Paragon Banking Group PLC

Preliminary Financial Report

For the year ended 30 September 2018

Diversification drives strong profit growth

Paragon Banking Group PLC ('Paragon' or the 'Group'), the specialist banking group, today announces its results for the year ended 30 September 2018.

Commenting on the results, Nigel Terrington, Chief Executive of Paragon, said:

"We have delivered another strong financial performance, with increased profits driven by broader lending growth and enhanced margins, whilst maintaining our high credit standards.

In the last year we have made great strides in our strategy to become a leading UK based specialist banking group. A combination of new start-up ventures and acquisitions means we now offer an increasingly broad range of products, supporting British savers, homeowners, landlords, consumers and small businesses.

The restructuring of our business last year enabled us to improve the efficiency of the allocation of our resources and capital. The broadening of our product range, coupled with our strong asset quality, leaves us well placed to deliver further targeted growth in the years ahead."

Financial highlights

- Underlying profit before tax increased by 7.8% to £156.5 million (2017: £145.2 million) Statutory profit before tax increased by 25.3% to £181.5 million (2017: £144.8 million)
- Net interest margin increased by 8 basis points to 2.21% (2017: 2.13%)
- Underlying EPS up 11.3% to 48.2p (2017: 43.3p). EPS up by 29.7% to 55.9p (2017: 43.1p)
- Underlying RoTE up to 14.0% (2017: 13.5%). RoTE increased to 16.1% (2017: 13.4%)
- Idem Capital portfolio sale recycles capital to support business growth and acquisitions
- Capital levels remain strong, with CET1 of 13.8% (2017: 15.9%) following acquisitions
- Dividend per share up by 23.6% to 19.4p (2017: 15.7p), in line with policy announced in November 2017

Strong new business flows in Mortgages and Commercial Lending divisions

- Mortgage lending up 10.8% to £1,623.2 million (2017: £1,464.5 million)
- Buy-to-let lending pipeline up 28.9% to £778.9 million (2017: £604.2 million)
- Commercial Lending volumes up 82.6% to £710.0 million (2017: £388.9 million)
- Titlestone development finance business acquired in July 2018
- Acquisition of Iceberg professions finance business in December 2017
- Net loan book growth of 9.0%

Diversified funding model underpinned by strong retail deposit flow

- Deposit balances increased by 46.5% to £5.3 billion (2017: £3.6 billion)

OVERVIEW AND OUTLOOK

1. Overview

Our results highlight another year of strong financial and operational progress, alongside significant developments in our strategy. It has been a year in which we have continued to proactively position our businesses and product lines to optimise returns to shareholders, embedding the business' status as one of the UK's leading specialist banks. We will continue to employ our deep through-the-cycle experience in our chosen markets to achieve good growth, greater diversification and an unwavering focus on our long-held risk principles.

2. Financial Performance

Underlying profits increased by 7.8% to £156.5 million, with growth in each of the Group's operating divisions, the largest increase occurring in Commercial Lending, where profits rose 41.1% to £19.9 million. Across the year, the combination of acquisitions and organic growth contributed to a 9.0% growth in net loan balances, which stood at £12.1 billion at September 2018. At the same time, the change in product mix within the balance sheet underpinned an 8 basis-point increase in net interest margins to 2.21%.

The Group's cost of risk remained low with a charge of 6 basis points, reflecting the Group's long term cautious approach to its risk appetite.

Underlying operating costs increased by £9.6 million to £111.9 million which includes part year costs that came with the acquisitions during the period. Like-for-like costs included increased levels of technology investment to increase our digital engagement with customers and intermediaries, enhance operational resilience, support growth in the newer divisions and deliver projects such as GDPR and the Group's IRB development. Consequently, the cost:income ratio was stable at 40.6%, and we remain focussed on delivering our medium target of low 30s%.

From 1 October 2018, the Group's impairment calculations will be based upon the IFRS9 methodology. A full transition document will be distributed ahead of the 2019 interim results, with the impact on provisions at 1 October 2018 expected to be approximately £27 million, which will be reflected through a movement in reserves.

3. New Business Activity

The Group's existing Mortgage and Commercial Lending divisions generated strong new lending growth in 2018 of 25.9%, with the core buy-to-let business showing good volume performance in the complex segment of the market, with complex completions increasing to 79.3% of advances in the year and representing 87.8% of the year end buy-to-let pipeline. The various Commercial Lending products saw good underlying lending growth of 45.4% in 2018.

The acquisitions of Iceberg (professions finance) in December 2017 and Titlestone (development finance) in July 2018 provide further capabilities and scale to the Group's Commercial Lending area. The total volume generated from these businesses in their first part year were £95.5 million (Iceberg) and £49.1 million (Titlestone).

The focus on specialist markets and the maintenance of the Group's cautious approach to credit is a core element of the Group's strategy. The change in product mix as legacy lending is replaced by complex buy-to-let and commercial lending supports growth in the Group's net interest margin. Greater new business volumes are starting to improve the operational leverage made possible by recent investments in infrastructure and capabilities, most notably in the Commercial Lending segment. This will be a key driver in moving the Group's cost:income ratio towards its medium-term target level.

The Group's retail deposit franchise has made further progress over the last year with balances reaching £5.3 billion, a 46.5% increase on last year. High retention levels have been achieved, supported by stronger customer engagement and improvements in our savings customer service metrics, including further improvements in our Net Promoter Score.

We have accessed the capital markets opportunistically during the year, issuing our first mortgage backed security for over 2 years, with a transaction that was the largest for over a decade and at the lowest price since the financial crisis. We have also completed a £200.0 million warehouse facility with Bank of America Merrill Lynch which will provide a source of cost-effective standby funding. Separately we received an upgrade in our corporate debt rating from Fitch to BBB which could facilitate further new debt issuance at efficient pricing.

4. Capital Management

Our capital ratio remains strong and comfortably ahead of our minimum regulatory requirements. The CET1 ratio stands at 13.8% (2017: 15.9%), with a total capital ratio of 16.2% (2017: 18.7%). A key part of our strategy has been to strike an appropriate balance between maintaining robust capital levels to support our immediate requirements and future growth prospects, whilst actively managing these levels to optimise returns for shareholders. We have made good progress on IRB and remain on track to submit our application to the PRA in early 2019.

Capital was recycled from Idem Capital to Commercial Lending in 2018, with the sale of a portfolio at a premium supporting the growth in capital requirements following the Titlestone acquisition. In addition to financing its growing loan portfolio and the goodwill associated with the two acquisitions, the Group also completed £25.0 million of share buy-backs (before costs) in the year and increased dividends by 23.6% to 19.4 pence per share. The dividend cover ratio is now at its target level of 2.5x. We believe there is significant optionality available to employ the Group's capital to support our ongoing growth prospects. Consequently no buy-back is expected in 2019, although it will remain an option to be employed in the future to enhance shareholder returns.

5. Diversification, Growth and Capital Optimisation

The restructuring of the Group, which effectively resulted in the Bank subsuming the rest of the organisation, took effect at the beginning of this year. It has worked well. We now have much greater mobility of capital, funding flexibility and greater operational centralisation, something which is a genuine advantage when actively managing the Group's various business lines. We have always been disciplined in not chasing business simply for the sake of growth. This is particularly true at the moment with strong competition in UK banking markets. We are a specialist bank and create points of differentiation through having a better understanding of our markets, our customers and the application of credit risk. Our centralised bank operating model and greater mobility of capital enables us to allocate resources more efficiently to where we can achieve the most optimal balance between growth, returns and risk.

Alongside the two acquisitions we have also sold assets. Idem Capital sold a portfolio of loans, generating a significant capital gain, demonstrating our ability to recycle capital away from areas where we believe the risk return equation is currently sub-optimal, towards areas offering more attractively balanced prospects.

6. Outlook

The Group's strategy remains unchanged, focusing on using its extensive credit experience to enable it to operate effectively and with a low-risk appetite in its chosen range of specialist markets. The deep understanding in these sectors, combined with the flexibility of the operating model, enables the Group to focus resources to optimise growth, risk and reward. The diversification delivered by a series of organic and acquisitive developments over the past five years, combined with a broadly-based funding approach leaves the business well placed to deliver further value to its shareholders over the coming years.

The Group enters 2019 with a strong new business pipeline, is well positioned in its chosen markets and equipped with high levels of liquidity. Despite the potential for economic uncertainties arising from Brexit and elsewhere, the Group remains confident of its future prospects.

KEY PERFORMANCE INDICATORS

	2018	2017	Change	% change
Profit before tax	£181.5m	£144.8m	+36.7m	+25.3%
Underlying profit*	£156.5m	£145.2m	+11.3m	+7.8%
Basic EPS	55.9p	43.1p	+12.8p	+29.7%
Underlying EPS*	48.2p	43.3p	+4.9p	+11.3%
Dividend per share	19.4p	15.7p	+3.7p	+23.6%
Return on Tangible Equity ('RoTE')	16.1%	13.4%		
Underlying RoTE*	14.0%	13.5%		
Cost:income ratio	40.6%	40.5%		
Core Tier 1 ratio	13.8%	15.9%		
Total capital ratio	16.2%	18.7%		
UK leverage ratio	6.4%	6.6%		
Share buy-backs	£25.0m	£50.0m		

* Appendix A

New Business	Advances and investments		Pipeline	
	2018	**2017**	**2018**	**2017**
Buy-to-let	1,495.5	1,399.9	778.9	604.2
Other mortgage lending	127.7	64.6		
Total Mortgages	**1,623.2**	**1,464.5**		
Asset finance	354.7	220.0		
Other commercial lending	355.3	168.9		
Total Commercial Lending	**710.0**	**388.9**		
Total advances	**2,333.2**	**1,853.4**		
Portfolio acquisitions	83.4	98.0		
Total new business	**2,416.6**	**1,951.4**		

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Paragon will be holding a results presentation for analysts on 21 November 2018 at 9:30 am at UBS, 5 Broadgate, London EC2M 2QS. The presentation material will be available on the Group's website at www.paragonbankinggroup.co.uk/investors **from 11:00 am on the same day.**

CAUTIONARY STATEMENT

Sections of this preliminary announcement, including but not limited to the Management Report, may contain forward-looking statements with respect to certain of the plans and current goals and expectations relating to the future financial condition, business performance and results of the Group. These have been made by the directors in good faith using information available up to the date on which they approved this report. By their nature, all forward-looking statements involve risk and uncertainty because they relate to future events and circumstances that are beyond the control of the Group and depend upon circumstances that may or may not occur in the future. There are a number of factors that could cause actual future financial conditions, business performance, results or developments to differ materially from the plans, goals and expectations expressed or implied by these forward-looking statements and forecasts. Nothing in this document should be construed as a profit forecast.

STRATEGY REVIEW

The past five years have seen the Group transition from being a monoline centralised lender to a diversified specialist banking group. This process has generated a closer alignment of the Group's cash and capital resources, facilitated growth and diversification, both organically and via acquisition, and accessed a broader and more stable funding base. Across this period the Group has improved returns to its shareholders and optimised its flexibility to recycle capital internally to support the needs of its growth businesses.

The past year has evidenced the strengths of this strategic approach, which will continue to drive the Group's development going forward.

The Group supports the needs of its consumer and SME customers and seeks to develop its presence in these markets through a combination of specialist product design, distribution and underwriting supported by its efficient centralised operating platform and resilient technology. Organic growth has been strong during the year, augmented by business and portfolio acquisitions. The Group has an outstanding through-the-cycle record in challenging markets with excellent risk metrics, reflective of the cautious and prudent approach it takes to its risk appetite alongside its highly effective operating model.

We expect growth to remain strong in the future, with a focus on the delivery of our organic strategy being augmented by proposition expansion, where such developments provide an attractive risk profile and shareholder return.

During the year the activities of the Commercial Lending division have been strengthened by two acquisitions. Iceberg, completed in December 2017, expanded the Group's lending to professional firms and Titlestone, completed in July 2018, generated a step-change in the size and scope of the Group's development finance presence. Both acquisitions were funded by a combination of retail deposits and internally generated capital resources. Capital for the Titlestone purchase was also partly provided by a recycling of capital from Idem Capital, where a portfolio of loans was sold during the final quarter of 2018, generating a significant gain that has been separately identified in this year's accounts.

Alongside the strategic progress demonstrated in the year, the Group has delivered strong results for its shareholders. The table below summarises these on both a statutory and an underlying basis, the latter excluding the costs and benefits arising from the acquisitions and asset sales mentioned above which do not form part of the day-to-day activities of the Group. The underlying results, therefore, should provide greater clarity on the Group's operating performance.

	Statutory	Underlying (Appendix A)
Profit before tax	**Up 25.3% to £181.5 million** *(2017: £144.8 million)*	**Up 7.8% to £156.5 million** *(2017: £145.2 million)*
Basic EPS	**Up 12.8 pence to 55.9 pence** *(2017: 43.1 pence)*	**Up 4.9 pence to 48.2 pence** *(2017: 43.3 pence)*
RoTE	**Up 2.7 pps to 16.1%** *(2017: 13.4%)*	**Up 0.5 pps to 14.0%** *(2017: 13.5%)*

STRATEGY REVIEW

Lending

Strong and targeted growth in organic business volumes has been delivered during 2018. The scale of our Commercial Lending division has been supplemented by business acquisitions, while Idem Capital also completed a loan portfolio purchase transaction of commercial lending assets. Excluding the contribution from the acquired businesses, organic originations grew 18.1% to £2,188.6 million (2017: £1,853.4 million). Including post-acquisition lending from the acquired businesses, total lending increased by 25.9% to £2,333.2 million.

The Group's largest business remains its buy-to-let franchise. The UK private rented sector continues to see strong levels of demand from tenants, which is expected to continue for the foreseeable future. The buy-to-let market has experienced a period of disruption following a series of fiscal and regulatory changes aimed at both landlords and lenders. Against this backdrop the Group's performance has remained strong, with over twenty years' experience of servicing the needs of professional landlords differentiating it from other lenders and allowing the business to make market share gains during the year. New buy-to-let origination levels increased by 6.8% from the previous year's level to £1,495.5 million in the year to September 2018 (2017: £1,399.9 million), with the Group's market share, as measured by the figures reported by UK Finance, increasing from 3.93% to 4.11%.

However, survey data suggests that the Group has a more material share of the professional landlord market. With this sector comprising approximately 23% of the market as a whole, the survey results indicate the Group's share of its target market was in the region of 14%.

The most recent regulatory changes in the buy-to-let market require lenders to collect and analyse more information about the landlord's property portfolio and wider business than has previously been common in the market. Consequently, some lenders have restricted their buy-to-let activity as a result of the increased demands of such a complex underwriting process. The Group's expertise in this particular market segment has positioned the business well to benefit from these changes and further increase its market share.

The Group's other mortgage businesses comprise its second mortgage activities, where new origination levels rose 17.3% to £71.2 million during the year (2017: £60.7 million) and a specialist residential lending operation, which remains in its pilot phase with distribution limited to a small number of brokers pending final product reviews and associated systems and process enhancements. New specialist residential volumes totalled £56.5 million during the year (2017: £3.9 million).

Further asset and income diversification is generated by the Group's Commercial Lending division. The division's asset finance activities have been transformed to service a broader mid-market range of SME customers, as opposed to restricting lending solely to the more limited niches originally serviced. Customer credit profiles are generally stronger in this larger sector, with margins commensurately lower. This strategy has resulted in higher new business volumes (up 61.2% on the year ended 2017 to £354.7 million in 2018, including £95.5 million generated by the acquired Iceberg operation).

The motor finance business also saw strong growth in 2018. Operating in the hire and lease purchase segments of the market (with no exposure to personal contract purchase products), new business origination grew by 48.3% to £177.9 million during the year (2017: £120.0 million).

The division's development finance operation was enhanced by the acquisition of Titlestone in the year, accelerating its expansion. This operation provides funding, principally to smaller property developers, and new drawings totalled £136.8 million (2017: £48.9 million), with £49.1 million of this arising in Titlestone.

STRATEGY REVIEW

The Group's structured lending unit, which provides lending solutions to non-bank financial institutions, agreed its first facilities in the year with three arrangements active by the year end. Drawings in the year were £40.6 million with a balance of £38.7 million by the year end. By the end of 2018 the business was operating at breakeven, with a positive contribution to Group profit expected in 2019.

The Group's portfolio purchase business, Idem Capital, is an established purchaser of loan portfolios. Gross purchases in 2018 were £83.4 million (2017: £98.0 million). The sector has proved increasingly popular for both specialist purchasers and credit funds in recent years, with available returns reducing accordingly. Idem Capital has retained its credit and pricing discipline across the past year, but as a consequence, current year activity has been focussed on augmenting the organic asset and motor finance advances made elsewhere in the Group though the purchase of such loans from other lenders.

Funding

The Group continued to expand its retail deposit funding base and increased its access to Bank of England facilities during the year. At 30 September 2018, retail savings balances were £5.3 billion and the Term Funding Scheme ('TFS') and other central bank drawings totalled £1.0 billion, compared with savings deposits of £3.6 billion and £0.7 billion TFS drawings a year earlier. In addition to funding new advances, the Group refinanced a number of previously securitised or warehoused portfolios using retail deposits. Similar refinancing activity is expected over the coming years.

The Group also launched its first securitisation since 2015, raising £435.3 million through the Paragon Mortgages (No. 25) transaction.

The Group's funding has become increasingly diversified in the years following the financial crisis. Funding for pre-2010 balances is still primarily provided by securitisation funding arranged around the time of advance.

Retail deposits represent the Group's primary source of funding for new lending, whilst securitisation approach is used and when conditions in that market are attractive, as they were during the year, allowing the Group to maintain a diversified approach to its funding.

Capital

The Group's CET1 ratio was managed down to 13.8% in 2018 (2017: 15.9%), reflecting balance sheet growth, product diversification, acquisitions and higher distributions to shareholders through buy-backs and enhanced dividend levels. The Group's total capital ratio was 16.2% at September 2018 (2017: 18.7%).

Enhancing shareholder returns on a sustainable basis is a key objective for the Group and during the year underlying basic EPS increased by 11.3% (29.7% on the statutory basis). Following a reduction to a 2.75 times dividend cover ratio in 2017 the Group targeted a further reduction to 2.5 times in 2018. The dividend for the year of 19.4 pence reflects the new target, based on underlying performance, and has increased by 23.6% (2017: 15.7 pence).

The Group has adopted a formulaic approach to its interim dividend levels going forward, with the interim dividend per share from the 2018 interim being one half of the final dividend declared in the preceding period in normal circumstances.

STRATEGY REVIEW

The Group's share buy-back programme progressed in the year, with £25.2 million having been invested, enhancing shareholder returns, until the programme was suspended to reflect the capital requirements of the Titlestone acquisition. The Group is not anticipating a share buy-back in 2019, but will seek the normal shareholder approvals at its February 2019 Annual General Meeting ('AGM') to allow flexibility if conditions change and surplus capital becomes available.

The business remains well funded, strongly capitalised and effectively placed to continue to deliver long term, sustainable returns through its robust operating model. The Group is positioned to respond quickly to the challenges and to take advantage of the opportunities that will arise given changes in the broader operating environment.

A more detailed discussion of the Group's performance is given below covering:

Lending review	Funding review	Financial review	Operational review
Lending, performance and markets	Retail deposits, wholesale funding and capital management	Results for the year	People, risk and regulation

LENDING REVIEW

The Group's operations are organised into three divisions, based on product type, origination and servicing capabilities. This organisational and management structure has been in place throughout the year.

New business advances and investments in the year, together with the year end loan balances, by division, are summarised below:

	Advances and investments in the year		Net loan balances at the year end	
	2018 £m	2017 £m	2018 £m	2017 £m
Mortgages	1,623.2	1,464.5	10,473.5	9,953.9
Commercial Lending	710.0	388.9	1,133.2	558.8
Idem Capital	83.4	98.0	521.1	611.4
	2,416.6	1,951.4	12,127.8	11,124.1

The Group's loan book increased by 9.0% in the year, with new advances and investments 23.8% higher than in the previous financial year.

Mortgages

The Group's Mortgages division offers buy-to-let first charge and owner-occupied first and second charge mortgages on residential property in the UK. In all its offerings, it targets niche markets where its focus on detailed case-by-case underwriting and its robust and informed approach to property risk differentiate it from mass market and other specialist lenders.

Housing and mortgage market

The UK mortgage and housing market remains finely balanced and activity remains subdued, with this position having continued throughout the financial year. New mortgage approvals, reported by the Bank of England, in the year ended 30 September 2018, at £255.4 billion had increased by only 2.1% from the previous year, (2017: £250.1 billion), with remortgaging increasing by 9% and house purchase mortgages declining by 2%. This level of transactions remains some 30% below the 2007 peak in the market.

The Nationwide House Price Index reported annual growth of only 2.0%, a reduction from the 2.3% seen in 2017, with London seeing a decline in prices, although house prices there remain close to their 2007 peak. Growth has been at this level for the past eighteen months, with expectations of future increases remaining modest. The most recent Nationwide analysis forecasts an increase of only 1.0% over 2018 as a whole.

These market trends were supported by the latest survey data from the Royal Institution of Chartered Surveyors ('RICS') UK Residential Market Survey, which highlighted a lack of market momentum with market confidence drifting downwards, but with a mixed picture on house price expectations across the country.

LENDING REVIEW

For the mortgage industry, the interest rate environment, which is still low by historic levels despite recent rises, has led to benign credit conditions, with low arrears and a negligible level of forced sales. Overall the economic environment for the mortgage market currently appears both positive and sustainable.

The impact of a potential economic downturn, whether as a result of the Brexit process or otherwise, remains an area of focus across all lending markets. The Group seeks to mitigate its exposure to such conditions through a robust approach to property valuation, employing an experienced in-house property team who undertake around two thirds of valuations and conduct validation work on 100% of valuations performed by third party surveyors. The internally conducted surveys are subject to regular monitoring and the Risk and Compliance function includes qualified property risk resource. The weighted average loan to value ratio across the Group's first mortgage books at 66.0% (2017: 66.3%) (note 5) provides significant protection in the event of a future downturn.

Buy-to-let

The year has seen the buy-to-let mortgage market continuing to reshape following a period of sustained regulatory intervention. Following changes to tax and stamp duty affecting landlords, the Prudential Regulation Authority ('PRA') introduced new rules on the conduct of buy-to-let underwriting, which came into force partly in the 2017 financial year and partly at the start of the current period.

The regulatory changes were implemented in two phases:

- From 1 January 2017 the PRA imposed common standards for affordability testing in the buy-to-let sector, similar, in principle, to the approach adopted by the Financial Conduct Authority ('FCA') for owner-occupied lending under the Mortgage Conduct of Business ('MCOB') rules.
- From 1 October 2017, lenders were required to underwrite portfolio buy-to-let cases on a much more specialised basis, differentiating between portfolio and non-portfolio landlords, based on the number of properties owned with buy-to-let finance.

UK Finance ('UKF') reported that completions in the year ended 30 September 2018 were £36.4 billion, compared to £35.7 billion in the same period in 2017. Within this total, new lending for buy-to-let property purchases saw a decrease, from £9.9 billion to £8.8 billion. Remortgaging levels grew, from £24.6 billion in 2017 to £26.1 billion in 2018. However, with more customers choosing longer term fixed rate loans, the potential capacity for remortgage activity is expected to reduce in the medium term.

Almost all new buy-to-let lending continues to be at initially fixed rates, but the preference for longer fixed periods, driven by customer expectations of interest rate rises to come, has been one of the most significant market trends over recent years, with 49% of market-wide completions in September 2018 having a five year fixed term or longer, compared to around 40% of the September 2017 completions and around 20% of completions a year earlier.

Activity in the market supports the Group's analysis of the likely impact of the regulatory changes, with clear evidence of a polarisation of the landlord population between portfolio landlords and those with single properties. The proportion of portfolio landlords operating through corporate structures has also continued to increase.

LENDING REVIEW

In response to this, the positions of the lenders active in the market have also become more clearly defined, with some major lenders, including some of the largest, not offering a portfolio landlord proposition, some addressing portfolio landlords only in a limited way and a smaller group of specialised lenders, including the Group, offering a full range of products. This has been driven by the availability of experienced resource, system and process capability.

Overall the Group considers these changes to be positive, with a more sharply focussed class of buy-to-let landlords emerging. These should be motivated to provide a better service to tenants and their funding requirements are a good match for the products offered by the Group, providing an opportunity for the Group to grow its market share, albeit in a potentially smaller market.

The impact of these, and previous, changes on the lettings market is less easy to determine at this stage. The tenure distribution of households remained stable in the latest English Housing Survey 2016-17, with the private rented sector continuing to house 20% of all households. The September 2018 RICS UK Residential Market Survey reports increasing tenant demand against lower levels of landlord instructions, creating upward pressure on rents, which RICS expects will increase by over 2% in the current year, accelerating to a rate of 3.5% per annum over the next five years. This should have a positive impact on affordability for buy-to-let landlords.

Lending activity

The Group's new lending activity in the segment during the year is set out below.

	2018 £m	2017 £m
First charge buy-to-let	1,495.5	1,399.9
First charge owner-occupied	56.5	3.9
Second charge	71.2	60.7
	1,623.2	1,464.5

Total mortgage lending in the Group increased by 10.8% in the year. The majority of this increase arose from the division's core buy-to-let products, but other mortgage offerings also contributed.

Buy-to-let

The Group's buy-to-let lending increased by 6.8% year on year, despite the disruption in the market described above and the consequent pressure on volumes. The pipeline of buy-to-let loans in process at the year end was £778.9 million, an increase of 28.9% on the position a year earlier (2017: £604.2 million).

The changes in the way in which buy-to-let landlords are addressing the market, driven by the recent regulatory changes, can be seen in the analysis of the Group's new buy-to-let lending by customer type, compared to the previous year. In the table below, complex customers are those with portfolios of four properties or more, or specialist properties, and corporate customers are those operating through limited companies. Other complex customers are non-corporate customers with portfolios of four properties or more or with specialist properties.

LENDING REVIEW

	30 September 2018 £m	30 September 2018 %	30 September 2017 £m	30 September 2017 %
Buy-to-let advances				
Corporate customers	656.7	43.9%	293.5	21.0%
Other complex customers	528.8	35.4%	609.4	43.5%
Total corporate and complex	1,185.5	79.3%	902.9	64.5%
Non-complex customers	310.0	20.7%	497.0	35.5%
	1,495.5	100.0%	1,399.9	100.0%

These advances showed the impact on the Group's business of the concentration of buy-to-let activity among more professional investors, many operating through corporate structures. This trend is set to continue into the next financial year, with 87.8% of pipeline cases being either corporate or complex (2017: 70.4%).

In common with the wider buy-to-let market, the Group has seen a significant increase in customer preference for new buy-to-let mortgage loans which have an initial fixed rate period of five years, rather than the shorter terms typically chosen previously. The proportion of five-year products, by number, in the Group's new buy-to-let lending, at 72.9% had increased significantly since last year (2017: 50.8%). This should increase the stability of the Group's balance sheet going forward, with longer-dated product maturities supporting higher growth rates in the loan portfolio in the medium term.

Other mortgage lending

The Group's second charge mortgage lending has increased 17.3% during the year, but remains at modest levels. The second charge market is currently not large, with total lending of £1,031 million in the financial year reported by the Finance and Leasing Association ('FLA') little changed from the previous year (2017: £1,003 million). A significant part of this total does not fall within the Group's risk appetite and the Group seeks to target only that population of customers with the strongest credit quality in this area, avoiding any form of sub-prime business, which necessarily limits the addressable market.

The Group continued to develop its offering in specialist sectors of the owner-occupied mortgage market during the period. This lending remains in a pilot phase, with it yet to be established whether a sufficiently large opportunity exists which would generate satisfactory returns at acceptable risk levels.

LENDING REVIEW

Performance

The outstanding loan balances in the segment are set out below, analysed by business line.

	30 September 2018 £m	30 September 2017 £m
Post-2010 assets		
First charge buy-to-let	4,481.8	3,661.1
First charge owner-occupied	59.4	3.9
Second charge	141.3	98.4
	4,682.5	3,763.4
Legacy assets		
First charge buy-to-let	5,779.8	6,175.4
First charge owner-occupied	11.2	15.1
	10,473.5	9,953.9

At 30 September 2018 the balance on the Group's mortgage portfolio was 5.2% higher than a year earlier, with the post-2010 buy-to-let book having grown by 22.4%.

The annualised redemption rate on post-2010 buy-to-let mortgage assets at 16.7% (2017: 22.7%), has reduced from the high level seen in 2017, reflecting both the profile of product maturities and the changing focus towards complex landlord customers. The annualised redemption rate on pre-crisis lending, at 6.0%, is the same as that seen in the year ended 30 September 2017, reflecting the properties of those loans relative to current market offerings.

The redemption rate was also reduced by greater numbers of the Group's customers opting to re-fix their loans during the period, rather than redeem and refinance elsewhere. This affected both customers on products which reached the end of their initial fixed rates and also on those already on reversionary rates. This process was enhanced by systems developments to make the process as easy as possible for customers. While the Group earns a smaller margin on these switch products, the customers should then stay with the Group for a longer period on their new fixed rates, offsetting the reduction in margin over the medium term.

Arrears on the buy-to-let book as a whole have marginally increased in the year to 0.11% (2017: 0.08%), with arrears on post-2010 lending standing at 0.01% (2017: 0.02%). These arrears remain very low compared to the national buy-to-let market, with UKF reporting arrears of 0.42% across the buy-to-let sector at 30 September 2018 (2017: 0.45%). This exemplary performance reflects the Group's focus in underwriting on the credit quality and financial capability of its customers, underpinned by a detailed and thorough assessment of the value and suitability of the property as security.

Second charge arrears increased to 0.21% from 0.06% in the year, as the book began to season, with performance remaining strong, while the new residential lending has yet to see any arrears, although the loans are still comparatively unseasoned.

The Group's receiver of rent process for buy-to-let assets helps to reduce the level of losses by giving direct access to the rental flows from the underlying properties, while allowing tenants to stay in their homes. At the year end 770 properties were managed by a receiver on the customer's behalf, a reduction of 6.2% since 2017 (2017: 821 properties) as cases on the old book resolve and post-2010 cases perform well.

LENDING REVIEW

Outlook

Looking forward, the Group's mortgage business is strongly positioned as a specialist participant in a market which is still restructuring following fiscal and regulatory change. Its focus on specific customer requirements is key to growing volumes and enhancing earnings.

An important part of the division's strategy going forward will be to continue to enhance systems to improve the experience of customers and brokers. This will include increasing opportunities for customer 'self-service' and more direct system links to major brokers.

The business is well placed to withstand potential instability in the UK economy, with its strong credit standards and robust assessment of security condition and value affording it a high degree of protection. Average loan-to-value ratios on new buy-to-let lending were 71.8% for the year ended 30 September 2018, with stressed affordability levels in line with or above the PRA requirements. Continued strong rental demand and good affordability suggests the Group's customers will be resilient in the face of anticipated rate rises or broader economic uncertainty. Exposure on owner-occupied lending is low, and the risk position on second charge lending has been carefully managed.

Overall the Group supports the provision of housing in the UK in a controlled and sustainable way, and through its relationships with landlords and trade bodies seeks to promote higher standards in the private rented sector.

Commercial Lending

The Group's Commercial Lending division brings together a number of streams of mostly asset backed lending to, or through, commercial organisations. The principal customer focus of the division is on lending to SME and mid-sized corporate customers, which is an important differentiator from the rest of the Group's business.

During the year the Commercial lending division significantly broadened its activities. The acquisition of Titlestone added substantial volume and capacity to the division's development finance unit, the acquisition of Iceberg expanded short-term business lending and the new structured lending offering was launched in the year.

The asset finance market in the UK is substantial, covering some £75.1 billion of outstanding balances at 30 September 2018 (2017: £74.7 billion) and £32.1 billion of advances in the year then ended (2017: £31.2 billion). It is the Group's strategy to target niches within this market where its particular skill sets can be best applied, and its capital effectively deployed to optimise the relationship between growth, risk and return.

Examples of such niches are the financing of waste collection vehicles for local authorities, construction equipment and complex veterinary equipment. Outside the leasing market the division also has niche offerings providing other forms of funding, generally to SME businesses.

Access to customers is generally through specialist brokers, including the Group's in-house brokerage, Premier Asset Finance ('Premier'), or equipment suppliers and the markets in which the division operates tend to be fragmentary, with different brokers focussed on different asset types.

LENDING REVIEW

The common themes of these diverse business lines are a reliance on understanding and engaging with the customer and the valuation of any security, together with expertise in collections and security realisation. In common with the rest of the Group, the division's focus is on the maintenance of strong credit standards and it does not pursue business volumes at the expense of margins. The division relies heavily on specialist teams to address the separate business lines, either sourced externally or internally developed.

Acquisition of Titlestone

During July 2018 the Group acquired the entire share capital of Titlestone Property Services Limited and a portfolio of loan assets from its related companies (together 'Titlestone'). Titlestone provide development finance loans to smaller property developers, a field in which the Group already had a presence. The acquired loan portfolio was valued at £227.4 million, but there were no other significant tangible assets in the acquired business. The consideration paid was £274.3 million in cash (note 7).

The addition of the Titlestone team to the Group's existing development finance unit offers the opportunity for the Group to reach critical mass in this market much more swiftly than would be possible through purely organic growth, and the team's network of relationships with developers, brokers and other professionals will provide a solid foundation for the further expansion of this business.

Following the acquisition, the Titlestone and Paragon teams were merged and the business rebranded as Paragon Development Finance. The Group's strategic objective is to expand its lending to cover a larger part of the UK as the Titlestone business, in common with the Group's initial development finance offering, was focussed on the South East of England and the Group sees additional promising opportunities outside this area.

The combined operation is focussed primarily on smaller residential developments, where assets are likely to be more liquid and where demand is likely to be more resilient under economic stress. This area has also been identified as one where there is a shortage of available funding. It also aligns with the UK's public policy priority of increasing house building, where the Help to Buy scheme is acting to support prices of completed developments.

A project is currently taking place to integrate the new operation into the Group, which will continue into the new financial year. Progress so far has been encouraging and the acquired business has generated £49.1 million of new lending since acquisition. The Group is confident that this business will form a significant and profitable part of the division's activity in future periods.

Acquisition of Iceberg

During December 2017 the Group acquired the assets and business of Iceberg, a specialist broker and lender, which had previously operated through two limited liability partnerships (note 6). Iceberg focuses principally on short-term unsecured business funding for professionals such as solicitors and accountants and, through solicitors, in lending to parties in inheritance and matrimonial proceedings based upon the strength of their prospects. The consideration paid was £6.8 million in cash, with deferred consideration of up to £13.0 million payable, dependent upon performance.

The combination of the market intelligence and contacts in the Iceberg business with the Group's funding capabilities is expected to create additional value in the asset finance business over time, adding higher lending volumes to this specialist product set.

LENDING REVIEW

At acquisition Iceberg was acting as a broker, passing on the majority of its originations for funding by other lenders. Access to Group funding will enable the value of the Iceberg loan portfolio to grow over time with a consequent increase in revenues and contribution.

Loan balances of £2.0 million were acquired with the business and, by 30 September 2018, there were £32.9 million of Iceberg generated assets on the Group's balance sheet. Advances in the nine months since acquisition were £95.5 million.

The process of integrating the Iceberg operations with those of the Group continues. Progress in the first nine months has been good and the prospects for future benefits from the acquisition are encouraging.

Lending activity

The division's SME customer base has had a broadly stable year with no indications of a Brexit impact so far, however recent surveys indicate nervousness going forward, which may start to impact on the investment decisions of small and medium sized firms.

The new lending activity in the segment during the year is set out below.

	2018 £m	2018 £m	2017 £m
Asset finance – ongoing operations	259.2		
Asset finance - Iceberg	95.5		
Asset finance		354.7	220.0
Motor finance		177.9	120.0
Development finance - ongoing	87.7		
Development finance - Titlestone	49.1		
Development finance		136.8	48.9
Structured lending		40.6	-
		710.0	388.9

The asset finance business has seen a 17.8% like-for-like growth in the period as the business continues to develop following strategic changes introduced over the past two years. Including Iceberg, the value of new lending in the book was up 61.2%. This result is significantly in excess of the guidance of £0.6 billion given at the half year, even excluding the Titlestone business. Significantly, the developments in the year have led to greater diversity in 2018's advances than was seen in 2017, in line with the Group's strategy.

The Asset Finance business has remained competitive in its core 'hard asset' (i.e. construction equipment) market despite pricing pressure from new entrants. It has maintained its focus on margins and sought to support its business levels through good customer relationships and service standards.

Asset finance advances include the Group's first aviation loans, where £12.4 million was outstanding at the year end, and although the operation is still in its early stages, the credit quality of customers is good. This business provides a good example of the niche focus employed by the Group within the wider asset finance space.

LENDING REVIEW

The asset finance business also made a significant investment in assets for hire under operating leases, both term and spot, acquiring £19.3 million of assets to generate future income (2017: £12.9 million). Following the last two years of investment, net operating lease income increased by 26.7% to £3.8 million for the year (2017: 3.0 million).

This growth has taken place against a backdrop of aggressive competition in the market and continuing economic nervousness in UK industry, leading to some reluctance by SMEs to take on new finance commitments, especially longer-term arrangements, at least until the UK's future trading relationship with Europe becomes clearer.

The motor finance business continues to develop with a 48.3% increase in new lending. Product offerings remain carefully targeted to avoid the riskier and mass market and the Group has no exposure to the personal contract purchase and similar product types which have caused concern to commentators and regulators during the year. The business addresses specialist propositions in the motor finance market where distinctive products can generate appealing returns and make effective use of the Group's capital. This includes funding less mainstream vehicle types, such as light commercial vehicles and motorhomes. The current rate of growth is expected to moderate as the business becomes more mature, with the specialist segment of the market always being limited to some degree.

The Group's organically grown development finance business provided funding for small-scale property developments with an average facility size of around £2.0 million, a significantly underserved market. Advances grew by 79.3% in the year as the business expanded into new areas of the country including Yorkshire and the Midlands. This experience served to confirm the viability of the business stream and provided support to the decision to acquire Titlestone in July 2018. Post-acquisition the larger development finance business presents a significant growth opportunity, with undrawn facilities and pipeline commitments of £366.7 million providing a springboard for the start of the new financial year.

During the second half of the year, the first of the Group's structured lending facilities, with Liberis, the business cash flow lender, went live. This was followed by a further two facilities during the year with more scheduled to complete after the year end. Initial returns appear promising, with the team building a good relationship in the market place.

The structured lending unit provides senior debt to the UK non-bank lending market and deploys loans to help support 'best-in-class' businesses working across consumer and commercial lending. Transactions are secured on underlying assets and structured using established robust methodologies. The business addresses certain segments where the Group may be under-weight or has no exposure at all and where working with a recognised industry expert is preferable to organic expansion. Outstanding facilities at 30 September 2018 have reached £52.5 million, of which £38.7m had been drawn at the year end.

Across all business lines growth has been carefully controlled with credit quality and margins prioritised over expansion and care has been taken to focus effort on those sectors or subsectors of the market most suited to the Group's business model and most likely to provide it with a good return on capital.

LENDING REVIEW

Performance

The outstanding loan balances in the segment are set out below, analysed by business line.

	30 September 2018 £m	30 September 2017 £m
Asset finance	403.4	323.6
Motor finance	256.6	163.0
Development finance	352.8	42.3
Structured lending	38.7	-
Invoice factoring	21.8	14.8
Professions finance	42.6	1.4
Unsecured business lending	13.1	9.0
Other loans	4.2	4.7
	1,133.2	558.8

Professions finance includes Iceberg assets and similar assets generated in the ongoing business, with receivables financing and other unsecured lending to business included as 'other loans' above.

Margins in the segment have remained strong but have reflected both the changing business mix and the strategic repositioning of the asset finance to address the larger, higher quality but lower margin mid-range segment of the asset finance market.

Arrears on the segment's business remain low with arrears in the asset finance business at 0.78% and motor finance at 0.93% (2017: 0.97% and 0.56% respectively), comparable to those in the wider sector, with the FLA reporting average arrears for asset finance at 0.70% and car finance at 2.50% at 30 September 2018 (2017: 0.60% and 2.20%).

Credit quality in both the organic and acquired Development Finance books has been good, and the overall performance of the projects has been in line with expectations. These accounts are monitored on a case-by-case basis by the Credit Risk function. At 30 September 2018 no accounts had been identified by the monitoring process as being likely to result in a loss, beyond a small number of Titlestone accounts identified on acquisition and allowed for in the purchase price. The average loan to gross development value for the portfolio at the year end, a measure of security cover, was 63.2% (2017: 60.6%). This increase reflects the initially cautious launch of the product in 2017 and the mix effect from the acquired portfolio.

Overall the charge for impairment in the segment was £2.0 million (2017: £0.1 million), which remains low relative to the book size.

Outlook

The Group's intention is to continue to develop its businesses, selectively focussing on those areas where the greatest return can be achieved. This will involve both increasing the reach of its existing offerings and adding further product lines or specialisms, to improve the diversity of its loan book. It will also prioritise maintaining margins and customer relationships in the existing books. The division seeks to be responsive and flexible in addressing the market, but its UK focus means that it is exposed to a downturn in investment amongst UK business as a whole.

LENDING REVIEW

The coming year will see the continuation of the integration of the Group's development finance operations and the geographical expansion of the proposition within the UK. The continued growth of the aviation finance and structured lending products is also anticipated. A particular priority will be the on-going integration of the acquired operations into the division.

Overall the division has a good platform on which to build and increasing scale and diversity will enable a better return to be generated from its resources, control framework and investments in systems.

Idem Capital

The Group's Idem Capital division includes its acquired loan portfolios, together with its pre-2010 legacy consumer accounts.

Idem Capital has a strong capability in loan administration and an ability to self-develop systems, allowing it to respond to regulatory developments and more specialised portfolio requirements. Unlike many market participants, Idem Capital is able to deploy securitisation and particularly retail funding to support its investment.

The division's focus is on acquiring portfolios where it can enhance value through its collections process and access to funding, and which will augment the organic origination activities of the Group. It uses its analytical skills base, which it sees as a core differentiator, to identify and evaluate portfolios brought to market against these criteria. Its principal area of focus over recent years has been on portfolios of UK paying secured and unsecured consumer finance balances, but it has the capability to leverage Group expertise in other asset classes which was used in the year.

It is also willing to consider transactions, deal by deal, on a partnership basis, having acted as a co-investor, servicer or both in various deals in the past. All opportunities are considered.

Overall Idem Capital's success rests on understanding assets, strong analytics, advanced servicing capabilities and the efficient use of funding.

Lending activity

Towards the end of the year the Group completed a £83.4 million portfolio purchase of primarily motor finance receivables. The loans, acquired from a UK bank, were predominantly performing, asset-backed, UK loans and have been successfully migrated on to the Group's systems where they will be managed through their normal contractual lives. This was the sole purchase in the year and represents Idem Capital's first purchase outside its traditional target areas of secured and unsecured consumer loans, providing an excellent example of the division acquiring portfolios of recently originated and performing loans to complement the Group's broader new business flows.

The portfolio purchase market has continued to be busy with a large number of participants bidding on transactions. The operation participated in all of the significant bid processes in its target asset classes, including some very large transactions, but market pricing has generally been aggressive and has driven up bidding on some transactions beyond levels where the Group considers them to be capable of achieving satisfactory return levels within its risk appetite. Activity in the asset sales market tends to be 'lumpy' and the Group's level of investment in any period will reflect the number, type and quality of portfolios offered, together with the levels of return other market participants are willing to accept.

LENDING REVIEW

The Group believes that its ability to accurately evaluate a potential acquisition is a core strength and it is not willing to compromise on credit quality or target return levels in pursuit of volumes. Idem Capital remains on the panels of all the principal UK vendors.

The Group completed a disposal of assets with a carrying value of £54.7 million in the final quarter of the year, realising a profit of £28.0m against book value. The Group took the decision to crystallise the opportunity presented by a strong market price for the assets sold to realise a capital gain and to recycle this capital to support further growth in the commercial lending division, where the acquisition of Titlestone took place in the same quarter.

The sale also enabled the repayment of Idem Capital's external funding facility, incurring exit costs of £1.2m, including break fees and accelerated amortisation of capital structuring costs.

Performance

The value of the loan balances in the segment are set out below, analysed by business line.

	30 September 2018 £m	**30 September 2017 £m**
Second charge mortgage loans	274.6	392.3
Unsecured consumer loans	173.7	219.1
Motor finance	72.8	-
	521.1	611.4

The reduction in balances is a result of the scale of realisations from the brought forward consumer loans portfolios, together with the asset disposals in the year. This was offset, partially, by the asset finance portfolio acquisition.

120 month Estimated Remaining Collections ('ERC') on acquired consumer assets reduced from £688.8 million at 30 September 2017 to £489.6 million at the year end, for the same reasons. It should be noted, however, that as the asset finance portfolio acquired during the year was not acquired at a discount and valued on a cash flow basis, its future recoveries are not included in the ERC amounts.

Margins achieved by Idem Capital vary materially by portfolio and are also impacted by the strength of cash generation, particularly when this exceeds expectations for assets acquired at a discount. Where purchases are focussed on performing portfolios, the margin dynamics will more closely resemble those achieved by similar originated assets. The sale of loan balances during September will serve to accelerate this mix-led change in margin profile for the division.

LENDING REVIEW

Maintaining a high level of customer service is key to the success of Idem Capital and complaints and compliance issues in the acquired portfolios remained low in the period. Flows of redress cases, where the original lender is required to compensate the customer for conduct issues on acquired accounts, have increased in the period. It should be noted that the terms of loan acquisitions generally leave responsibility for pre-acquisition conduct issues, such as Payment Protection Insurance ('PPI'), with the vendor, not the Group. The Group's recorded complaint levels, on the measures published by the Financial Ombudsman Service, remain very low with only 58 new complaints in the six months ended 30 June 2018, while the Group's overturn rate in the same period, where the ombudsman reversed the Group's decision, at 35%, is broadly in line with the 30% average for the industry. Operational improvements have continued to be made in systems, processes and employment patterns which are expected to generate operational efficiencies in future periods.

Arrears on the segment's secured lending business have improved to 15.8% (2017: 17.5%), the reduction arising from the sale of some of the poorer performing accounts in the year. These arrears levels remain higher than the average for the sector, but this reflects the seasoning of the balances, which are mostly more than ten years old and the inclusion of accounts which are currently making full monthly payments but had missed payments at some point in the past. Average arrears for secured lending of 9.4% at 30 September 2018 were reported by the FLA (2017: 11.2%).

None of the division's remaining portfolios at the year end were regarded as materially underperforming, with strong overall cash generation. The Group monitors actual cash receipts from acquired portfolios against those forecast in the evaluation which informed the purchase price. Up to 30 September 2018 such collections were 109.7% of those forecast to that point (2017: 109.3%).

Overall the segment had a credit for impairment of £0.1 million (2017: £1.5 million charge), representing the stable arrears position and the impact of improving house prices on secured provisioning.

Outlook

While the Group expects that flows of assets for disposal will continue to build, increasing economic uncertainty may restrict the scope for vendors and purchasers to arrive at mutually acceptable pricing, especially for unsecured assets and the flow of completed deals in the market may slow down.

The division's strategy in this market will continue to focus on transactions which are more idiosyncratic in nature and therefore make best use of its core skills in pricing, data, operations and account management in generating value, together with the purchase of portfolios of performing loans similar in nature to those being originated within the Group's Mortgages and Commercial Lending divisions.

The business will continue to maintain its detailed and disciplined approach to evaluating, pricing and bidding on portfolios, not compromising on margins and risk, ensuring that the Group's capital is appropriately deployed and thereby generating appropriate shareholder value.

The division is well placed to manage its assets going forward, and the refocus of the portfolio in the period should reduce credit exposures if economic conditions in the UK deteriorate.

FUNDING REVIEW

Over the past five years the Group has transitioned from being entirely wholesale funded to its present broadly diversified funding model, focussed around its retail savings deposit flows.

Debt and deposit funding

During the year, the Group continued its strategy of focussing its funding on its retail savings capability. However, having also optimised its use of central bank funding at attractive rates to support lending during the early part of the year, the Group completed a securitisation transaction in April 2018, taking advantage of strong investor demand and the attractive rates then available to structure its first deal since 2015. The growth of retail deposit funding flows also allowed the Group to reduce the amount of warehouse funding facilities required to support for new lending during the year.

The Group's funding at 30 September 2018 is summarised as follows:

	2018	**2017**	**2016**
	£m	**£m**	**£m**
Retail deposit balances	5,296.6	3,615.4	1,873.9
Securitised and warehouse funding	6,490.3	7,781.8	9,947.1
Central bank facilities	1,024.4	700.0	-
Tier 2 and retail bonds	445.4	444.8	554.3
Total on balance sheet funding	13,256.7	12,542.0	12,375.3
Off balance sheet central bank facilities	108.7	109.0	108.8
	13,365.4	12,651.0	12,484.1

The Group actively prepares its interest rate exposure position for likely increases in UK interest rates indicated by Bank of England guidance. The risk of a downward movement in rates in recent years has been limited by an apparent absolute lower bound on market rates. This will cease to be the case as rates rise and this is addressed by the Group's treasury policy. The Group's funding and hedging policies are also influenced by the levels of longer-dated fixed rate products now being offered, and it is seeking, where possible, to increase the levels of maturity matching in its overall balance sheet position.

Retail funding

The Group's savings business provides customers with a range of deposit options, offering value for money and competitive rates, combined with the protection provided by the Financial Services Compensation Scheme ('FSCS'). The business currently sources all deposits through its website, with its strong repeat business and net promoter scores complemented by access to price comparison websites and recommendations from industry savings experts. The business model provides the Group with a stable funding platform, with a focus on term funding to manage interest rate risk and the ability to limit product availability to short periods of time. At the end of the period 74.5% of deposits were term or notice accounts (2017: 83.3%).

Retail deposits continue to represent a reliable, cost-effective and scalable source of finance for the Group. As a consequence of the preference for retail funding in the Group funding strategy, the volume of retail deposits has continued to grow significantly during the period, with balances at 30 September 2018, at £5,296.6 million, having increased by 46.5% over the year (2017: £3,615.4 million).

FUNDING REVIEW

However, this represents only a small proportion of the UK savings market, with household savings balances reported by the Bank of England increasing by 4.9% in the year ended 30 September 2018 to £1,174.6 billion (2017: £1,119.2 billion), although these deposits remain overwhelmingly with clearing banks and building societies. The strong supply has helped to maintain the recent trend for low savings rates with the average annual interest on two-year fixed interest bonds, reported by the Bank of England, having increased from 1.26% in September 2017 to 1.42% in September 2018, with rates on one-year bonds increasing slightly from 0.78% in September 2017 to 0.95% in September 2018, the increases being less than the base rate increases in the same period. It does not appear, therefore, that the closure of the TFS to new drawings in February 2018 has had any material impact on rates in the savings market although the trend of rates has been generally upwards.

New entrants to the banking market have adopted similar approaches to the savings market as the Group, and therefore competition for internet-sourced deposits is increasing. The level of competition forces the Group to remain competitive on pricing, products and service. Even so, rates may be influenced by the funding needs of other participants in the market, which are beyond the Group's control.

During the year the savings business has continued to develop to address these competitive challenges, with improvements to customers' ability to access their accounts, improved service from the website and enhanced opening hours of our telephone support group.

Savings balances at the year end are analysed below.

	Average interest rate		Average initial balance		Proportion of deposits	
	2018 %	2017 %	2018 £000	2017 £000	2018 %	2017 %
Fixed rate deposits	1.94%	1.89%	19	24	68.8%	74.0%
Variable rate deposits	1.36%	1.21%	16	19	31.2%	26.0%
All balances	1.76%	1.71%	18	23	100.0%	100.0%

The average initial term of fixed rate deposits was 27 months (2017: 28 months).

The proportion of short term deposits (easy access and those available at three months' notice or less) has increased in the period to 30.3% (2017: 22.6%), representing £1,606.0 million of the balance (2017: £1,035.4 million). This has been driven by market requirements, as customer anticipation of rate rises in the near term leads to a preference for short-dated deposits.

The Group's products process and approach have been recognised in the industry and by customers and during the year it won the 'Best Monthly Interest Provider' award in the 2018 Moneynet awards and was named as the 'Best Long-term Fixed Rate Cash ISA Provider' in the 2018 SavingsChampion.co.uk awards.

In customer feedback 90% of those opening a savings account with the Group in the year, who provided data, stated that they would 'probably' or 'definitely' take a second product (2017: 87%). The net promoter score in the same survey was +61, up from +59 for the 2017 financial year.

When customers with maturing savings balances in the year were surveyed 90% stated that they would 'probably' or 'definitely' consider taking out a replacement product with the Group (2017: 89%) with a net promoter score (the excess of positive over negative feedback per 100 respondents) at maturity of +50, up from +42 for the 2017 financial year. This performance is particularly valuable to the Group, given the benefits of customer, and deposit, retention.

FUNDING REVIEW

The Group's outsourced administration platform continues to meet its needs and provides a cost-effective, stable and scalable solution in the medium to long term, with a new agreement having been signed in the period to provide longer-term security to this important commercial relationship.

In order to broaden the franchise and reduce dependence on price-comparison websites as a source of customers, the Group has been working to develop alternative routes to market, which are expected to be rolled out during the coming year. This includes the launch of the Group's savings products on the Hargreaves Lansdown Active Savings platform after the year end. It is also investigating potential new savings products and customer groups, in order to mitigate the pressure on rates which is imposed by competitive pressures, and to ensure it manages its increasing levels of maturing retail balances effectively.

The size and diversity of the Group's deposit base is expected to continue to expand, forming the principal funding source for new lending activities. The guarantee provided by the FSCS scheme is likely to reduce the potential for an economic downturn to impact liquidity and the profile of the Group's target customers suggests that they are likely to be resilient in those circumstances.

Wholesale funding

The performance of the UK wholesale funding markets over the year has been mixed, with more activity than in recent periods, particularly following the cessation of the TFS. Pricing has, however, been subject to some volatility, being attractive in the early part of the year, while becoming more expensive again towards the end of the period, with increases driven by increasing UK inflation, concerns over international trade, the impact of uncertainty in Italy and a lack of clarity on the terms of the UK's exit from the EU.

The Group's strategic objective of creating a broader-based funding structure, coupled with the availability of attractively priced funding from the Bank of England during the first half of the period, has meant that its use of securitisation and similar funding tools is presently limited to those instances where a particularly compelling case can be made in terms of the tenor, cost and availability of the funding. As a result, the Group did not access the public securitisation market after November 2015 until April 2018, when Paragon Mortgages (No. 25) PLC ('PM25') was launched. This was the largest value and lowest interest margin transaction completed by the Group since 2007.

PM25, backed by a mixture of new and legacy buy-to-let mortgage assets, raised £435.3 million of external funding in sterling Mortgage Backed Floating Rate Notes. The senior notes were rated AAA by Fitch and Aaa by Moodys and bear interest at London Interbank Offered Rate ('LIBOR') plus a margin of 0.65%. The initial average rate on the external notes was 0.72% above LIBOR.

The transaction contained several novel features, which enhanced its value to the Group's funding strategy. It has the capacity to accept further loans, rather than repaying redemption monies immediately. This extends the expected life to five years, rather than four and makes the funding both more cost-effective and more suitable for the five-year fixed rate mortgage products which are becoming increasingly popular in the market. The deal also generated internally held rated notes which may either be sold later or used as collateral for Bank of England facilities, giving the Group significantly enhanced funding and liquidity options.

FUNDING REVIEW

During the year the Group paid down two securitisation transactions, one funding legacy mortgages and one funding post-2010 mortgages. These assets were refinanced, principally with retail deposits, releasing significant cash balances for use elsewhere in the Group. After the year end notice was given on a further legacy mortgage transaction and the Group's remaining consumer finance transaction. Further such refinancing transactions should be expected over the coming years.

As a consequence of the increased focus on retail deposit funding, the Group's warehouse capacity, which had been used to fund buy-to-let mortgage originations, was rationalised, with the £550.0 million of capacity which existed at 30 September 2017 being closed out in the year. The Group recognises the benefit of wholesale warehouse funding to provide standby capability, particularly in the event of market disruption elsewhere, and as an alternative to retail deposit funding for liquidity purposes. Following the year end a new £200.0 million facility was agreed with Bank of America Merrill Lynch. With an interest rate of LIBOR plus 0.95%, this will provide a source of cost-effective standby funding.

The Group continues to regard wholesale and structured lending as an important part of its funding mix, but these markets will only be accessed where it is appropriate and cost effective to do so.

Central bank facilities

The Group has continued to access the funding facilities offered by the Bank of England, which provide flexible, low-cost collateralised loans designed to reinforce the transmission of low base rates to households and businesses.

The most significant of these facilities for the Group has been the TFS, which was available for new drawings until February 2018 and was used by the Group to support new lending. Drawings on this facility were made against the security of pools of mortgage loans. The interest cost of new TFS funding was very attractive, compared with either retail deposits or securitisation, and repayment is due four years after the drawing, in 2021/22. In common with many UK institutions, the Group made extensive use of the TFS up to its withdrawal and drawings by the scheme's closure had increased to £944.4 million, which remained in place at the year end (2017: £700.0 million), providing 7.1% of the Group's external funding. The Group also has access to the short term Indexed Long-Term Repo scheme ('ILTR'), which gives access to six-month liquidity from the Bank of England, secured against pre-positioned pools of assets.

The Group's liquidity drawdown under the Funding for Lending Scheme ('FLS'), which provides liquidity of £108.7 million (2017: £109.0 million) remained in place throughout the period. The terms of this facility are such that neither the drawing nor the liquidity provided appear on the Group's balance sheet.

The Group has also pre-positioned further mortgage loans and certain other assets with the Bank of England to act as collateral for further drawings on central bank funding lines, if and when required.

The Group will continue to access these facilities in future, as part of its overall funding framework.

FUNDING REVIEW

Funding for Idem Capital assets

Idem Capital utilised retail deposit financing for its £83.4 million portfolio purchase in July 2018. This was made possible by the quality of the portfolio acquired, with the profile of the loans acquired more closely matching new motor and asset finance originations in the Commercial Lending segment and therefore meeting the Bank's risk appetite.

During the year Idem Capital has had a non-recourse funding facility with Citibank, which was used to fund assets from time to time. This facility was paid down in September 2018, when the loans it had funded were either sold or refinanced, more cost-effectively, with retail deposits. Idem Capital's strategic focus on better quality portfolios, which are more suitable for retail deposit funding, meant that the facility was less relevant to its on-going operations.

Certain legacy assets, principally second charge mortgage balances, are also funded through pre-credit crisis securitisation structures.

Corporate funding

While the Group's working capital has been primarily provided by equity since 2008, in recent years it has expanded its use of corporate debt funding, issuing both retail bonds and Tier 2 corporate bonds. All the Group's working capital debt funding has been raised since the credit crisis and therefore there are no legacy issues relating to these borrowings.

The Group is rated by Fitch Ratings, which reviewed its rating in the light of the Group's 2017 reorganisation and, on 6 April 2018, upgraded its Long-Term Issuer Default Rating to BBB from BBB- rating with a stable outlook. The BB+ rating on the Group's £150 million Tier 2 Bond was also upgraded to BBB- at the same time.

Although no corporate debt was issued in the period, such borrowings continue to form part of the Group's long-term funding strategy and the enhanced rating will support further long-dated corporate debt issuance in both scale and pricing terms.

Summary

The Group's overall funding position remains strong. Retail deposit flows represent the core element in the funding programme, however the successful securitisation in the year demonstrates the continuing benefits delivered by a diversified funding base.

Further information on all the above borrowings is given in note 21.

FUNDING REVIEW

Capital management

The Group's funding model places primary reliance on retail deposit funding, which has fundamentally changed the working capital cycle of the Group, reducing the variability in working capital demand and hence enabling an on-going reduction in working capital levels relative to the size of the balance sheet.

Dividend and dividend policy

In its 2017 results announcement the Company announced a policy of targeting a dividend cover ratio of 2.75 times in 2017 and 2.50 times in the current financial year and thereafter, subject to the requirements of the business and the availability of cash resources. The final dividend for the year ended 30 September 2017, paid in the year, was declared in accordance with that policy.

To provide greater transparency, the Company also indicated that its interim dividend per share will normally be 50% of the previous final dividend, in the absence of any indicators which might make such a level of payment inappropriate and an interim dividend for the year of 5.5 pence per share was paid in July 2018 in accordance with this policy.

In determining the level of dividend for the year, the Board has considered the dividend policy, but has also taken into account the Group's strategy, capital requirements, principal risks, the level of available retained earnings in the Company, its cash resources and the objective of enhancing shareholder value. In particular the Board considered the capital requirements of the businesses acquired in the year and the nature of the significant one-off items of cost and income included in the result for the year. The Board determined that the existing policy remained appropriate, but that the one-off items, which do not relate to ongoing earnings generation would be excluded from the earnings used to derive the dividend.

On this basis, the Board is proposing, subject to approval at the Annual General Meeting on 14 February 2019, a final dividend of 13.9 pence per share which, when added to the interim dividend, gives a total dividend of 19.4 pence per share for the year. This represents an increase of 23.6% from 2017, bringing the dividend cover to 2.5 times, based on earnings excluding one-off items (2017: 2.75 times) (note 4(a)).

Regulatory capital

The Group is subject to supervision by the PRA on a consolidated basis, as a group containing an authorised bank. As part of this supervision, the regulator will issue individual capital guidance setting an amount of regulatory capital, defined under the international Basel III rules, implemented through the Capital Requirements Regulation and Directive ('CRD IV'), which the Group is required to hold relative to its risk weighted assets in order to safeguard depositors in the event of severe losses being incurred by the Group. During the year the PRA determined that the amount of the regulatory capital required should be disclosed by firms in their public reporting.

The Group maintains extremely strong capital and leverage ratios, with a total capital ratio of 16.2% at 30 September 2018 (2017: 18.7%) and a UK leverage ratio at 6.4% (2017: 6.6%) (note 4(d)). The CET1 ratio, 13.8% at 30 September 2018, reduced during the period (2017: 15.9%), reflecting the growth in the balance sheet, acquisition of goodwill and distributions to shareholders though buy-backs and dividends. The Group's medium term CET1 target remains at 13.0%.

FUNDING REVIEW

The Group's total regulatory capital at 30 September 2018 was £1,045.7 million (2017: £1,030.5 million), a level in excess of the amount required by the PRA guidance, including the £727.7 million required in respect of Pillar 1 and Pillar 2a. This amount includes variable and fixed components and further capital buffers, either specific to the Group or applicable across the sector, may also be required.

In December 2017, the BCBS published its final proposals regarding amendments to the assessment of institutions' capital adequacy, in its document 'Basel III: Finalising post-crisis reforms'. This addresses both the Standardised Approach ('SA') for credit risk, presently used by the Group and the Internal Ratings Basis ('IRB'), which is based on firms' own internal calculations and subject to supervisory approval.

The new BCBS rules are scheduled to take effect from 1 January 2021 and the most material change for the Group relates to an increase in the risk weightings applicable to buy-to-let lending assets. The proposals may also serve to limit the comparative advantage available to IRB users over SA users through the use of floors, setting minimum capital requirements where the IRB is used. The final proposals are much less severe in their treatment of buy-to-let, amongst other asset classes, than the proposals published two years earlier, but would still require the Group to carry increased capital. The final version of the framework still needs to be enacted into EU law to take effect and there are important areas where discretion is given to national supervisors or other competent bodies. Therefore, the full impact of the reforms will not be certain until the legislative process is complete, and the appropriate bodies have made their intended use of their discretions clear. The Group will be closely monitoring developments as this process progresses.

The Group also notes the steps taken by the PRA towards using its assessment of Pillar 2 capital to reduce the perceived capital disadvantage of banks using the SA compared to IRB banks, which the regulator regards as distortive to the market. The PRA published its final policy statement on this in October 2017, and the Group is considering its potential impact, when taken with the Basel reforms described above.

IRB approach

The Group continues to develop its own IRB approach to credit risk, notwithstanding the outcome of the CRD and PRA processes. It has substantial performance data, excellent credit metrics and core competences in credit risk and analytics to support the adoption of an IRB approach for determining appropriate risk weightings for its assets.

In addition to the potential capital advantages from adopting the IRB approach, the Group sees broader business benefits from adopting the disciplines required by IRB as a core part of its risk management structure, which should lead to further enhancements in the internal risk governance framework.

Other UK institutions currently using an IRB approach for their buy-to-let portfolios achieve materially lower risk weightings than the 35% required by the present SA, with PRA benchmark figures, most recently updated in October 2017, being typically in the low to mid-teen percentages.

The Group expects to be in a position to apply formally to the PRA for IRB authorisation for its buy-to-let and development finance portfolios in early 2019. These will be the first portfolio for which authorisation is sought, with development work continuing for further asset classes which will be added on a phased basis to achieve the coverage required by the IRB rules.

FUNDING REVIEW

Liquidity

The Group's operational capital and funding requirements are also influenced by the need to retain sufficient liquidity in the business to meet its cash requirements in the short and long term, as well as to provide a buffer under stress. There is also a regulatory requirement to hold liquidity in Paragon Bank. The Board regularly reviews liquidity risk appetite and closely monitors a number of key internal and external measures. The most significant of these, which are calculated for the Paragon Bank regulatory group on a basis which is standardised across the banking industry are set out below.

Indicator	2018	2017	Regulatory minimum
LCR – Liquidity coverage ratio	144%	246%	100%
NSFR – Net stable funding requirement	113%	118%	100% ‡

‡ From 1 January 2019

This shows the available liquidity at the year end to be well in excess of regulatory minimums.

Gearing and share buy-backs

The Group's reorganisation completed in 2017, coupled with the strong capital base and low leverage, provide the opportunity for the business to reduce its over-reliance on equity capital, improving returns for shareholders. The future requirement to raise debt for liquidity purposes has been reduced by its access to retail deposit funding and the Group is able to take a long-term view of opportunities available to it in the corporate debt markets to optimise its funding, working capital and regulatory capital position over time.

At the same time the Group will carefully monitor any excess equity position and consider whether any adjustment is required, either through further changes in the dividend policy or through share buy-backs.

In November 2014 the Company announced a share buy-back programme, which had been extended to £215.0 million by November 2017. During the year the Group bought back 5.1 million of its ordinary shares at a cost of £25.2 million, including stamp duty and transaction expenses (note 26); these shares being held in treasury. Treasury shares may subsequently be cancelled.

Since the programme commenced in 2014 the issued share capital has reduced from 306.6 million shares to 260.7 million shares, a decrease of 15.0%. The size and timing of the programme is reviewed periodically to take account of anticipated investment opportunities and the balance of the Group's debt and equity capital resources.

As a result of the potential capital requirements of the Titlestone acquisition the programme was suspended during the year and no further buy-backs are proposed in the short term.

Capital outlook

The appropriate level of capital for the business to meet its operational requirements and strategic development objectives is kept under review by the Board, in particular when major acquisitions or other significant changes take place. The strength of the Group's business lines, the diversification which has been achieved in the funding base in recent years and the further opportunities for growth and sustainability opened up by the group reorganisation in 2017, provide the foundations for the capital base to sustain the Group going forward.

FINANCIAL REVIEW

The financial year ended 30 September 2018 saw the Group's underlying profit (appendix A) increase by 7.8% to £156.5 million (30 September 2017: £145.2 million) while on the statutory basis profit before tax increased by 25.3% to £181.5 million (30 September 2017: £144.8 million) including a gain on the scale of financial assets of £28.0m. Earnings per share increased by 29.7% to 55.9 pence on the statutory basis (30 September 2017: 43.1 pence) and by 11.3% to 48.2 pence on an underlying basis (30 September 2017: 43.3 pence).

Results for the year

CONSOLIDATED RESULTS
For the year ended 30 September 2018

	2018 Underlying £m	2018 Adjustments (App. A) £m	2018 Total £m	2017 £m
Interest receivable	451.7	0.2	451.9	409.2
Interest payable and similar charges	(195.2)	(2.1)	(197.3)	(176.6)
Net interest income	256.5	(1.9)	254.6	232.6
Net leasing income	3.8	-	3.8	3.0
Gain on disposal of financial assets	-	28.0	28.0	-
Other income	15.5	-	15.5	17.2
Total operating income	275.8	26.1	301.9	252.8
Operating expenses	(111.9)	(2.3)	(114.2)	(102.3)
Provisions for losses	(7.4)	-	(7.4)	(5.3)
	156.5	23.8	180.3	145.2
Fair value net gains / (losses)	-	1.2	1.2	(0.4)
Operating profit being profit on ordinary activities before taxation	156.5	25.0	181.5	144.8
Tax charge on profit on ordinary activities			(35.7)	(27.6)
Profit on ordinary activities after taxation			145.8	117.2

	2018	2017
Dividend – rate per share for the year	19.4p	15.7p
Basic earnings per share	55.9p	43.1p
Diluted earnings per share	54.2p	41.9p

The exclusions from underlying results above (appendix A) relate principally to the acquisitions and asset sales in the period which do not form part of the day-to-day activities of the Group. The adjustments reduce earnings and related measures but have been made to provide greater clarity to users on the operating performance of the business.

FINANCIAL REVIEW

The acquired Iceberg and Titlestone businesses contributed £4.1 million to underlying profits and £1.9 million to statutory profits. This contribution is expected to increase going forward.

Total underlying operating income increased by 9.1% to £275.8 million (2017: £252.8 million). Total operating income on the statutory basis, at £301.9 million (2017: £252.8 million) also included the £28.0m one off gain on Idem Capital asset disposals arising in the year. Net interest income increased by 9.5% to £254.6 million from the £232.6 million recorded in the year ended 30 September 2017. The increase reflects growth in the size of the average loan book, which rose by 6.4% to £11,626.0 million over the year (2017: £10,930.8 million) (appendix B).

Underlying net interest margin ('NIM') in the year ended 30 September 2018 increased to 2.21% compared to the 2.13% in the previous year (appendix C). On the statutory basis, which includes the costs of building up the cash balances required for the Titlestone acquisition and the break costs of the Idem funding facility, the NIM was 2.19% (2017: 2.13%) (appendix C). The increase in NIM is in line with guidance given at the half year.

During the year, a gain of £28.0 million, was realised on the sale of long-standing Idem Capital consumer loan assets where the EIR based accounting, coupled with movements in the debt purchase market caused the carry and market values to diverge markedly. After costs incurred on the settlement of related funding arrangements the net gain was £26.8 million. This disposal represents a major refocus of the Idem Capital operation and included assets purchased in a large number of different transactions. It also supports the redistribution of capital to the Group's growth businesses, with the Titlestone acquisition occurring in the same quarter. As such, this gain is unlikely to be repeated in future periods.

Excluding the gain on disposal, other operating income was little changed at £19.3 million for the year, compared with £20.2 million in 2017.

Underlying operating expenses increased by 9.4% to £111.9 million from £102.3 million reported in the previous year, partly reflecting the increase in the average number of employees to 1,349, a 2.4% rise (2017: 1,317) and the level of employees joining the payroll in the period, which saw employment costs increase by 13.3% year on year. The year has also seen significant investments in systems and personnel in order to support the development, launch and start up phases of new product lines such as development finance, structured lending and aviation finance. Further investment was made to support the expansion of existing business lines, to enhance the Group's operational resilience, to improve its cyber security and to meet its General Data Protection Requirements ('GDPR') requirements. Despite this, the overall underlying cost:income ratio remained stable at 40.6% (2017: 40.5%) (appendix C) and remains significantly below the industry average.

The Board remains focussed on controlling operating costs through the application of rigorous budgeting and monitoring procedures and the underlying costs for the period and in line with guidance given to the market. The Group expects the overall cost:income ratio to improve over time as acquired and start-up operations are integrated into the Group and it starts to see the benefits of income growth from its new and expanded operations.

Total operating expenses, which included the costs of the Iceberg and Titlestone acquisition transactions, increased by 11.6% to £114.2 million (2017: £102.3 million), giving a cost:income ratio on a statutory basis of 37.8% (appendix C).

The charge of £7.4 million for loan impairment has increased from that for 2017 (2017: £5.3 million). As a percentage of average loans to customers (appendix B) the impairment charge remains broadly stable at 0.06% compared to 0.05% in 2017. The Group has seen favourable trends in arrears performance over the period, both in terms of new cases reducing and customers correcting past arrears, whilst increasing property values have served to reduce overall exposure to losses on enforcement of security. The loan books continue to be carefully managed and the credit performance of the buy-to-let book remains exemplary.

FINANCIAL REVIEW

Yield curve movements during the period resulted in hedging instrument fair value net gains of £1.2 million (2017: £0.4 million net losses), which do not affect cash flow. The fair value movements of hedged assets or liabilities are expected to trend to zero over time, as such this item represents a timing difference. The Group remains economically and appropriately hedged.

Corporation tax has been charged at the rate of 19.6%, increased from 19.1% for the previous year. The reduction in the underlying rate of UK corporation tax applying to the Group in the year, from 19.5% to 19.0%, has been offset by the increased proportion of the Group's profit to which the 8.0% Bank Tax Surcharge applies.

Profits after taxation of £145.8 million (2017: £117.2 million) have been transferred to consolidated equity, which totalled £1,095.9 million at the year end (2017: £1,009.4 million), representing a tangible net asset value of £3.59 per share (2017: £3.45 per share) and an unadjusted net asset value of £4.25 per share (2017: £3.84 per share) (Appendix D).

Segmental results

The Group analyses its results between three segments, which are the principal divisions for which performance is monitored:

- Mortgages, including the Group's buy-to-let, and owner-occupied first and second charge lending and related activities
- Commercial Lending, including the Group's equipment and motor finance leasing activities, together with development finance, structured lending and other offerings targeted towards SME customers
- Idem Capital, including loan assets acquired from third parties and legacy assets which share certain credit characteristics with them

The Group's central administration and funding costs, principally the costs of service areas, establishment costs, and bond interest have not been allocated. Items excluded from underlying profit have also been included in unallocated costs, as these are not included in divisional results internally.

The underlying operating profits of these business segments are detailed fully in note 8 to the accounts and are summarised below.

	2018 Segment £m	2018 One off £m	2018 Total £m	2017 £m
Segmental profit				
Mortgages	144.8	-	144.8	143.3
Commercial Lending	19.9	(0.1)	19.8	14.1
Idem Capital	78.2	26.8	105.0	75.9
	242.9	26.7	269.6	233.3
Unallocated central costs	(86.4)	(2.9)	(89.3)	(88.1)
	156.5	23.8	180.3	145.2

FINANCIAL REVIEW

Mortgages

Trading activity during the year in the Mortgages division delivered further growth during the year, with the segmental profit at £144.8 million, up 1.0% from the previous year (2017: £143.3 million). Net interest income increased by 4.3% to £157.6 million (2017: £151.1 million), broadly in line with the growth in the loan book of 5.2%. The costs of the division increased as a result of higher activity levels while other income reduced during the period, in part reflecting an increasing trend for borrowers to choose fee-free loan products. The overall result was also affected by a £1.8 million increase in impairment provision in the year, with the variance arising on a small number of legacy loans.

Commercial Lending

Segmental profit in Commercial Lending increased 41.1% in the year to £19.9 million (2017: £14.1 million). The operations acquired in the year, Iceberg and Titlestone contributed £4.1 million to the divisional operating result. Excluding the £229.3 million of acquired assets, the loan book grew 61.8% in the year, and reached £1,133.2 million at 30 September 2018, driving the increase in net interest income.

A number of business units within the Commercial Lending segment remain in start-up phase, including the structured lending area, which made a loss during the period and is expected to make a positive contribution during 2019.

Idem Capital

The Idem Capital division's portfolios continued to perform well in the year to 30 September 2018. Strong cash performance in the year supported an increase in segmental profit of 3.0% to £78.2 million (2017: £75.9 million).

In September a sale of some non-core low-quality balances from the division's older portfolios realised a net gain of £26.8 million, after allowing for break costs in associated funding arrangements.

FINANCIAL REVIEW

Assets and liabilities

SUMMARY BALANCE SHEET
30 September 2018

	2018 £m	**2017 £m**
Intangible assets	169.3	104.4
Investment in customer loans	12,127.8	11,124.1
Derivative financial assets	855.7	906.6
Free cash	238.0	305.5
Other cash	1,072.6	1,191.4
Other assets	51.7	50.2
Total assets	14,515.1	13,682.2
Equity	1,095.9	1,009.4
Retail deposits	5,296.6	3,615.4
Borrowings	7,961.2	8,927.2
Pension deficit	19.5	29.8
Other liabilities	141.9	100.4
Total equity and liabilities	14,515.1	13,682.2

The increase in intangible assets results from £65.5 million of intangible assets and goodwill recognised on the Iceberg and Titlestone acquisitions in the year. The valuation of these assets was reconsidered at the year end and is presently considered to be appropriate.

The Group's loan assets include:

- Buy-to-let and owner-occupied first mortgage assets in the Mortgages segment
- Second charge mortgages, with new originations in Mortgages and purchased and similar legacy assets in Idem Capital
- Other unsecured consumer lending in Idem Capital
- Asset finance and motor finance loans in the Commercial Lending segment, with similar purchased accounts in the Idem Capital segment
- Development finance loans in the Commercial Lending segment
- Structured lending loans in the Commercial Lending segment
- Professions finance, invoice finance and other finance for SME businesses in the Commercial Lending segment

FINANCIAL REVIEW

The allocation of these loan assets between segments is set out below.

	2018 £m	2017 £m
Mortgages	10,473.5	9,953.9
Commercial Lending	1,133.2	558.8
Idem Capital	521.1	611.4
	12,127.8	11,124.1

An analysis of the Group’s financial assets by type is shown in note 16. Movements in the Group’s loan asset balances are discussed in the lending review section.

Movements in derivative financial assets arise principally as a result of the effect of changes in exchange rates on instruments forming cash flow hedges for the Group’s floating rate notes. These movements do not impact on the Group’s results.

Cash flows from the Group’s loan portfolios remained strong during 2018. These flows, together with an increased deposit base, financed the expansion of the Group’s loan book, supported portfolio and business acquisitions and underpinned an increased dividend payment to the Group’s shareholders. Cash was also utilised in the share buy-back programme, which commenced during December 2014 and where £25.2 million (including costs) was deployed in the year. Free cash balances were £238.0 million at 30 September 2018 (2017: £305.5 million) following the acquisitions towards the end of the period (note 15).

Movements in the Group’s funding are discussed in the funding review section.

The accounting value of the deficit in the Group’s defined benefit pension plan has reduced significantly over the year ended 30 September 2018. Gilt yields increased over the year and more recent market mortality assumptions were adopted and together these resulted in the deficit under International Accounting Standard (‘IAS’) 19 falling to £19.5 million (2017: £29.8 million). A corresponding actuarial gain of £8.9 million before tax was recognised in other comprehensive income (2017: gain of £29.0 million).

During the year a Pension Funding Partnership (‘PFP’) arrangement was agreed with the Trustee, effectively granting The Paragon Pension Plan (‘the Plan’) a charge over the Group’s head office building as security for its agreed contributions and thereby reducing the Plan’s funding risk.

While the valuation under IAS 19 is that which is required to be disclosed in the accounts, pension trustees generally use the technical provisions basis as provided in the Pensions Act 2004 to measure scheme liabilities. On this basis, the deficit at the triennial valuation date was £18.0 million and this had reduced to £15.2 million at 30 September 2018 excluding the benefit to the plan of the PFP (30 September 2017: £14.9 million), representing an 87% funding level (30 September 2017: 87%). Including the benefit of the PFP the deficit was £3.7 million, a 97% funding level.

FINANCIAL REVIEW

Accounting changes

On 1 October 2018 the Group adopted the provisions of International Financial Reporting Standard ('IFRS') 9, which will require loss provisions on financial assets to be calculated on the basis of expected rather than incurred losses. This will result in the Group's impairment provisions increasing by approximately £27 million at that date and its equity reducing by £22 million after tax.

For regulatory capital purposes the CRR allows the impact of the transition to be phased in over a five year period, so that the initial impact on capital ratios will be negligible. On a fully loaded basis the transition to IFRS 9 will result in the Group's CET1 ratio reducing from 13.8% to 13.5%.

It should be noted that this movement represents principally an acceleration of the impairment charge and is therefore a timing difference, rather than an additional loss.

The Group continues to develop, test and validate its IFRS 9 approach and therefore these estimates are provisional and may be revised on the basis of this further analysis.

OPERATIONAL REVIEW

Management and people

The Group's people are both its most significant cost and the key to its future growth and development. Over 1,300 people worked for the Group throughout the period, at its Solihull headquarters and other locations across the UK. The training and development of these people together with a rigorous recruitment and selection process are a key part of the Group's organic growth strategy and underpin the strong progress made and the Group's Investors in People Champion status.

Governance and management

As had been announced during February 2018, on 10 May 2018 Robert Dench, resigned as both Chairman and director after fourteen years on the Board, having become Chairman in 2007. His tenure in the chair has seen major challenges and changes for the Group, covering the credit crisis, the Group's return to lending, the launch of Paragon Bank and most recently the transition to a specialist banking group. Throughout these events Bob has chaired the Board in a collegiate, but challenging way and has been a supportive Chairman to the management team, with his wealth of banking experience being an invaluable asset to the Group throughout his tenure. He left the Group in a strong strategic position and excellent financial health.

Bob left to take up a new challenge as Chairman of The Co-operative Bank p.l.c., and departed with the sincere thanks and good wishes of his fellow directors and other colleagues.

Fiona Clutterbuck succeeded Bob as Chairman on 10 May 2018, having previously been Senior Independent Director and an independent non-executive director of the Group. She also succeeds Bob as Chairman of the Nomination Committee and ceases to be a member of the Audit Committee.

This appointment was the result of a thorough and independent recruitment process, involving both internal and external candidates, during which it became clear that Fiona was the best candidate to become Chairman. She has a strong knowledge of the Group, having served on the Board since 2012 and has a wealth of financial services experience, having held senior positions at leading UK and international banks. She was most recently Head of Strategy, Corporate Development and Communications at the Phoenix Group, until March 2018, while also serving as a non-executive director at a number of prominent listed companies.

Following Fiona's appointment, Peter Hartill, an independent non-executive director since 2011, was appointed to succeed her as Senior Independent Director, in addition to his responsibilities as Chairman of the Audit Committee, while Hugo Tudor, an independent non-executive director since 2014, succeeded Fiona as Chairman of the Remuneration Committee.

On 31 December 2018 Alan Fletcher and Patrick Newberry will step down from the Board. Alan has served as a director since 2009, including a lengthy term as Chairman of the Remuneration Committee, ceasing to be independent for corporate governance purposes earlier this year. Pat served first as an independent director of Paragon Bank PLC from its earliest months of operation in 2014, serving as chairman of its audit committee, and joined the Board of Paragon Banking Group when the two boards were unified in 2017. They will leave with the thanks of the Group and their fellow directors for their support and dedication in the development of both the Group and Paragon Bank PLC, and the best wishes of their colleagues for the future.

The Group's second annual statement under the Modern Slavery Act 2015 was published on its website in March 2018. Relevant policies have been reviewed and updated as appropriate. All employees have completed an annual e-learning module on this subject to raise awareness and understanding.

OPERATIONAL REVIEW

People and development

The Group continues to focus on maintaining an efficient and effective workforce, increasing employee numbers by 1.7% over the year. This increase includes those who joined the Group as a result of the Iceberg and Titlestone acquisitions and bringing these people into the Group has been an important priority during the year. The Group maintains its accreditation from the UK Living Wage Foundation and minimum pay continues to meet the levels set by the Foundation.

The Group prides itself on the fact that its people remain with it for a long time. Its annual employee attrition rate of 16.1% is below the national average and 26.8% of its people have over ten years service, with 10.9% having achieved over 20 years with the Group. We believe this is due to providing quality development opportunities and creating a place where people want to work, which has meant that knowledge and experience have been retained in each of our specialist areas. We believe our people are well positioned to support the Group's future growth strategy.

The Group was proud to have signed the Women in Finance Charter, sponsored by HM Treasury, in 2017. The Charter's objectives reflect the Group's own aspirations in the field of gender diversity and in January 2017, the Group published its first set of internal targets under the Charter.

The Group published an interim update in January 2018 and the latest update at 30 September 2018 confirms the Group is making good progress towards its targets:

- 52.3% of employees receiving management career development/leadership training are female (target 50%)
- 58.4% of the workforce are on flexible working contracts (target 10%)
- 32.3% of the flexible working available is on a part time basis (target 50%)

The Group notes the publication of the Hampton-Alexander review on gender diversity during the year. The Group believes that its Women in Finance primary objective is consistent with the review's recommendation and notes that its proportion of female senior managers at the year end, as defined by HA, was 29.1% (2017: 31.4%).

The Group has calculated its gender pay gap at April 2018, as required by law. This calculation shows that median female pay in the Group was 30.8% less than the median male pay. This is broadly in line with the results reported by other financial services companies and narrower than the 39.8% gap for the sector reported by the Office of National Statistics in their Annual Survey of Hours and Earnings published in October 2018.

The Group will be analysing its gender pay gap data as part of its Women in Finance initiative to determine if there are areas where urgent action is required, but preliminary results suggest where groups of similar positions exist, there is no evidence of systematic gender bias on pay.

The Group's succession planning strategy has also been an important area of focus during the year, with all Board and executive management roles together with their direct reports identified from a leadership and specialist perspective. Immediate successors are in place for these roles for the short term to provide business continuity and longer-term succession plans are being developed for those with career aspirations and strong potential. This area will remain a priority for the Board, with the assistance of the Nomination Committee, during the forthcoming year.

OPERATIONAL REVIEW

Risk

The effective management of risk is crucial to the achievement of the Group's strategic objectives. To ensure this is achieved the Group operates a risk governance framework, structured around a formal three lines of defence model (business areas, Risk and Compliance function and Internal Audit) supervised at Board level.

During the year the Group's risk governance framework has worked effectively to manage and mitigate the risks to which the Group is exposed from its various operational activities, while continuing to enhance its ability to manage all categories of risk. In particular this has been focussed on:

- The continuing evolution of the Group's risk appetite statements and embedding them in the processes of the businesses
- The embedding of a new operational risk management system in business areas for use on a day-to-day basis
- The review of cyber security controls and the evaluation of ongoing investments in systems resilience and security
- Support for the integration of acquired operations and the development of new businesses and product types, to ensure they are fully captured by the risk management framework

The principal challenges in the risk environment faced by the Group during the year included:

- The potential impact of the proposals on capital regulation from the BCBS
- Execution and transitional risks arising from recent acquisitions, particularly the acquisitions of Titlestone and Iceberg in the period
- The impact of continuing uncertainty as to the terms on which the UK will leave the EU in March 2019
- The impact of fiscal changes over recent years on the demand for buy-to-let mortgages in the UK
- Changes in the regulatory environment relating to the underwriting of buy-to-let mortgages
- Heightened cyber-security risks as a result of the increasing sophistication and frequency of cyber-attacks affecting the financial services sector
- Major regulatory developments including the implementation of the GDPR
- The level of business change required in respect of a move away from LIBOR linked products

The Group continues to closely monitor its exposure to current and emerging risks as they develop, and a particular focus continues to be the risks arising from the present uncertainties surrounding the UK's future relationship with the European Union. At this point the Group considers itself well placed to mitigate the impact of the risks to which it is exposed.

OPERATIONAL REVIEW

Regulation

The Bank is authorised by the PRA and regulated by the PRA and the FCA. The Group is subject to consolidated supervision by the PRA and a number of its subsidiaries are authorised and regulated by the FCA. As a result, current and projected regulatory changes continue to pose a significant risk for the Group. The governance and risk management framework within the Group continues to be developed to ensure that the impacts of all new regulatory requirements are clearly understood and mitigated as far as possible. Regular reports on key regulatory developments are received at both executive and board risk committees.

Whilst the Group is impacted by a broad range of prudential and conduct regulations, given the nature of its operations, the following are of particular note:

- In March 2017, the FCA issued a policy statement to complete the consultation process regarding PPI that it began in 2015. This included setting a deadline of 29 August 2019 by which consumers will need to make PPI complaints and new rules and guidance on the handling of PPI complaints. Impacts from this process have, so far, been minimal and this is expected to remain the case.
- The impacts of the Second Payment Services Directive ('PSD2') have been evaluated with the support of external advice. It was determined that the Group is compliant with the regulations based on the current product suite. Consideration of PSD2 will form part of all future product development.
- The Senior Managers and Certification Regime ('SMCR') will be extended to cover a wider section of persons employed in the financial services sector during 2019. This will increase the number of the Group's employees within the SMCR and the oversight activities required to ensure compliance with the extended rules. These systems have been developed in the period and training modules for all impacted people have been delivered across the Group.
- The development of proposals, led by the Bank of England and the FCA, to establish SONIA (the Sterling Overnight Index Average) administered by the Bank of England as the primary sterling interest rate benchmark by the end of 2021, in place of LIBOR, continues to be monitored to assess any potential impact on the Group. In November 2017 the regulators announced that the latest stage of this process would commence in January 2018, with consultations taking place during the year.
- In December 2017 the BCBS published its 'Basel III: Finalising post-crisis reforms' document. This has clarified the proposed increase to the capital risk weights for buy-to-let lending under the revised standardised approach and the introduction of a capital output floor based on the revised standardised approach. The proposed changes had been anticipated within the Group's IRB project.
- GDPR came into force with effect from May 2018, representing the most significant revision to data protection legislation for several decades. The Group continues to take appropriate steps to ensure that it is compliant with the new legislation.

Whilst the Group, along with the rest of the UK corporate sector, does not have clear visibility on potential regulatory changes that may be introduced following the UK's decision to leave the EU, it does not have any EU passporting issues that need to be considered.

OPERATIONAL REVIEW

Certain regulations applying in the financial services sector only affect entities over a certain size. The Group considers whether and when these regulations might apply to it in the light of the growth implicit in its business plans and puts appropriate arrangements in place to ensure it would be able to comply at that point.

Overall, the Group considers that it is well placed to address all the regulatory changes to which it is presently exposed.

CONCLUSION

The Group intends to maintain its current strategic approach moving forward, focussing on using its extensive credit experience to enable it to operate effectively and with a low-risk appetite in its chosen range of specialist markets. The deep understanding in these sectors, combined with the flexibility of the operating model, enables the Group to focus resources to optimise the relationship between growth, risk and reward. The diversification delivered by a series of organic and acquisitive developments over the past five years, combined with a broadly-based funding approach leaves the business well placed to deliver further value to its stakeholders over the coming years.

The Group enters 2019 with a strong new business pipeline, is well positioned in its chosen markets and equipped with high levels of liquidity. Despite the potential for economic uncertainties arising from Brexit and elsewhere, the Group remains confident of its future prospects.

PRINCIPAL RISKS

There are a number of potential risks and uncertainties to which the Group is exposed and which could impact significantly on its ability to conduct its business successfully. In the opinion of the directors these have not changed materially from those described in section A2.2 of the last annual report and accounts of the Company for the year ended 30 September 2017. These are summarised below.

Category	Risk	Description
Business	Economic	The Group could be materially affected by a severe downturn in the UK economy, as its income is wholly derived from activities within the country. The likelihood of this occurring has become more difficult to forecast given the continuing material uncertainties as to the terms on which the UK will leave the European Union ('EU') in March 2019. A material downturn in economic performance could reduce demand for the Group's loan products, increase the number of customers that default on their loans and cause security asset values to fall.
	Concentration	The Group's business plans could be particularly affected by any material change in the operation of the UK private rented sector and / or further regulatory intervention to control buy-to-let lending.
	Transition	Failure to manage major internal reorganisations or integrate acquired businesses, such as Titlestone, safely and effectively could adversely affect the Group's business plans and damage its reputation.
Credit	Customer	Failure to target and underwrite credit decisions effectively could result in customers becoming less able to service debt, exposing the Group to unexpected material losses.
	Counterparty	Failure of an institution holding the Group's cash deposits or providing hedging facilities for risk mitigation could expose the Group to loss or liquidity issues.
Conduct	Fair outcomes	Failure to deliver fair outcomes for its customers could impact on the Group's reputation, its ability to meet its regulatory obligations and its financial performance.
Operational	People	Failure to attract or retain appropriately skilled key employees at all levels could impact upon the Group's ability to deliver its business plans and strategic objectives.
	Systems	The inability of the Group's systems to support its business operations effectively and/or guard against cyber security risks could result in reputational damage and financial loss.
	Regulation	Given the highly regulated sectors in which the Group operates, compliance failures or failures to respond effectively to new and emerging regulatory and legal developments could result in reputational damage and financial loss.
Liquidity and Capital	Funding	If access to funding became restricted, either through market movements or regulatory intervention, this could result in the scaling back or cessation of some business lines.

PRINCIPAL RISKS

Category	Risk	Description
	Capital	Proposals by the Basel Committee on Banking Supervision ('BCBS') to change capital requirements for lending secured on residential property could have adverse financial implications for the Group.
Market	Interest rates	Reduction in margins between market lending and borrowing rates or mismatches in the Group balance sheet could impact profits.
Pension Obligation	Pensions	The obligation to support the Group's defined benefit pension plan might deplete resources.

The Group has considered and responded to all of these risks, mitigating the exposure as far as is practicable to ensure that its risk profile remains within the Board's stated risk appetite.

STATEMENT OF DIRECTORS' RESPONSIBILITES
in relation to financial statements

The responsibility statement below has been prepared in connection with the full annual accounts of the Company for the year ended 30 September 2018. Certain parts of these accounts are not presented within this announcement.

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations. The directors are required to prepare accounts for the Group in accordance with IFRS and have also elected to prepare company financial statements in accordance with IFRS. In respect of the financial statements for the year ended 30 September 2018, company law requires the directors to prepare such financial statements in accordance with IFRS, the Companies Act 2006 and Article 4 of the IAS Regulation.

International Accounting Standard 1 – 'Presentation of Financial Statements' requires that financial statements present fairly for each financial year the Company's financial position, financial performance and cash flows. This requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the International Accounting Standards Board's ('IASB') 'Framework for the Preparation and Presentation of Financial Statements'. In virtually all circumstances, a fair presentation will be achieved by compliance with all applicable IFRS. In preparing each of the Group and Company financial statements the directors are also required to:

- Properly select and apply suitable accounting policies consistently
- Make an assessment of the Group's and the Company's ability to continue as a going concern
- Present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information
- Provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance

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 Group and Company and the Group's profit or loss for the year.

The directors are responsible for keeping adequate accounting records which disclose with reasonable accuracy at any time the financial position of the Company, for safeguarding the assets, for the Group's systems of Internal Control and for taking reasonable steps for the prevention and detection of fraud and other irregularities. They are also responsible for the preparation of a strategic report, directors' report, directors' remuneration report and corporate governance statement which comply with the applicable requirements of the Companies Act 2006.

The directors are responsible for the maintenance and integrity of the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements differs from legislation in other jurisdictions.

STATEMENT OF DIRECTORS' RESPONSIBILITES
in relation to financial statements

Each of the current directors confirms that, to the best of their knowledge:

- The financial statements, prepared in accordance with IFRS as adopted by the EU, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and of the Group taken as a whole
- The Directors' Report, including those other sections of the Annual Report incorporated by reference, comprises a management report for the purposes of the Disclosure Guidance and Transparency Rules, which includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face
- The Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's performance, business model and strategy

Approved by the Board of Directors and signed on behalf of the Board.

PANDORA SHARP

Company Secretary

21 November 2018

Board of Directors

F J Clutterbuck	A K Fletcher	B A Ridpath
N S Terrington	P J N Hartill	F F Williamson
R J Woodman	H R Tudor	G H Yorston
J A Heron	P J Newberry	

CONSOLIDATED INCOME STATEMENT
For the year ended 30 September 2018

	Note	2018 £m	2018 £m	2017 £m	2017 £m
Interest receivable	9		451.9		409.2
Interest payable and similar charges	10		(197.3)		(176.6)
Net interest income			254.6		232.6
Other leasing income		16.3		14.4	
Related costs		(12.5)		(11.4)	
Net leasing income		3.8		3.0	
Gain on disposal of financial assets	11	28.0		-	
Other income	12	15.5		17.2	
Other operating income			47.3		20.2
Total operating income			301.9		252.8
Operating expenses			(114.2)		(102.3)
Provisions for losses			(7.4)		(5.3)
Operating profit before fair value items			180.3		145.2
Fair value net gains / (losses)	13		1.2		(0.4)
Operating profit being profit on ordinary activities before taxation			181.5		144.8
Tax charge on profit on ordinary activities			(35.7)		(27.6)
Profit on ordinary activities after taxation for the financial year			145.8		117.2

	Note	2018	2017
Earnings per share			
- basic	14	55.9p	43.1p
- diluted	14	54.2p	41.9p

The results for the current and preceding years relate entirely to continuing operations.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended 30 September 2018

		2018		2017	
	Note	**£m**	**£m**	**£m**	**£m**
Profit for the year			145.8		117.2
Other comprehensive income					
Items that will not be reclassified subsequently to profit or loss					
Actuarial gain on pension scheme	23	8.9		29.0	
Tax thereon		(1.7)		(5.5)	
			7.2		23.5
Items that may be reclassified subsequently to profit or loss					
Cash flow hedge gains taken to equity		1.0		0.5	
Tax thereon		(0.2)		(0.1)	
			0.8		0.4
Other comprehensive income for the year net of tax			8.0		23.9
Total comprehensive income for the year			153.8		141.1

CONSOLIDATED BALANCE SHEET
30 September 2018

	Note	2018 £m	2017 £m	2016 £m
Assets				
Cash – central banks	15	895.9	615.0	315.0
Cash – retail banks	15	414.7	881.9	922.6
Short term investments		-	-	7.1
Loans to customers	16	12,103.7	11,115.4	10,750.0
Derivative financial assets	18	855.7	906.6	1,366.4
Sundry assets		19.0	12.7	12.7
Property, plant and equipment		56.8	46.2	39.2
Intangible assets	19	169.3	104.4	105.4
Total assets		14,515.1	13,682.2	13,518.4
Liabilities				
Short term bank borrowings		1.1	0.6	1.2
Retail deposits	20	5,292.4	3,611.9	1,874.7
Derivative financial liabilities	18	4.7	7.1	15.8
Asset backed loan notes	21	5,554.7	6,475.8	8,374.1
Secured bank borrowings	21	935.6	1,306.0	1,573.0
Retail bond issuance	21	296.1	295.7	295.3
Corporate bond issuance	21	149.3	149.1	259.0
Central bank facilities	21	1,024.4	700.0	-
Sundry liabilities	22	114.4	74.6	78.7
Current tax liabilities		21.4	17.4	16.7
Deferred tax liabilities		5.6	4.8	2.0
Retirement benefit obligations	23	19.5	29.8	58.4
Total liabilities		13,419.2	12,672.8	12,548.9
Called up share capital	24	281.6	281.5	295.9
Reserves	25	918.3	811.0	736.1
Own shares	26	(104.0)	(83.1)	(62.5)
Total equity		1,095.9	1,009.4	969.5
Total liabilities and equity		14,515.1	13,682.2	13,518.4

Approved by the Board of Directors on 21 November 2018.
Signed on behalf of the Board of Directors

N S Terrington	R J Woodman
Chief Executive	Chief Financial Officer

CONSOLIDATED CASH FLOW STATEMENT
For the year ended 30 September 2018

	Note	2018 £m	2017 £m
Net cash generated by operating activities	28	1,074.4	1,474.7
Net cash (utilised) / generated by investing activities	29	(282.8)	3.2
Net cash (utilised) by financing activities	30	(978.4)	(1,218.0)
Net (decrease) / increase in cash and cash equivalents		(186.8)	259.9
Opening cash and cash equivalents		1,496.3	1,236.4
Closing cash and cash equivalents		1,309.5	1,496.3
Represented by balances within:			
Cash	14	1,310.6	1,496.9
Short term bank borrowings		(1.1)	(0.6)
		1,309.5	1,496.3

CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY
For the year ended 30 September 2018

Year ended 30 September 2018

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Cash flow hedging reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m	£m
Transactions arising from								
Profit for the year	-	-	-	-	-	145.8	-	145.8
Other comprehensive income	-	-	-	-	0.8	7.2	-	8.0
Total comprehensive income	-	-	-	-	0.8	153.0	-	153.8
Transactions with owners								
Dividends paid (note 27)	-	-	-	-	-	(43.1)	-	(43.1)
Shares cancelled	-	-	-	-	-	-	-	-
Own shares purchased	-	-	-	-	-	-	(31.4)	(31.4)
Exercise of share awards	0.1	0.3	-	-	-	(10.9)	10.5	-
Charge for share based remuneration	-	-	-	-	-	6.1	-	6.1
Tax on share based remuneration	-	-	-	-	-	1.1	-	1.1
Net movement in equity in the year	0.1	0.3	-	-	0.8	106.2	(20.9)	86.5
Opening equity	281.5	65.5	28.7	(70.2)	2.5	784.5	(83.1)	1,009.4
Closing equity	281.6	65.8	28.7	(70.2)	3.3	890.7	(104.0)	1,095.9

CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY (Continued)
For the year ended 30 September 2018

Year ended 30 September 2017

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Cash flow hedging reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m	£m
Transactions arising from								
Profit for the year	-	-	-	-	-	117.2	-	117.2
Other comprehensive income	-	-	-	-	0.4	23.5	-	23.9
Total comprehensive income	-	-	-	-	0.4	140.7	-	141.1
Transactions with owners								
Dividends paid (note 27)	-	-	-	-	-	(38.0)	-	(38.0)
Shares cancelled	(15.0)	-	15.0	-	-	(45.1)	45.1	-
Own shares purchased	-	-	-	-	-	-	(69.7)	(69.7)
Exercise of share awards	0.6	0.9	-	-	-	(4.0)	4.0	1.5
Charge for share based remuneration	-	-	-	-	-	4.2	-	4.2
Tax on share based remuneration	-	-	-	-	-	0.8	-	0.8
Net movement in equity in the year	(14.4)	0.9	15.0	-	0.4	58.6	(20.6)	39.9
Opening equity	295.9	64.6	13.7	(70.2)	2.1	725.9	(62.5)	969.5
Closing equity	281.5	65.5	28.7	(70.2)	2.5	784.5	(83.1)	1,009.4

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

1. GENERAL INFORMATION

The financial information set out in the announcement does not constitute the Company's statutory accounts for the years ended 30 September 2016, 30 September 2017 or 30 September 2018, but is derived from those statutory accounts, which have been reported on by the Company's auditors. Statutory accounts for the years ended 30 September 2016 and 30 September 2017 have been delivered to the Registrar of Companies and those for the year ended 30 September 2018 will be delivered to the Registrar following the Company's Annual General Meeting. The reports of the auditors in each case were unqualified, did not draw attention to any matters by way of emphasis and did not contain an adverse statement under sections 498(2) or 498(3) of the Companies Act 2006.

Sections of this preliminary announcement, including but not limited to the Management Report, may contain forward-looking statements with respect to certain of the plans and current goals and expectations relating to the future financial condition, business performance and results of the Group. These have been made by the directors in good faith using information available up to the date on which they approved this report. By their nature, all forward-looking statements involve risk and uncertainty because they relate to future events and circumstances that are beyond the control of the Group and depend upon circumstances that may or may not occur in the future. There are a number of factors that could cause actual future financial conditions, business performance, results or developments to differ materially from the plans, goals and expectations expressed or implied by these forward-looking statements and forecasts. Nothing in this document should be construed as a profit forecast.

Copies of the Annual Report and Accounts for the year ended 30 September 2018 will be distributed to shareholders in due course. Copies of this announcement can be obtained from the Company Secretary, Paragon Banking Group PLC at 51 Homer Road, Solihull, West Midlands, B91 3QJ and on the Group's website at www.paragonbankinggroup.co.uk.

2. ACCOUNTING POLICIES

The annual financial statements of the Group for the year ended 30 September 2018 have been prepared in accordance with International Financial Reporting Standards ('IFRS') as adopted for use in the European Union. Accordingly, the preliminary financial information has been prepared in accordance with the recognition and measurement criteria of IFRS. The particular accounting policies adopted are those described in the Annual Report and Accounts of the Group for the year ended 30 September 2017.

The critical accounting estimates and judgements affecting the condensed financial information are the same as those described in note 6 to the accounts of the Group for the year ended 30 September 2017.

New and revised reporting standards

No new or revised reporting standards significantly affecting the Group's accounting have been issued since the approval of the Group's financial statements for the year ended 30 September 2017.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

2. ACCOUNTING POLICIES (CONTINUED)

IFRS 9

IFRS 9, which will be implemented in the Group's accounting from of 1 October 2018 changes the basis of recognition of impairment of financial assets from an incurred loss to an expected credit loss ('ECL') approach for financial assets held at amortised cost. This introduces a number of new concepts and changes to the approach to provisioning set out in IAS 39.

The Group's IFRS 9 project, described in note 2 of the 2017 financial statements, continues to make progress to implement the new rules. A more detailed report on progress will be given in the Annual Report and Accounts for the year ending 30 September 2018.

It is estimated that the Group's new IFRS 9 provisioning approach will result in an increase in provisions of approximately £27.0m. The total impact on equity, net of tax is expected to be a reduction of £22.0m. This estimate is provisional and may be subsequently changed as the Group continues to further develop, calibrate and test its provisioning models, as described above.

The Group intends to take advantage of the transitional relief on regulatory capital, which will spread the impact of the introduction of IFRS 9 on capital over a five year period.

Going concern

The business activities of the Group, its current operations and those factors likely to affect its future results and development, together with a description of its financial position and funding position, are described in the Management Report. The principal risks and uncertainties affecting the Group are described on pages 46 and 47.

Note 6 to the accounts for the year ended 30 September 2017 includes an analysis of the Group's working and regulatory capital position and policies, while note 7 includes a detailed description of its funding structures, its use of financial instruments, its financial risk management objectives and policies and its exposure to credit, interest rate and liquidity risk. Critical accounting estimates affecting the results and financial position disclosed in that annual report are discussed in note 5. The position and polices described in these notes remain materially unchanged to the date of this preliminary announcement.

The Group has a formalised process of budgeting, reporting and review. The Group's planning procedures forecast its profitability, capital position, funding requirement and cash flows. Detailed annual plans are produced for two-year periods with longer term forecasts covering a five-year period, which include detailed income forecasts. These plans provide information to the directors which is used to ensure the adequacy of resources available for the Group to meet its business objectives, both on a short term and strategic basis.

The Group's retail deposits of £5,296.6 million (note 20), accepted through Paragon Bank, are repayable within five years, with 68.5% of this balance (£3,630.7 million) payable within twelve months of the balance sheet date. The liquidity exposure represented by these deposits is closely monitored; a process supervised by the Asset and Liability Committee. The Group is required to hold liquid assets in Paragon Bank to mitigate this liquidity risk. At 30 September 2018 Paragon Bank held £724.9 million of balance sheet assets for liquidity purposes, in the form of central bank deposits (note 15). A further £108.7 million of liquidity was provided by the Bank of England FLS, bringing the total to £833.6 million.

Paragon Bank manages its liquidity in line with the Board's risk appetite and the requirements of the PRA, which are formally documented in the Board's approved ILAAP. The Bank maintains a liquidity framework that includes a short to medium term cash flow requirement analysis, a longer-term funding plan and access to the Bank of England's liquidity insurance facilities, where pre-positioned assets would support drawings of £716.0m.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

2. ACCOUNTING POLICIES (CONTINUED)

The Group's securitisation funding structures ensure that a substantial proportion of its originated loan portfolio is match-funded. This proportion was increased by the issue of the Paragon Mortgages (No. 25) PLC securitisation in April 2018. Repayment of the securitisation borrowings is restricted to funds generated by the underlying assets and there is limited recourse to the Group's general funds. Recent and current loan originations are financed through retail deposits and may be refinanced through securitisation where this is appropriate and cost effective.

The earliest maturity of any of the Group's working capital debt is in December 2020, when the oldest of the Group's retail bond issues matures.

The Group's cash analysis continues to show a strong cash position, even after allowing for significant discretionary payments, and its securitisation investments produce substantial cash flows.

The Group has demonstrated its ability to raise retail and corporate bond debt when required through its Euro Medium Term Note Programme and other programmes. The Group's access to debt is also enhanced by its corporate BBB rating, upgraded from BBB- by Fitch Ratings in April 2018, and its status as an issuer is evidenced by the BBB- rating of its £150.0 million Tier-2 bond issue (upgraded from BB+ in April 2018).

In order to assess the appropriateness of the going concern basis the directors considered the Group's financial position, the cash flow requirements laid out in its forecasts, its access to funding, the assumptions underlying the forecasts and the potential risks affecting them.

After performing this assessment, the directors concluded that it was appropriate for them to continue to adopt the going concern basis in preparing the Annual Report and Accounts.

3. FAIR VALUES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

IFRS 7 – 'Financial Instruments: Disclosures' requires that where assets are measured at fair value these measurements should be classified using the fair value hierarchy set out in IFRS 13 – 'Fair Value Measurement'. This hierarchy reflects the inputs used, and defines three levels.

- Level 1 measurements are unadjusted market prices
- Level 2 measurements are derived from directly or indirectly observable data, such as market prices or rates
- Level 3 measurements rely on significant inputs which are not derived from observable data

As quoted prices are not available for level 2 and 3 measurements, the valuation is derived from cash flow models based, where possible, on independently sourced parameters. The accuracy of the calculation would therefore be affected by unexpected market movements or other variances in the operation of the models or the assumptions used.

The Group had no financial assets or liabilities in the year ended 30 September 2018 or the year ended 30 September 2017 carried at fair value and valued using level 3 measurements, other than contingent consideration amounts (note 22).

The Group has not reclassified any of its measurements during the year.

The methods by which fair value is established for each class of financial assets and liabilities are set out below.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

3. FAIR VALUES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

a) Assets and liabilities carried at fair value

Derivative financial assets and liabilities

Derivative financial instruments are stated at their fair values in the accounts. The Group uses a number of techniques to determine the fair values of its derivative assets and liabilities, for which observable prices in active markets are not available. These are principally present value calculations based on estimated future cash flows arising from the instruments, discounted using a risk adjusted interest rate. The principal inputs to these valuation models are LIBOR benchmark interest rates for the currencies in which the instruments are denominated, being sterling, euros and dollars. The cross-currency basis swaps have a notional principal related to the outstanding currency borrowings and therefore the estimated rate of repayment of these notes also affects the valuation of the swaps. In order to determine the fair values the management applies valuation adjustments to observed data where that data would not fully reflect the attributes of the instrument being valued, such as particular contractual features or the identity of the counterparty. The management reviews the models used on an ongoing basis to ensure that the valuations produced are reasonable and reflect all relevant factors. These valuations are based on market information and they are therefore classified as level 2 measurements. Details of these assets are given in note 18.

Contingent consideration

The value of the contingent considerations shown in note 22 are required to be stated at fair value in the accounts. These amounts are valued based on the expected outcomes of the performance tests set out in respective sale and purchase agreements, discounted as appropriate. The most significant inputs to these valuations are the Group's forecasts on future activity relating to the businesses or individuals concerned, which are drawn from the overall Group forecasting model. As such, these are classified as unobservable inputs and the valuations classified as level 3 measurements.

Short term investments

The short-term investments are freely traded securities for which a market price quotation is available and are classified as level 1 measurements.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

3. FAIR VALUES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

b) Assets and liabilities carried at amortised cost

Cash, bank loans and securitisation borrowings

The fair values of cash and cash equivalents, bank loans and overdrafts and asset backed loan notes, which are carried at amortised cost are considered to be not materially different from their book values. In arriving at that conclusion market inputs have been considered but because all the assets mature within three months of the year end and the interest rates charged on financial liabilities reset to market rates on a quarterly basis, little difference arises. This also applies to the parent company's loans to its subsidiaries.

While the Group's asset backed loan notes are listed, the quoted prices for an individual note may not be indicative of the fair value of the issue as a whole, due to the specialised nature of the market in such instruments and the limited number of investors participating in it.

As these valuation exercises are not wholly market based they are considered to be level 2 measurements.

Corporate debt

The Group's retail and corporate bonds are listed on the London Stock Exchange and there is presently a reasonably liquid market in the instruments. It is therefore appropriate to consider that the market price of these borrowings constitutes a fair value. As this valuation is based on a market price, it is considered to be a level 1 measurement.

Retail deposits

To assess the likely fair value of the Group's retail deposit liabilities, the directors have considered the estimated cash flows expected to arise based on a mixture of market based inputs, such as rates and pricing and non-market based inputs such as withdrawal rates. Given the mixture of observable and non-observable inputs, these are considered to be level 3 measurements.

Loan assets

To assess the likely fair value of the Group's loan assets in the absence of a liquid market, the directors have considered the estimated cash flows expected to arise from the Group's investments in its loans to customers based on a mixture of market based inputs, such as rates and pricing and non-market based inputs such as redemption rates. Given the mixture of observable and non-observable inputs these are considered to be level 3 measurements.

Sundry assets and liabilities

Fair values of financial assets and liabilities disclosed as sundry assets and sundry liabilities are not considered to be materially different to their carrying values.

These assets and liabilities are of relatively low value and may be settled at their carrying value at the balance sheet date or shortly thereafter.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

3 FAIR VALUES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

The Group has reviewed its classification of the level of valuations for retail deposits and loan assets, where valuations are derived from a mixture of observable and non-observable outputs, and concluded it is more in line with market practice to classify them as level 3 measurements rather than, as previously, level 2.

The fair values for financial assets and liabilities held at amortised cost, other than those where carrying values are so low that any difference would be immaterial, determined in accordance with the methodologies set out above, are summarised below.

	2018 Carrying amount £m	2018 Fair value £m	2017 Carrying amount £m	2017 Fair value £m
The Group				
Financial assets				
Loans and receivables				
Loans to customers	12,127.8	12,222.9	11,124.1	11,191.9
Cash	1,310.6	1,310.6	1,496.9	1,496.9
	13,438.4	13,533.5	12,621.0	12,688.8
Financial liabilities				
Other liabilities				
Asset backed loan notes	5,554.7	5,554.7	6,475.8	6,475.8
Corporate and retail bonds	445.4	478.3	444.8	480.4
Retail deposits	5,296.6	5,301.7	3,615.4	3,615.1
Secured bank borrowings	935.6	935.6	1,306.0	1,306.0
	12,232.3	12,270.3	11,842.0	11,877.3

The fair value of retail deposits shown above will include amounts for the related accrued interest.

4. CAPITAL MANAGEMENT

(a) **Dividend policy**

The Board reviewed its dividend policy in September 2017, concluding that the changes made would make the Group’s use of working capital more efficient and that there was, therefore, less need to retain earnings to support future growth. It therefore determined that the targeted dividend cover ratio (on the basis set out below) would be reduced from 3.00 times, initially to 2.75 times for the year ended 30 September 2017 and then, subject to the requirements of the business, to 2.5 times for the current year. The Company considers it has access to sufficient cash resources to pay dividends at this level and that its distributable reserves are abundant for this purpose.

The most recent review, in September 2018, confirmed this policy but concluded that the significant one-off income and costs arising in the year, principally relating to asset sales and acquisitions should be excluded from earnings for this purpose. The interim and final dividends for the year ended 30 September 2018 have been declared in accordance with the policy, as amended.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

4. CAPITAL MANAGEMENT (CONTINUED)

For the purposes of dividend policy the Group defines dividend cover based on earnings per share, adjusted where considered appropriate and dividend per share. This is the most common measure used by financial analysts.

The derivation of the dividend for the year, which is subject to approval at the forthcoming AGM is set out below.

	Note	2018	2017
Earnings per share (p)	14	55.9	43.1
Adjustment for one off items (p)		(7.3)	-
Adjusted earnings per share (p)		48.6	43.1
Dividend cover target (times)		2.5	2.75
Proposed dividend per share in respect of the year (p)	27	19.4	15.7

(b) **Return on tangible equity (‘RoTE’)**

RoTE is a measure of an entity’s profitability used by investors. RoTE is defined by the Group by comparing the profit after tax for the year, adjusted for amortisation charged on intangible assets, to the average of the opening and closing equity positions, excluding intangible assets and goodwill.

The Group’s consolidated RoTE for the year ended 30 September 2018 is derived as follows:

	Note	2018 £m	2017 £m
Profit for the year after tax		145.8	117.2
Amortisation of intangible assets		2.1	1.6
Adjusted profit		147.9	118.8
Divided by			
Opening equity		1,009.4	969.5
Opening intangible assets	19	(104.4)	(105.4)
Opening tangible equity		905.0	864.1
Closing equity		1,095.9	1,009.4
Closing intangible assets	19	(169.3)	(104.4)
Closing tangible equity		926.6	905.0
Average tangible equity		915.8	884.5
Return on Tangible Equity		16.1%	13.4%

This table is not subject to audit

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

4. CAPITAL MANAGEMENT (CONTINUED)

(c) **Regulatory capital**

The Group is subject to supervision by the PRA on a consolidated basis, as a group containing an authorised bank. As part of this supervision the regulator will issue individual capital guidance setting an amount of regulatory capital, which the Group is required to hold relative to its risk weighted assets in order to safeguard depositors from loss in the event of severe losses being incurred by the Group. This is defined by the international Basel III rules, set by the Basel Committee on Banking Supervision ('BCBS') and currently implemented in UK law by EU Regulation 575/2013, referred to as the Capital Requirements Regulation ('CRR').

The Group's regulatory capital is monitored by the Board, its Risk and Compliance Committee and the Asset and Liability Committee, who ensure that appropriate action is taken to ensure compliance with the regulator's requirements. The future regulatory capital requirement is also considered as part of the Group's forecasting and strategic planning process.

The tables below demonstrate that at 30 September 2018 the Group's regulatory capital of £1,045.7m (2017: £1,030.5m) was comfortably in excess of the amounts required by the regulator, including £727.7m in respect of Pillar 1 and Pillar 2a capital, which is comprised of fixed and variable elements. The CRR also requires firms to hold additional capital buffers, including a Capital Conservation Buffer of 1.875% of risk weighted assets (at 30 September 2018) and a Counter-Cyclical Buffer, currently 0.5% of risk weighted assets. Firm specific buffers may also be required.

The Group's regulatory capital differs from its equity as certain adjustments are required by the regulator. A reconciliation of the Group's equity to its regulatory capital determined in accordance with CRD IV at 30 September 2018 is set out below.

	Note	2018 £m	2017 £m
Total equity		1,095.9	1,009.4
Deductions			
Proposed final dividend	27	(35.8)	(28.9)
Intangible assets	19	(169.3)	(104.4)
Common Equity Tier 1 ('CET1') capital		890.8	876.1
Other tier 1 capital		-	-
Total Tier 1 capital		890.8	876.1
Corporate bond	21	150.0	150.0
Less: amortisation adjustment	†	-	-
		150.0	150.0
Collectively assessed credit impairment allowances		4.9	4.4
Total Tier 2 capital		154.9	154.4
Total regulatory capital		1,045.7	1,030.5

† When tier 2 capital instruments have less than five years to maturity the amount eligible as regulatory capital reduces by 20% per annum. No such adjustment is required in respect of the Corporate Bond issued in the year ended 30 September 2016, which matures in 2026.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

4. CAPITAL MANAGEMENT (CONTINUED)

The total exposure amount calculated under the CRD IV framework against which this capital is held, and the proportion of these assets it represents, are calculated as shown below.

	2018 £m	2017 £m
Credit risk		
Balance sheet assets	5,767.3	4,907.7
Off balance sheet	87.8	68.3
Total credit risk	5,855.1	4,976.0
Operational risk	485.1	464.9
Market risk	-	-
Other	105.1	67.8
Total exposure amount	6,445.3	5,508.7
	%	**%**
Solvency ratios		
CET1	13.8	15.9
Total regulatory capital	16.2	18.7

This table is not subject to Audit

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

4. CAPITAL MANAGEMENT (CONTINUED)

The table below shows the calculation of the UK leverage ratio, based on the consolidated balance sheet assets adjusted as shown. The PRA has proposed a minimum UK leverage ratio of 3.25% for UK firms.

	Note	2018 £m	2017 £m
Total balance sheet assets		14,515.1	13,682.2
Add: Credit fair value adjustments on loans to customers	16	24.1	8.7
Debit fair value adjustments on retail deposits	20	4.2	3.5
Adjusted balance sheet assets		14,543.4	13,694.4
Less: Derivative assets	18	(855.7)	(906.6)
Central bank deposits	15	(895.9)	(615.0)
CRDs		(6.2)	(1.6)
Accrued interest on sovereign exposures		(0.4)	-
On-balance sheet items		12,785.2	12,171.2
Less: Intangible assets	19	(169.3)	(104.4)
Total on balance sheet exposures		12,615.9	12,066.8
Derivative assets	18	855.7	906.6
Potential future exposure on derivatives		172.1	191.3
Total derivative exposures		1,027.8	1,097.9
Post offer pipeline at gross notional amount		817.7	417.9
Adjustment to convert to credit equivalent amounts		(569.2)	(208.9)
Off balance sheet items		248.5	209.0
Tier 1 capital		890.8	876.1
Total leverage exposure		13,892.2	13,373.7
UK leverage ratio		6.4%	6.6%

This table is not subject to audit

The UK leverage ratio is prescribed by the PRA and differs from the leverage ratio defined by Basel and the CRR due to the exclusion of central bank balances from exposures.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

5. CREDIT RISK

The Group's business objectives rely on maintaining a high-quality customer base and place strong emphasis on good credit management, both at the time of acquiring or underwriting a new loan, where strict lending criteria are applied, and throughout the loan's life.

The Group's credit risk is primarily attributable to its loans to customers. There are no significant concentrations of credit risk to individual counterparties due to the large number of customers included in the portfolios.

The Group's balance sheet loan assets at 30 September 2018 are analysed as follows:

	2018 £m	2018 %	2017 £m	2017 %
Buy-to-let mortgages	10,261.6	84.6%	9,836.5	88.4%
Owner-occupied mortgages	70.6	0.6%	19.0	0.2%
Total first charge residential mortgages	10,332.2	85.2%	9,855.5	88.6%
Second charge mortgage loans	415.9	3.5%	490.7	4.4%
Loans secured on residential property	10,748.1	88.7%	10,346.2	93.0%
Development finance	352.8	2.9%	42.3	0.4%
Loans secured on property	11,100.9	91.6%	10,388.5	93.4%
Motor finance loans	329.4	2.7%	163.0	1.5%
Other consumer loans	173.7	1.4%	219.1	2.0%
Asset finance loans	403.4	3.3%	323.6	2.9%
Factoring and discounting balances	34.9	0.3%	23.8	0.2%
Professions finance	42.6	0.4%	1.4	-
Structured lending	38.7	0.3%	-	-
Other commercial loans	4.2	-	4.7	-
Total loans to customers	12,127.8	100.0%	11,124.1	100.0%

Other consumer loans include unsecured loans either advanced by Group companies or acquired from their originators at a discount.

Professions Finance includes loans originated by the acquired Iceberg business note 6. These are generally short term unsecured loans made to lawyers and accountants for working capital purposes.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

5. CREDIT RISK (CONTINUED)

An analysis of the indexed loan to value ratio (‘LTV’) for those loan accounts secured on residential property by value at 30 September 2018 is set out below. LTVs for second charge mortgages are calculated allowing for the interest of the first charge holder, while for acquired accounts the effect of any discount on purchase is allowed for.

	2018 First mortgages %	2018 Secured loans %	2017 First mortgages %	2017 Secured loans %
Loan to value ratio				
Less than 70%	60.6	66.1	62.1	56.7
70% to 80%	29.7	17.4	25.0	17.5
80% to 90%	7.1	9.3	9.5	11.5
90% to 100%	0.8	3.5	1.3	7.1
Over 100%	1.8	3.7	2.1	7.2
	100.0	100.0	100.0	100.0
Average loan to value ratio	66.0	65.9	66.3	70.0
Of which:				
Buy-to-let	66.1		66.4	
Owner-occupied	51.3		30.9	

The regionally indexed LTVs shown above are affected by changes in house prices, with the Nationwide house price index, for the UK as a whole, registering an annual increase of 2.0% in the year ended 30 September 2018 (2017: 2.0%).

The increase in the LTV ratio for the owner-occupied accounts relates to the greater number of new lending accounts, which have higher LTV levels than legacy cases.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

5. CREDIT RISK (CONTINUED)

The number of accounts in arrears by asset class, based on the most commonly quoted definition of arrears for the type of asset, at 30 September 2018 and 30 September 2017, compared to the industry averages at those dates published by UK Finance ('UKF') and the FLA, was:

	2018 %	2017 %
First mortgages		
Accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	0.11	0.08
Buy-to-let accounts excluding receiver of rent cases	0.03	0.02
Owner-occupied accounts	3.15	3.55
UKF data for mortgage accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	0.42	0.45
Buy-to-let accounts excluding receiver of rent cases	0.38	0.41
Owner-occupied accounts	0.86	0.95
All mortgages	0.78	0.86
Second charge mortgage loans		
Accounts more than 2 months in arrears		
All accounts	13.64	17.55
Post-2010 originations	0.21	0.06
Legacy cases (Pre-2010 originations)	17.91	16.75
Purchased assets	14.81	19.69
FLA data for secured loans	9.40	11.20
Car loans		
Accounts more than 2 months in arrears	3.91	0.67
FLA data for point of sale hire purchase	2.50	2.20
Asset finance loans		
Accounts more than 2 months in arrears	0.78	0.97
FLA data for business lease / hire purchase loans	0.70	0.60

No published industry data for asset classes comparable to the Group's other books has been identified. Where revised data at 30 September 2017 has been published by the FLA or UKF, the comparative industry figures above have been amended.

Arrears information is not given for development finance or factoring activities as the structure of the products means that such a measure is not relevant.

The Group calculates its headline arrears measure for buy-to-let mortgages, shown above, based on the numbers of accounts three months or more in arrears, including purchased Idem Capital assets, but excluding those cases in possession and receiver of rent cases designated for sale. This is consistent with the methodology used by UKF in compiling its statistics for the buy-to-let mortgage market as a whole.

The number of accounts in arrears will naturally be higher for legacy books, such as the Group's legacy second charge mortgages and residential first mortgages than for comparable active ones, as performing accounts pay off their balances, leaving arrears accounts representing a greater proportion of the total.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

5. CREDIT RISK (CONTINUED)

The figures shown above for secured loans incorporate purchased portfolios which generally include a high proportion of cases in arrears at the time of purchase and where this level of performance is allowed for in the discount to current balance represented by the purchase price. However this will lead to higher than average reported arrears.

The payment status of the carrying balances of the Group's live loan assets, at 30 September 2018 and at 30 September 2017, split between those accounts considered as performing and those included in the population for impairment testing, is shown below. Balances for immaterial asset classes are not shown. 'Asset finance loans' below includes other related loan balances. Fully provided non-live accounts shown in note 17 are excluded from the tables below.

Days past due is not a relevant measure for the development finance, structured lending or invoice discounting businesses, due to their particular contractual arrangements.

First mortgages

	2018 £m	2017 £m
Not past due	10,211.1	9,724.2
Arrears less than 3 months	101.7	112.6
Performing accounts	10,312.8	9,836.8
Arrears 3 to 6 months	3.0	1.1
Arrears 6 to 12 months	2.2	1.9
Arrears over 12 months	5.7	7.7
Possessions and similar cases	22.1	22.5
Impairment population	33.0	33.2
Total gross balances	10,345.8	9,870.0
Impairment provision on live cases	(12.7)	(12.7)
Timing adjustments	(0.9)	(1.8)
Carrying balance	10,332.2	9,855.5

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

5. CREDIT RISK (CONTINUED)

Consumer and asset finance

	Second charge mortgage loans £m	Motor finance loans £m	Asset finance loans £m	Total £m
30 September 2018				
Not past due	350.7	310.8	388.6	1,050.1
Arrears less than 2 months	19.4	13.2	13.8	46.4
Performing accounts	370.1	324.0	402.4	1,096.5
Arrears 2 to 6 months	11.0	3.2	1.3	15.5
Arrears 6 to 9 months	4.1	0.9	0.7	5.7
Arrears 9 to 12 months	3.3	0.6	-	3.9
Arrears over 12 months	29.9	2.1	0.6	32.6
Specifically impaired asset finance cases	-	-	0.5	0.5
Impairment population	48.3	6.8	3.1	58.2
Total gross balances	418.4	330.8	405.5	1,154.7
Impairment provision on live cases	(1.5)	(1.7)	(1.7)	(4.9)
Timing adjustments	(1.0)	0.3	(0.4)	(1.1)
Carrying balance	415.9	329.4	403.4	1,148.7
30 September 2017				
Not past due	400.8	158.0	315.3	874.1
Arrears less than 2 months	20.5	5.0	10.0	35.5
Performing accounts	421.3	163.0	325.3	909.6
Arrears 2 to 6 months	14.9	0.7	0.5	16.1
Arrears 6 to 9 months	7.1	0.2	0.7	8.0
Arrears 9 to 12 months	5.4	0.1	-	5.5
Arrears over 12 months	46.2	0.3	0.1	46.6
Specifically impaired asset finance cases	-	-	2.7	2.7
Impairment population	73.6	1.3	4.0	78.9
Total gross balances	494.9	164.3	329.3	988.5
Impairment provision on live cases	(2.1)	(1.2)	(3.1)	(6.4)
Timing adjustments	(2.1)	(0.1)	(1.2)	(3.4)
Carrying balance	490.7	163.0	325.0	978.7

Arrears in the tables above are based on the contractual payment status of the customers concerned. Where assets have been purchased by the Group, customers may already have been in arrears at the time of acquisition and an appropriate adjustment made to the consideration paid.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

5. CREDIT RISK (CONTINUED)

Acquired assets

Almost all of the Group's unsecured consumer loan assets are part of purchased debt portfolios where the consideration paid will have been based on the credit quality and performance of the loans at the point of the transaction. Collections on purchased accounts have been comfortably in excess of those implicit in the purchase prices.

In the debt purchase industry, Estimated Remaining Collections ('ERCs') is commonly used as a measure of the value of a portfolio. This is defined as the sum of the undiscounted cash flows expected to be received over a specified future period. In the Group's view, this measure may be suitable for heavily discounted, unsecured, distressed portfolios, but is less applicable for the types of portfolio in which the Group has invested, where cash flows are higher on acquisition, loans may be secured on property and customers may not be in default. In such cases, the IAS 39 amortised cost balance, at which these assets are carried in the Group balance sheet, provides a better indication of value.

However, to aid comparability, the 84 and 120 month ERC values for the Group's purchased consumer loan assets, are set out below. These are derived using the same models and assumptions used in the EIR calculations, but the differing bases of calculation lead to different outcomes.

	2018 Carrying value £m	2018 84 month ERC £m	2018 120 month ERC £m	2017 Carrying value £m	2017 84 month ERC £m	2017 120 month ERC £m
Loans to customers	364.2	434.9	489.6	503.5	608.9	688.8

Amounts shown as loans to customers above include loans disclosed as first mortgages and other loans (note 16) and are included in the aging tables above at their carrying values.

Development finance

Development finance cases include both originated accounts and accounts recognised on the Titlestone acquisition note 7.

Development finance loans do not require customers to make payments during the life of the loan, therefore arrears and past due measures cannot be used to monitor credit risk. Instead, cases are monitored on an individual basis by management and Credit Risk. The average loan to gross development value ('LTGDV') ratio for the portfolio at year end, a measure of security cover, is analysed below.

LTGDV	2018 By value %	2018 By number %	2017 By value %	2017 By number %
50% or less	3.4	4.4	4.2	7.3
50% to 60%	18.9	22.8	36.6	39.0
60% to 65%	63.3	59.6	42.6	41.5
65% to 70%	7.1	9.6	16.6	12.2
70% to 75%	0.7	0.7	-	-
Over 75%	6.6	2.9	-	-
	100.0	100.0	100.0	100.0

The average LTGDV cover at the year end was 63.2% (2017: 60.6%).

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

5. CREDIT RISK (CONTINUED)

LTGDV is calculated by comparing the current expected end of term exposure with the latest estimate of the value of the completed development based on surveyors' reports.

At 30 September 2018 the development finance portfolio comprised 136 accounts (2017: 41) with a total carrying value of £352.8m (2017: £42.3m). Of these accounts only four were considered at risk of loss (2017: none). These accounts had been acquired in the Titlestone purchase where an allowance for losses was made in the IFRS 3 fair value calculation. There was, therefore, no impairment provision under IAS 39 (2017: £nil).

6. ACQUSITION OF ICEBERG

On 13 December 2017 the Group acquired the trade and assets of The Iceberg Partnerships LLP and on 20 December 2017 it acquired the trade and assets of Iceberg Client Credit LLP. These entities (together 'Iceberg') were related to each other. Iceberg is a finance broker and lender dealing with specialist business lending to mid-sized UK law firms and similar concerns. The acquisition allows the Group to increase the reach of its commercial finance operations to new products and customer groups.

The consideration for the acquisition will be satisfied entirely in cash. Cash transferred on completion was £6.6m, with a further payment made, following the agreement of completion accounts, of £0.2m.

Further contingent consideration, of between £nil and £13.0m, is payable in cash based on volumes and pricing of lending generated by the acquired business over a five year period. £11.8m has been provided in the accounts in respect of this contingent consideration, based on the net present value of the maximum amount. This is considered to be the fair value of the consideration at the transaction date, based on initial forecasts for the business. Transaction costs of £0.2m have been included in operating expenses for the year ended 30 September 2018.

The post-acquisition contribution of Iceberg to consolidated revenue for the year ended 30 September 2018 was £1.8m and its contribution to consolidated profit before tax for the period was £0.1m.

The amounts recognised in the consolidated accounts on acquisition in respect of the identifiable assets acquired are set out below. The amounts presented are considered to be materially consistent with the existing accounting policies of the Group. The Group has yet to finalise its exercise to determine these balances and therefore the amounts presented in this note should be considered as provisional. Final amounts will be presented with the Group's annual results for the year ending 30 September 2019.

	Note	£m
Assets		
Loans to customers	a	2.0
Intangible assets	b	0.1
Total net identifiable assets		2.1
Goodwill	c	16.5
Consideration	d	18.6

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

6. ACQUISITION OF ICEBERG (CONTINUED)

a) Loans to customers

The financial assets acquired comprised loans to individuals in advance of amounts which become payable in respect of probate and matrimonial legal processes. Their fair value was £2.0m, the gross contractual value was £2.1m and the contractual flows not to be collected were £0.1m.

b) Intangible assets

Identifiable intangible assets acquired represent broker networks and trading arrangements. They will be amortised over a ten year period.

c) Goodwill

The goodwill of £16.5m arising from the acquisition consists of the values of the business relationships, market positions and knowledge base inherent in the business which do not qualify for recognition as intangible assets. These will be utilised in the future development of the acquired business and in expanding the Group's asset finance activities. None of the goodwill is expected to be deductible for tax purposes.

The goodwill has been allocated to the Asset Finance cash generating unit ('CGU') for impairment testing period as its activities have become part of the activities of the wider Asset Finance business.

d) Consideration

The total consideration accounted for on acquisition was:

	Total £m
Consideration paid on completion	6.6
Consideration paid on agreement of completion accounts	0.2
Contingent consideration	11.8
Total consideration	18.6

7. ACQUISITION OF TITLESTONE

On 3 July 2018 the Group acquired the entire share capital of Titlestone Property Finance Limited ('TPF'), together with a portfolio of loans held by companies related to it, (together 'Titlestone'). Titlestone is a development finance business, active in similar markets to the Group's own development finance operation, and its acquisition allows the Group to increase the reach of its proposition and to reach a more economic scale more rapidly than would be possible through organic growth alone.

The Group acquired 100% of the voting interests in TPF and the consideration for the shares and the loan portfolio was satisfied entirely in cash. Cash transferred on completion was £274.3m and there are no deferred or contingent consideration arrangements. Transaction costs of £1.1m have been included in operating expenses for the year ended 30 September 2018.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

7. ACQUISITION OF TITLESTONE (CONTINUED)

The contribution of Titlestone to consolidated revenue for the year ended 30 September 2018 was £6.6m and its contribution to consolidated profit before tax for the period is set out below.

	£m	£m
Contribution to consolidated profit excluding costs of acquisition		3.8
Transaction costs	(1.1)	
Other acquisition related expenses	(0.9)	
Total costs of acquisition		(2.0)
Contribution to consolidated profit after costs of acquisition		1.8

The amounts recognised in the consolidated accounts on acquisition in respect of the identifiable assets acquired and liabilities assumed are set out below. The amounts presented are considered to be materially consistent with the existing accounting policies of the Group. The Group has yet to finalise its exercise to determine these balances and therefore the amounts presented in this note should be considered as provisional. Final amounts will be presented with the Group's annual results for the year ending 30 September 2019.

	Note	£m	£m
Cash	c		0.1
Loans to customers	a		227.4
Sundry Assets			0.2
Intangible assets	b		1.3
Total assets			229.0
Sundry liabilities		(2.0)	
Deferred tax		(0.3)	
Total liabilities			(2.3)
Total net identifiable assets			226.7
Goodwill	d		47.6
Consideration	c		274.3

a) Loans to customers

The financial assets acquired at 3 July 2018 comprised development finance loans. Their fair value was £227.4m, the gross contractual value was £231.0m and the total value expected not to be collected was £5.9m

b) Intangible assets

Identifiable intangible assets acquired represent broker networks and trading arrangements. They will be amortised over a ten year period

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

7. ACQUISITION OF TITLESTONE (CONTINUED)

c) Cashflow on acquisition

	£m
Net cashflow on acquisition were	
Payment for shares	46.7
Payments for loans	227.6
Total payments on completion	274.3
Cash	(0.1)
Net cash outflow	274.2

The fair value and the gross contractual value of the cash balances acquired were equal to their book value. There are no contractual cash flows which are expected not to be collectible.

d) Goodwill

The goodwill of £47.6m arising from the acquisition consists of the values of the business relationships, market positions and knowledge base inherent in the business which do not qualify for recognition as intangible assets. These will be utilised in the future development of the Group's development finance operations, with which the acquired activities are being merged. None of the goodwill is expected to be deductible for tax purposes.

The acquired goodwill has been allocated to a CGU including both the acquired operations and the Group's organically generated development finance business with which it has been merged.

8. SEGMENTAL INFORMATION

The Group analyses its operations, both for internal management reporting and external financial reporting, on the basis of the markets from which its assets are generated. The segments used are described below:

- Mortgages, including the Group's buy-to-let, and owner-occupied first and second charge lending and related activities
- Commercial Lending, including the Group's motor finance and other equipment leasing activities, together with development finance and other offerings targeted towards SME customers
- Idem Capital, including loan assets acquired from third parties and legacy assets which share certain credit characteristics with them

Dedicated financing and administration costs of each of these businesses are allocated to the segment. Shared central costs are not allocated between segments, nor is income from central cash balances or the carrying costs of unallocated savings balances.

Loans to customers and operating lease assets are allocated to segments as are dedicated securitisation funding arrangements and their related cross-currency basis swaps and cash balances.

Retail deposits and their related costs are allocated to the segments based on the utilisation of those deposits. Retail deposits raised in advance of lending are not allocated.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

8. SEGMENTAL INFORMATION (CONTINUED)

Other assets and liabilities are not allocated between segments.

The costs arising in the year ended 30 September 2018 from the Iceberg and Titlestone acquisitions of £2.2m have not been allocated as they are not directly related to customer facing activity, nor has the gain relating to the sale of financial assets.

All of the Group's operations are conducted in the UK, all revenues arise from external customers and there are no inter-segment revenues. No customer contributes more than 10% of the revenue of the Group.

Financial information about these business segments, prepared on the same basis as used in the consolidated accounts of the Group, is shown below.

Year ended 30 September 2018

	Mortgages £m	Commercial Lending £m	Idem Capital £m	Unallocated Items £m	Total Segments £m
Interest receivable	299.1	50.1	97.9	4.8	451.9
Interest payable	(141.5)	(17.9)	(10.1)	(27.8)	(197.3)
Net interest income	157.6	32.2	87.8	(23.0)	254.6
Other operating income	7.6	10.9	0.7	28.1	47.3
Total operating income	165.2	43.1	88.5	5.1	301.9
Direct costs	(14.9)	(21.2)	(10.4)	(67.7)	(114.2)
Provisions for losses	(5.5)	(2.0)	0.1	-	(7.4)
	144.8	19.9	78.2	(62.6)	180.3

Year ended 30 September 2017

	Mortgages £m	Commercial Lending £m	Idem Capital £m	Unallocated Items £m	Total Segments £m
Interest receivable	274.7	33.8	98.9	1.8	409.2
Interest payable	(123.6)	(10.6)	(11.4)	(31.0)	(176.6)
Net interest income	151.1	23.2	87.5	(29.2)	232.6
Other operating income	9.6	9.9	0.7	-	20.2
Total operating income	160.7	33.1	88.2	(29.2)	252.8
Direct costs	(13.7)	(18.9)	(10.8)	(58.9)	(102.3)
Provisions for losses	(3.7)	(0.1)	(1.5)	-	(5.3)
	143.3	14.1	75.9	(88.1)	145.2

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

8. SEGMENTAL INFORMATION (CONTINUED)

The segmental profits disclosed above reconcile to the group results as shown below.

	2018 £m	2017 £m
Results shown above	180.3	145.2
Fair value items	1.2	(0.4)
Operating profit	181.5	144.8

The assets and liabilities attributable to each of the segments at 30 September 2018 and 30 September 2017 on the basis described above were:

	Note	Mortgages £m	Commercial Lending £m	Idem Capital £m	Total Segments £m
30 September 2018					
Segment assets					
Loans to customers	16	10,473.5	1,133.2	521.1	12,127.8
Operating lease assets		-	35.4	-	35.4
Cross-currency basis swaps	18	829.7	-	-	829.7
Securitisation cash	15	319.0	-	19.8	338.8
		11,622.2	1,168.6	540.9	13,331.7
Segment liabilities					
Allocated deposits		4,702.4	1,443.5	411.0	6,556.9
Securitisation funding		6,457.2	-	33.1	6,490.3
		11,159.6	1,443.5	444.1	13,047.2

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

8. SEGMENTAL INFORMATION (CONTINUED)

	Note	Mortgages £m	Commercial Lending £m	Idem Capital £m	Total Segments £m
30 September 2017					
Segment assets					
Loans to customers	16	9,953.9	558.8	611.4	11,124.1
Operating lease assets		-	23.4	-	23.4
Cross-currency basis swaps	18	896.3	-	-	896.3
Securitisation cash	15	543.0	-	31.0	574.0
		11,393.2	582.2	642.4	12,617.8
Segment liabilities					
Allocated deposits		3,401.2	686.9	249.8	4,337.9
Securitisation funding		7,597.1	-	184.7	7,781.8
		10,998.3	686.9	434.5	12,119.7

An analysis of the Group's financial assets by type and segment is shown in note 16. All of the assets shown above were located in the UK.

The additions to non-current assets, excluding financial assets, in the year which are included in segmental assets above are investments of £19.3m (2017: £12.9m) in assets held for leasing under operating leases, included in the Commercial Lending segment. No other fixed asset additions were allocated to segments.

The segmental assets and liabilities may be reconciled to the consolidated balance sheet as shown below.

	2018 £m	2017 £m
Total segment assets	13,331.7	12,617.8
Unallocated assets		
Central cash and investments	971.8	922.9
Unallocated derivatives	26.0	10.3
Operational property, plant and equipment	21.4	22.8
Intangible assets	169.3	104.4
Other	(5.1)	4.0
Total assets	14,515.1	13,682.2

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

8. SEGMENTAL INFORMATION (CONTINUED)

	2018 £m	2017 £m
Total segment liabilities	13,047.2	12,119.7
Unallocated liabilities		
Unallocated retail deposits	(1,260.3)	(722.5)
Derivative financial instruments	4.7	7.1
Central borrowings	1,470.9	1,145.4
Tax liabilities	27.0	22.2
Retirement benefit obligations	19.5	29.8
Other	110.2	71.1
Total liabilities	13,419.2	12,672.8

9. INTEREST RECEIVABLE

	2018 £m	2017 £m
Interest receivable in respect of		
Loans and receivables	408.9	375.1
Finance leases	34.4	28.8
Factoring income	2.2	2.2
Interest on loans to customers	445.5	406.1
Other interest receivable	6.4	3.1
Total interest on financial assets	451.9	409.2

10. INTEREST PAYABLE AND SIMILAR CHARGES

	Note	2018 £m	2017 £m
On retail deposits		83.1	47.9
On asset backed loan notes		60.3	70.2
On bank loans and overdrafts		16.5	22.7
On corporate bonds		10.9	13.1
On retail bonds		18.6	18.6
On central bank facilities		5.2	1.1
Total interest on financial liabilities		194.6	173.6
On pension scheme deficit	23	0.8	1.3
Discounting on contingent consideration	22	0.5	0.3
Other finance costs		1.4	1.4
		197.3	176.6

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

11. GAIN ON DISPOSAL OF FINANCIAL ASSETS

During the year, the Group realised a gain of £28.0m on the disposal of second charge mortgages and unsecured consumer loans held in its Idem Capital division. The loans were originally acquired from various third parties as part of a number of portfolio purchases over time.

As a consequence of this transaction, facility break costs of £1.2m were incurred. These have been included within interest payable on asset backed loan notes.

12. OTHER INCOME

	2018 £m	2017 £m
Loan account fee income	9.0	9.0
Broker commissions	2.1	3.6
Third party servicing	3.4	3.3
Other income	1.0	1.3
	15.5	17.2

13. FAIR VALUE NET GAINS / (LOSSES)

The fair value net gain / (loss) represents the accounting volatility on derivative instruments which are matching risk exposure on an economic basis generated by the requirements of IAS 39. Some accounting volatility arises on these items due to accounting ineffectiveness on designated hedges, or because hedge accounting has not been adopted or is not achievable on certain items. The losses and gains are primarily due to timing differences in income recognition between the derivative instruments and the economically hedged assets and liabilities. Such differences will reverse over time and have no impact on the cash flows of the Group.

14. EARNINGS PER SHARE

Earnings per ordinary share is calculated as follows:

		2018	2017
Profit for the year (£m)		145.8	117.2
Basic weighted average number of ordinary shares ranking for dividend during the year (million)		260.8	271.6
Dilutive effect of the weighted average number of share options and incentive plans in issue during the year (million)		8.4	8.0
Diluted weighted average number of ordinary shares ranking for dividend during the year (million)		269.2	279.6
Earnings per ordinary share	- basic	55.9p	43.1p
	- diluted	54.2p	41.9p

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

15. CASH AND CASH EQUIVALENTS

	2018 £m	2017 £m	2016 £m
Balances with central banks	895.9	615.0	315.0
Balances with other banks	414.7	881.9	922.6
Cash and cash equivalents	1,310.6	1,496.9	1,237.6

Only 'Free Cash' is unrestrictedly available for the Group's general purposes. Cash received in respect of loan assets funded through warehouse facilities and securitisations is not immediately available, due to the terms of those arrangements. This cash is shown as 'securitisation cash' below.

Balances with central banks form part of the liquidity buffer of Paragon Bank PLC and are therefore not available for the Group's general purposes. Free cash may also be deposited at the Bank of England.

Cash held by the Trustee of the Group's employee share ownership plan may only be used to invest in the shares of the Company, pursuant to the aims of that plan. This is shown as 'ESOP cash' below.

The total consolidated 'Cash and Cash Equivalents' balance may be analysed as shown below:

	2018 £m	2017 £m	2016 £m
Free cash	238.0	305.5	383.1
Securitisation cash	338.8	574.0	537.1
Liquidity buffer	724.9	615.0	315.0
ESOP cash	8.9	2.4	2.4
	1,310.6	1,496.9	1,237.6

16. LOANS TO CUSTOMERS

	Note	2018 £m	2017 £m	2016 £m
Loans to customers		12,127.8	11,124.1	10,737.5
Fair value adjustments from portfolio hedging		(24.1)	(8.7)	12.5
		12,103.7	11,115.4	10,750.0

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

16. LOANS TO CUSTOMERS (CONTINUED)

The Group's loan assets at 30 September 2018, analysed between the segments described in note 8 are as follows:

	Mortgages £m	Commercial Lending £m	Idem Capital £m	Total £m
At 30 September 2018				
First mortgages	10,332.2	-	-	10,332.2
Consumer loans	141.3	-	448.3	589.6
Motor finance	-	256.6	72.8	329.4
Asset finance	-	403.4	-	403.4
Development finance	-	352.8	-	352.8
Other loans	-	120.4	-	120.4
Loans to customers	10,473.5	1,133.2	521.1	12,127.8
At 30 September 2017				
First mortgages	9,855.5	-	-	9,855.5
Consumer loans	98.4	-	611.4	709.8
Motor finance	-	163.0	-	163.0
Asset finance	-	325.0	-	325.0
Development finance	-	42.3	-	42.3
Other loans	-	28.5	-	28.5
Loans to customers	9,953.9	558.8	611.4	11,124.1

The Group's purchased loan portfolios include £11.7m of first mortgages in the Mortgages segment (2017: £12.6m), and £352.5m of consumer loan and £72.8m of motor finance loans in the Idem Capital segment (2017: £490.9m and £nil). Information on the ERCs for first mortgages and consumer loans is given in note 5. All other loans above are internally generated or arise from acquired operations.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

17. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS

The following amounts in respect of impairment provisions, net of allowances for recoveries of written off assets, have been deducted from the appropriate assets in the balance sheet.

	First mortgages	Other loans and receivables	Finance leases	Total
	£m	£m	£m	£m
At 1 October 2016	88.8	22.6	1.2	112.6
Amounts provided in the period	3.8	2.3	2.2	8.3
Amounts written off	(3.5)	(6.6)	(0.2)	(10.3)
At 30 September 2017	89.1	18.3	3.2	110.6
Amounts provided in the period	5.6	0.6	2.9	9.1
Amounts written off	(3.7)	(7.6)	(1.0)	(12.3)
At 30 September 2018	91.0	11.3	5.1	107.4

Of the above balances, the following provisions were held in respect of realised losses not charged off, which remain on the balance sheet and provided for in full.

	First mortgages	Other loans and receivables	Finance leases	Total
	£m	£m	£m	£m
At 30 September 2018	78.2	-	0.9	79.1
At 30 September 2017	76.4	0.3	0.3	77.0

The amounts charged to the profit and loss account, net of recoveries of previously provided amounts are set out below.

	First mortgages	Other loans and receivables	Finance leases	Total
	£m	£m	£m	£m
Year ended 30 September 2018				
Amounts provided in the year	5.6	0.6	2.9	9.1
Recovery of amounts previously provided	(0.1)	(0.5)	(1.1)	(1.7)
Net impairment for year	5.5	0.1	1.8	7.4
Year ended 30 September 2017				
Amounts provided in the year	3.8	2.3	2.2	8.3
Recovery of amounts previously provided	(0.1)	(0.7)	(2.2)	(3.0)
Net impairment for year	3.7	1.6	-	5.3

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

18. DERIVATIVE FINANCIAL ASSETS AND LIABILITIES

	Note	2018 £m	2017 £m	2016 £m
Derivative financial assets		855.7	906.6	1,366.4
Derivative financial liabilities		(4.7)	(7.1)	(15.8)
		851.0	899.5	1,350.6
Of which:				
Foreign exchange basis swaps		829.7	896.3	1,364.8
Other derivatives		21.3	3.2	(14.2)
		851.0	899.5	1,350.6

The Group's securitisation borrowings are denominated in sterling, euros and US dollars. All currency borrowings are swapped at inception so that they have the effect of sterling borrowings. These swaps provide an effective hedge against exchange rate movements, but the requirement to carry them at fair value leads, when exchange rates have moved significantly since the issue of the notes, to large balances for the swaps being carried in the balance sheet. This is currently the case with both euro and US dollar swaps, although the debit balance is compensated for by retranslating the borrowings at the current exchange rate.

19. INTANGIBLE ASSETS

	2018 £m	2017 £m	2016 £m
Goodwill	162.2	98.1	98.4
Computer software	2.1	2.0	2.1
Other intangible assets	5.0	4.3	4.9
	169.3	104.4	105.4

Other intangible assets comprise brands and the benefit of business networks recognised on the acquisition of subsidiary companies.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

20. RETAIL DEPOSITS

The Group's retail deposits, held by Paragon Bank PLC, were received from customers in the UK and are denominated in sterling. The deposits comprise principally term deposits and 120 day notice accounts. The method of interest calculation on these deposits is analysed as follows:

	2018 £m	2017 £m	2016 £m
Fixed rate	3,643.1	2,675.9	1,332.5
Variable rates	1,653.5	939.5	541.4
	5,296.6	3,615.4	1,873.9

The weighted average interest rate on retail deposits at 30 September 2018, analysed by charging method, was:

	2018 %	2017 %	2016 %
Fixed rate	1.94	1.89	2.11
Variable rates	1.36	1.21	1.65

The contractual maturity of these deposits is analysed below.

	2018 £m	2017 £m	2016 £m
Amounts repayable			
In less than three months	256.8	211.4	55.7
In more than three months, but not more than one year	2,024.7	1,399.6	690.3
In more than one year, but not more than two years	1,010.6	770.0	572.9
In more than two years, but not more than five years	655.3	629.7	283.9
Total term deposits	3,947.4	3,010.7	1,602.8
Repayable on demand	1,349.2	604.7	271.1
	5,296.6	3,615.4	1,873.9
Fair value adjustments for portfolio hedging	(4.2)	(3.5)	0.8
	5,292.4	3,611.9	1,874.7

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

21. BORROWINGS

All borrowings described in the Group Accounts for the year ended 30 September 2017 remained in place throughout the period, except as noted below.

On 6 April 2018 Fitch Ratings announced an upgrade of the Group's Long-Term Issuer Default Rating and its senior unsecured debt rating to BBB from BBB-. Consequentially the rating of the Group's £150.0m Tier 2 Bond was also upgraded one notch from BB+ to BBB-.

During the period the Group continued to access facilities provided by the Bank of England. The Term Funding Scheme ('TFS') continued to be drawn upon until it ceased to be available for new drawings in February 2018 and since that time the Indexed Long-Term Repo ('ILTR') scheme has been accessed.

Of the Group's borrowings at 30 September 2017, the mortgage backed floating rate notes issued by Paragon Mortgages (No. 8) PLC were repaid in January 2018, following the purchase of its loan assets by other group companies, principally Paragon Bank PLC.

During the period, the warehouse facility in Paragon Seventh Funding Limited was not renewed and was paid down. This has reduced the Group's available warehouse capacity by £200.0m.

On 25 April 2018, a Group company, Paragon Mortgages (No. 25) PLC, issued £435.3m of sterling mortgage backed floating rate notes to external investors at par. £375.0m of the notes were class A notes, rated AAA by Fitch and Aaa by Moody's, £31.8m were class B notes, rated AA by Fitch and Aa1 by Moody's and £28.5m were class C notes rated A- by Fitch and A1 by Moody's. The interest rates above LIBOR on the notes were 0.65% on the A notes, 0.95% on the B notes and 1.30% on the C notes. The initial average interest margin on the transaction was 0.72% and the proceeds were used to refinance existing short term liabilities. The Group retained £289.4m of notes of various classes meaning that its investment represented 39.9% of the issued notes.

Repayments made in respect of the Group's borrowings are shown in note 30.

22. SUNDRY LIABILITIES

Sundry liabilities include £40.8m of amounts falling due after more than one year (2017: £23.5m). Contingent consideration of £25.7m, falling due after more than one year, is included in the sundry liabilities balance (2017: £14.0m).

23. RETIREMENT BENEFIT OBLIGATIONS

Since the last IAS 19 actuarial valuation at 30 September 2017 there have also been movements in financial conditions, requiring an adjustment to the actuarial assumptions underlying the calculation of the defined benefit obligation at 30 September 2018. In particular, over the period since the 30 September 2017 actuarial valuation, the discount rate has increased by 0.3% per annum, whereas expectations of long term inflation have increased by 0.1% per annum.

The net effect of these changes has resulted in a decrease in the value of the defined benefit obligation at 30 September 2018.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

23. RETIREMENT BENEFIT OBLIGATIONS (CONTINUED)

The movements in the deficit on the defined benefit plan during the year ended 30 September 2018 are summarised below.

	Year to 30 September 2018 £m	Year to 30 September 2017 £m
Opening pension deficit	29.8	58.4
Service cost	1.8	2.4
Net funding cost	0.8	1.3
Administrative expenses	0.5	0.4
Employer contributions	(4.5)	(3.7)
Amounts posted to other comprehensive income		
Return on plan assets not included in interest	(1.1)	(7.4)
Actuarial (gain) arising from demographic assumptions	(1.8)	(6.7)
Actuarial (gain) arising from experience adjustments	-	(4.2)
Actuarial (gain)/loss from changes in financial assumptions	(6.0)	(10.7)
Closing pension deficit	19.5	29.8

24. CALLED-UP SHARE CAPITAL

The share capital of the Company consists of a single class of £1 ordinary shares.

Movements in the issued share capital in the year were:

	2018 Number	2017 Number
Ordinary shares		
At 1 October 2017	281,489,701	295,852,094
Shares issued	107,235	637,607
Shares cancelled	-	(15,000,000)
At 30 September 2018	281,596,936	281,489,701

During the year the Company issued 107,235 shares (2017: 637,607) to satisfy options granted under Sharesave schemes for a consideration of £360,031 (2017: £1,575,925).

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

25. RESERVES

	2018 £m	2017 £m	2016 £m
Share premium account	65.8	65.5	64.6
Capital redemption reserve	28.7	28.7	13.7
Merger reserve	(70.2)	(70.2)	(70.2)
Cash flow hedging reserve	3.3	2.5	2.1
Profit and loss account	890.7	784.5	725.9
	918.3	811.0	736.1

26. OWN SHARES

	2018 £m	2017 £m
Treasury shares		
At 1 October 2017	66.6	46.2
Shares purchased	25.2	65.5
Shares cancelled	-	(45.1)
At 30 September 2018	91.8	66.6
ESOP shares		
At 1 October 2017	16.5	16.3
Shares purchased	6.2	4.2
Options exercised	(10.5)	(4.0)
At 30 September 2018	12.2	16.5
Balance at 30 September 2018	104.0	83.1
Balance at 1 October 2017	83.1	62.5

At 30 September 2018 the number of the Company's own shares held in treasury was 20,800,284 (2017: 15,693,643). These shares had a nominal value of £20,800,284 (2017: £15,693,643). These shares do not qualify for dividends.

The Employee Share Ownership Plan ('ESOP') shares are held in trust for the benefit of employees exercising their options under the Company's share option schemes and awards under the Paragon Performance Share Plan and Deferred Share Bonus Plan. The trustees' costs are included in the operating expenses of the Group.

At 30 September 2018, the trusts held 2,874,825 ordinary shares (2017: 3,180,661) with a nominal value of £2,874,825 (2017: £3,180,661) and a market value of £13,764,662 (2017: £13,975,824). Options, or other share-based awards, were outstanding against all of these shares at 30 September 2018 (2017: all). The dividends on all of these shares have been waived (2017: all).

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

27. EQUITY DIVIDEND

Amounts recognised as distributions to equity shareholders in the Group in the period:

	2018 Per share	2017 Per share	2018 £m	2017 £m
Equity dividends on ordinary shares				
Final dividend for the year ended 30 September 2017	11.0p	9.2p	28.9	25.5
Interim dividend for the year ended 30 September 2018	5.5p	4.7p	14.2	12.5
	16.5p	13.9p	43.1	38.0

Amounts paid and proposed in respect of the year:

	2018 Per share	2017 Per share	2018 £m	2017 £m
Interim dividend for the year ended 30 September 2018	5.5p	4.7p	14.2	12.5
Proposed final dividend for the year ended 30 September 2018	13.9p	11.0p	35.8	28.9
	19.4p	15.7p	50.0	41.4

The proposed final dividend for the year ended 30 September 2018 will be paid on 18 February 2019, subject to approval at the Annual General Meeting, with a record date of 11 January 2019. The dividend will be recognised in the accounts when it is paid.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

28. NET CASH FLOW FROM OPERATING ACTIVITIES

	2018 £m	2017 £m
Profit before tax	181.5	144.8
Non-cash items included in profit and other adjustments:		
Depreciation of operating property, plant and equipment	1.9	1.9
Profit on disposal of operating property, plant and equipment	(0.2)	(0.1)
Amortisation of intangible assets	2.1	1.6
Foreign exchange movement on borrowings	(67.6)	(468.9)
Other non-cash movements on borrowings	6.0	6.4
Impairment losses on loans to customers	7.4	5.3
Charge for share based remuneration	6.1	4.2
Net (increase) / decrease in operating assets:		
Operating lease assets	(12.0)	(7.4)
Loans to customers	(781.7)	(391.9)
Derivative financial instruments	50.9	459.8
Fair value of portfolio hedges	15.4	21.2
Other receivables	(6.1)	-
Net increase / (decrease) in operating liabilities:		
Retail deposits	1,681.2	1,741.5
Derivative financial instruments	(2.4)	(8.7)
Fair value of portfolio hedges	(0.7)	(4.3)
Other liabilities	24.6	(1.8)
Cash generated by operations	1,106.4	1,503.6
Income taxes (paid)	(32.0)	(28.9)
	1,074.4	1,474.7

Cash flows relating to plant and equipment held for leasing under operating leases are classified as operating cash flows.

29. NET CASH FLOW FROM INVESTING ACTIVITIES

	2018 £m	2017 £m
Proceeds from sales of operating property, plant and equipment	0.5	0.3
Purchases of operating property, plant and equipment	(0.8)	(1.7)
Purchases of intangible assets	(1.5)	(0.9)
Decrease in short term investments	-	7.1
Movement in loans to subsidiary undertakings	-	-
Acquisitions	(281.0)	(1.6)
Net cash (utilised) / generated by investing activities	(282.8)	3.2

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2018

30. NET CASH FLOW FROM FINANCING ACTIVITIES

	2018 £m	2017 £m
Shares issued (note 24)	0.4	1.5
Dividends paid (note 27)	(43.1)	(38.0)
Issue of asset backed floating rate notes	432.5	69.8
Repayment of asset backed floating rate notes	(1,289.7)	(1,503.0)
Repayment of corporate bonds	-	(110.0)
Movement on central bank facilities	324.4	700.0
Movement on other bank facilities	(371.1)	(268.6)
Purchase of shares (note 26)	(31.8)	(69.7)
Net cash (utilised) by financing activities	(978.4)	(1,218.0)

31. RELATED PARTY TRANSACTIONS

In the year ended 30 September 2018, the Group has continued the related party relationships described in note 64 on page 215 of the Annual Report and Accounts of the Group for the financial year ended 30 September 2017. Related party transactions in the period comprise the compensation of the Group's key management personnel, transactions with the Group Pension Plan and fees paid to a non-executive director in respect of his appointment as a director of the Corporate Trustee of the Group Pension Plan. There have been no changes in these relationships which could have a material effect on the financial position or performance of the Group in the period.

During the year certain of the non-executive directors of the Group were beneficially interested in savings deposits made with Paragon Bank, on the same terms as were available to members of the public. The amount of such deposits outstanding at the year end was £250,000 (2017: £nil).

Save for the transactions referred to above, there have been no related party transactions in the year end 30 September 2018.

ADDITIONAL FINANCIAL INFORMATION
For the year ended 30 September 2018

A. UNDERLYING RESULTS

The Group reports underlying profit excluding fair value accounting adjustments arising from its hedging arrangements and certain one-off items of income and costs relating to asset sales and acquisitions. These include the direct transaction cost of the acquisitions, the additional net funding costs of deposits built up over time to satisfy consideration on acquisitions and the break costs of the Idem Capital facility.

The transactions relating to the acquisitions and asset sales do not form part of the day-to-day activities of the Group and, therefore, their removal provides greater clarity on the Group's operational performance. There were no corporate acquisitions or significant asset sales in the year ended 30 September 2017.

This measure has been chosen following consideration of the needs of investors and analysts following the Group's shares, and because management feel it better represents the underlying economic performance of the Group's business.

	2018 £m	2018 £m	2017 £m
Profit on ordinary activities before tax		181.5	144.8
Less: Gain on disposal of financial assets		(28.0)	-
Add back: Acquisition related funding costs included in net interest	0.7		-
Add back: Overhead costs related to acquisition related funding	0.2		
Add back: Transaction costs	1.3		-
Add back: Acquisition related costs		2.2	-
Add back: Facility break costs		1.2	-
Add back: Other one-off costs		0.8	-
Add back: Fair value adjustments		(1.2)	0.4
Underlying profit		156.5	145.2

Underlying basic earnings per share, calculated on the basis of underlying profit, charged at the overall effective tax rate, is derived as follows.

	2018 £m	2017 £m
Underlying profit	156.5	145.2
Tax at effective rate	(30.8)	(27.7)
Underlying earnings	125.7	117.5
Basic weighted average number of shares (note 14)	260.8	271.6
Underlying earnings per share	48.2p	43.3p

ADDITIONAL FINANCIAL INFORMATION
For the year ended 30 September 2018

A. UNDERLYING RESULTS (CONTINUED)

Underlying return on tangible equity is derived using underlying earnings calculated on the same basis.

	2018 £m	2017 £m
Underlying earnings	125.7	117.5
Amortisation of intangible assets	2.1	1.6
Adjusted underlying earnings	127.8	119.1
Average tangible equity (note 4(b))	915.8	884.5
Underlying RoTE	14.0%	13.5%

B. INCOME STATEMENT RATIOS

The average net interest margin is calculated as follows:

	Note	2018 £m	2017 £m
Opening loans to customers	16	11,124.1	10,737.5
Closing loans to customers	16	12,127.8	11,124.1
Average loans to customers		11,626.0	10,930.8
Net interest		254.6	232.6
Net interest margin		2.19%	2.13%
Impairment provision		7.4	5.3
Impairment as a percentage of average loan balance		0.06%	0.05%

ADDITIONAL FINANCIAL INFORMATION
For the year ended 30 September 2018

B. INCOME STATEMENT RATIOS (CONTINUED)

Net interest margin on an underlying basis is derived as shown below

	2018 £m	**2017 £m**
Net interest (as above)	254.6	232.6
One off items related to interest		
Acquisition funding costs	0.7	-
Facility break costs	1.2	-
Underlying net interest	256.5	232.6
Average loans to customers (as above)	11,626.0	10,930.8
Underlying net interest margin	2.21%	2.13%

C. COST:INCOME RATIO

Cost:income ratio is derived as follows:

	Note	**2018 £m**	**2017 £m**
Cost – operating expenses		114.2	102.3
Total operating income		301.9	252.8
Cost / Income		37.8%	40.5%

Underlying cost:income ratio is derived as follows:

	2018 £m	**2017 £m**
Cost – as above	114.2	102.3
Acquisition costs expensed	(1.5)	-
Other one-off costs	(0.8)	-
Adjusted cost	111.9	102.3
Income – as above	301.9	252.8
Gain on disposal of financial asset	(28.0)	-
Acquisition net funding costs	0.7	-
Facility break costs	1.2	-
Adjusted income	275.8	252.8
Underlying cost:income ratio	40.6%	40.5%

ADDITIONAL FINANCIAL INFORMATION
For the year ended 30 September 2018

D. NET ASSET VALUE

	Note	2018	2017
Total equity (£m)		1,095.9	1,009.4
Outstanding issued shares (m)	24	281.6	281.5
Treasury shares (m)	26	(20.8)	(15.7)
Shares held by ESOP schemes (m)	26	(2.9)	(3.2)
		257.9	262.6
Net asset value per £1 ordinary share		£4.25	£3.84
Tangible equity (£m)	4	926.6	905.0
Tangible net asset value per £1 ordinary share		£3.59	£3.45