

**(i) Credit risk**

Before taking account of any collateral, the exposure to credit risk was

	<b>2006</b>	2005
	<b>£000</b>	£000
Cash and cash equivalents	<b>252</b>	249
Loans to Group undertakings	<b>1,777,951</b>	1,777,503
Debt securities	-	31,127
Derivative financial instruments	-	9,022
Exposure to credit risk	<b><u>1,778,203</u></b>	<u>1,817,901</u>

## Notes to the Financial Statements for the year ended 31 December 2006 (continued)

## 12. Financial instruments (continued)

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

## (ii) Liquidity risk

There is a liquidity facility of £30 0m provided by Rabobank Group in the event that the Company is unable to meet its financial commitments, on a temporary basis, in certain circumstances and subject to certain criteria. This facility was not required during the current or preceding year.

## (iii) Interest rate risk

As at the year end effective interest rates on financial instruments fell into the following ranges

	2006	2005
	%	%
Financial assets		
Cash and cash equivalents	2.51 - 5.34	3.82 - 5.50
Loans to Group undertakings	0.10 - 8.56	3.11 - 4.16
Financial liabilities		
Interest bearing loans and borrowings	3.87 - 8.56	2.30 - 8.23

A positive interest rate sensitivity gap exists when more assets than liabilities re-price during a given period. Although net interest income tends to benefit from a positive gap when interest rates are rising (and suffer a negative gap when rates are falling), the actual effect will depend upon a number of factors, including the extent to which repayments are made earlier or later than the next reset or maturity date. The carrying amount of derivative financial instruments, which are principally used to reduce the Company's exposure to interest rate movements, are included under the heading "non-interest bearing". The following tables analyse the re-pricing periods of the Company's assets and liabilities at 31 December 2006 and 31 December 2005.

	Within 3 months £000	After 3 months but within 6 months £000	After 6 months but within 1 year £000	After 1 year but within 5 years £000	After 5 years £000	Non-interest bearing £000	Total £000
<b>At 31 December 2006</b>							
<b>Assets</b>							
Loans to Group undertakings	1,777,951	-	-	-	-	-	1,777,951
Cash and cash equivalents	252	-	-	-	-	-	252
<b>Total financial assets</b>	<b>1,778,203</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>1,778,203</b>
<b>Liabilities</b>							
Interest-bearing loans and borrowings	1,741,049	-	-	-	-	-	1,741,049
Derivative financial instruments	-	-	-	-	-	37,131	37,131
<b>Total financial liabilities</b>	<b>1,741,049</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>37,131</b>	<b>1,778,180</b>
<b>Interest rate sensitivity gap</b>							
	37,154	-	-	-	-	(37,131)	23
<b>Cumulative gap</b>	<b>37,154</b>	<b>37,154</b>	<b>37,154</b>	<b>37,154</b>	<b>37,154</b>	<b>23</b>	<b>23</b>

## Notes to the Financial Statements for the year ended 31 December 2006 (continued)

## 12. Financial instruments (continued)

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

## (ni) Interest rate risk (continued)

		After 3 months	After 6 months	After 1 year			
	Within 3 months	but within 6 months	but within 1 year	but within 5 years	After 5 years	Non-interest bearing	Total
	£000	£000	£000	£000	£000	£000	£000
<b>At 31 December 2005</b>							
<b>Assets</b>							
Loans to Group							
undertakings	1,777,503	-	-	-	-	-	1,777,503
Cash and cash equivalents	249	-	-	-	-	-	249
Debt securities	-	-	-	-	-	31,127	31,127
Derivative financial							
instruments	-	-	-	-	-	9,022	9,022
<b>Total financial assets</b>	<b>1,777,752</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>40,149</b>	<b>1,817,901</b>
<b>Liabilities</b>							
Interest-bearing loans							
and borrowings	1,786,755	-	-	-	-	31,127	1,817,882
<b>Total financial</b>							
<b>liabilities</b>	<b>1,786,755</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>31,127</b>	<b>1,817,882</b>
<b>Interest rate</b>							
<b>sensitivity gap</b>	<b>(9,003)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>9,022</b>	<b>19</b>
Cumulative gap	(9,003)	(9,003)	(9,003)	(9,003)	(9,003)	19	19

## (c) 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 loans to Group undertakings are ultimately due from one entity, Aire Valley Funding 1 Ltd, and represent an interest in a portfolio of commercial mortgage loans secured on residential properties in England, Scotland and Wales.

## Notes to the Financial Statements for the year ended 31 December 2006 (continued)

## 13. Called up share capital

	2006 Shares	2005 Shares	2006 £	2005 £
Ordinary shares of £1 each				
<b>Authorised</b>				
As at 1 January and 31 December	<u>100,000</u>	<u>100,000</u>	<u>100,000</u>	<u>100,000</u>
<b>Allotted and issued</b>				
As at 1 January and 31 December	<u>50,000</u>	<u>50,000</u>	<u>12,501</u>	<u>12,501</u>

The issued share capital comprises two ordinary shares which are fully paid up and 49,998 ordinary shares which are one quarter paid up. The shares rank equally in respect of rights attaching to voting, dividends and in the event of a winding up.

## 14. Ultimate parent undertaking

The immediate parent undertaking of the Company is Aire Valley Holdings Limited a company incorporated and registered in England and Wales.

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

Under IFRS, the Company's ultimate controlling party is Bradford & Bingley plc a company incorporated and registered in England and Wales. Bradford & Bingley plc heads the largest and smallest group of companies into which the Financial Statements of the Company are consolidated. Copies of the Financial Statements of Bradford & Bingley plc may be obtained from the Company Secretary at Croft Road, Crossflatts, Bingley, West Yorkshire BD16 2UA.