Paragon Banking Group PLC

Preliminary announcement

For the year ended 30 September 2019

RNS Announcement
Paragon Banking Group PLC
26 November 2019

DELIVERING LENDING AND MARGIN GROWTH

Paragon Banking Group PLC ('Paragon' or the 'Group'), the specialist lender and banking group, today announces its full year results for the year ended 30 September 2019

Nigel Terrington, Chief Executive of Paragon, said:

"We are delighted to report another excellent financial and operational performance, underpinned by our effective diversification strategy and focus on specialist lending. Volumes, profits and dividends are up strongly, and we are moving closer to our medium-term target of over 15% return on tangible equity.

"Paragon's transformation to a broadly based specialist banking group has continued over the last year. Our customers have increasingly complex needs which are supported by ongoing technology investments and the deep experience of our employees. This approach, alongside a disciplined and prudent risk appetite, has enabled us to achieve strong lending growth at improving margins, whilst maintaining an exemplary credit performance.

"Whilst there is uncertainty in the environment we have prepared well and look forward with optimism to the opportunities ahead."

Operational and financial KPIs

- Growth in lending volumes of 8.5% to £2.53 billion (2018: £2.33 billion)
- Net interest margin ('NIM') improved to 229bp (2018: 221bp)
- Cost income ratio increased to 42.1% (2018: 40.6%)
- Underlying profit before tax increased 5.0% to £164.4 million (2018: £156.5 million)
- Retail deposit balances up 20.7% to £6.39 billion
- Technology developments enhancing customer and broker service
- Cost of risk (now measured under IFRS 9) 7bp (2018 IAS 39: 6bp)
- Strong capital base supporting growth, with basic CET1 of 13.7% (2018 13.8%)
- Increased dividend up 9.3% to 21.2 pence per share (2018: 19.4 pence)

OVERVIEW AND OUTLOOK

1. Overview

Paragon has delivered another year of excellent financial and operational progress, reflecting the strength of our strategy to become the UK's leading specialist bank. While we have significantly diversified the Group in recent years, we remain focused on specialist lending which requires a deep understanding of the markets in which we trade, the customers we serve, the products we provide, the services we offer and the risks we incur. This has enabled Paragon to both grow its business and create a structural improvement in its net interest margin at a time when the wider banking sector has been subject to considerable competitive and margin pressures.

2. Financial performance

Underlying profits for the year increased by 5.0% to £164.4 million with strong performances across the Group. Paragon's new mortgage lending has delivered higher margins than its legacy buy-to-let portfolio. Together with wider margins earned through significant new business growth within the Commercial Lending division, this helped to deliver an 8 basis-point improvement in net interest margin to 229 basis points. This was achieved despite the amortisation of the Idem Capital portfolio and the Group maintaining strong levels of liquidity, both actual and contingent, during the period in response to the economic uncertainties inherent in the UK's Brexit process.

We have seen lower levels of buy-to-let redemption activity in the period at 8.6%, down from 10.3% in 2018. This is led by greater levels of customer retention of our specialist landlord customers and the extension of product maturity profiles.

The Group completed the sale of its residual interest in its Paragon Mortgages (No.12) PLC ("PM12") securitisation in June. The sale generated an exceptional gain of £9.7 million and removed £695.8 million of legacy loan assets from the balance sheet, generating additional capital capacity. The Group's loan book therefore grew by 0.5% during the year to £12.1 billion. Excluding PM12, underlying growth was 7.0%.

Underlying operating costs were 11.9% higher than in 2018 at £125.2 million reflecting a full year's costs relating to the acquisitions of both Titlestone and Iceberg, acquired in July 2018 and December 2017 respectively. The Group continues to increase its spending to support IT resilience, and during the year it made further investments in developments both to improve efficiency and to provide an enhanced experience to its customers, a process that will continue into 2020 and beyond. The Group also incurred significant professional costs in the period to support its pending IRB application where project and professional costs contributed over £2.4 million to the cost base during 2019. The Group anticipates that these investments will contribute to improving operational leverage over the longer term.

Reflecting our disciplined underwriting approach, the Group's cost of risk has remained stable with a charge of 7 basis points, compared to 6 basis points in 2018, reflecting the introduction of the IFRS 9 accounting approach. The cost of risk is skewed towards newer lines of business where the growth is strongest. Careful management of all the Group's loan books continues to be a strategic priority, for both retention and credit purposes.

Underlying earnings per share increased 6.0% to 51.1 pence per share, and the underlying RoTE increased to 14.6% from 14.0% in 2018 as the Group continued to make progress towards the medium-term target of over 15%.

Statutory earnings per share were 11.6% lower year-on-year at 49.4 pence per share, despite the improved underlying performance. The statutory performance was as a result of the fair value losses during the period, impacted by declining swap rates and a strong gain recognised on the sale of an Idem Capital portfolio during 2018. The fair value movements, which relate principally to derivatives which are part of economic hedges not qualifying for hedge accounting are a non-cash items and will be profit neutral over time.

3. New business activity

The focus of our Mortgages division continues to be on meeting the needs of specialist landlords. Specialist buy-to-let lending comprised 91.4% of the period-end pipeline and 88.8% of completions (2018: 87.8% of pipeline and 79.3% of completions respectively). The Group’s buy-to-let lending, at £1.48 billion, was in line with the previous year (2018: £1.50 billion). Paragon’s pipeline of buy-to-let loans at the year-end was £911.7 million, an increase of 17.0% on the same position a year earlier (2018: £778.9 million).

Paragon’s Commercial Lending division has seen the greatest rate of growth, with new loans and advances up 36.3% at £968.0 million and the net loan book 28.1% higher at £1.45 billion as it benefitted from a full year of Titlestone. Total new advances were £258.0 million higher, with development finance up £226.1 million, SME lending up £51.8 million, structured lending up £9.1 million and motor finance down £29.0 million, following a strategic focus on margin improvement over volume growth. Our existing development finance business has now been fully integrated with the Titlestone business.

The strong returns available in the Commercial Lending division underpin the Group’s strategic decision to switch capital allocation towards it, rather than Idem Capital during 2019. Idem Capital retains the skill sets and optionality to make further investments should the risk adjusted returns on such purchases return to more sustainable levels. However, in the near term the Group expects to continue to redirect its capital resources to Commercial Lending.

The Group has continued to emphasise the importance of retail deposits within its funding mix, with balances rising 20.7% year-on-year to £6.39 billion, and now accounting for almost half the Group’s funding by the year end. The business currently sources the majority of its deposit flow through its online presence but has been actively pursuing a strategy to broaden the product range and distribution channels to increase capacity. Increasing the size of the addressable market will improve out price control and, in time, support margin management. A notable success this year has been the activity with wealth managers and banking platforms, where we see further opportunities for growth in the future.

The Group completed its first SONIA referenced securitisation transaction, Paragon Mortgages (No. 26) PLC during the year, demonstrating the optionality benefits of wholesale funding complementing Paragon's core retail funding strategy.

4. Capital management

Capital ratios remain strong, with a CET1 ratio of 13.7% marginally reduced during the period (2018: 13.8%), reflecting primarily the growth in the balance sheet and the impact of distributions to shareholders through buy-backs and dividends. The UK leverage ratio remains strong, at 6.7%. The Group maintains a strong capital position, with IFRS 9 transition not having a major impact (the fully-loaded CET1 ratio being 13.4%).

The Company's dividend policy is underpinned by the principle of enhancing shareholder returns on a sustainable basis. The Board is proposing a dividend of 21.2 pence per share for the year, an increase of 9.3% (2018: 19.4 pence) reflecting the strength of the business and its capital position. After accounting for fair value movements and gains in the year, this results in a dividend cover ratio of marginally less than 2.5 times. We expect our dividend cover ratio to be around 2.5 times in normal conditions going forward.

5. Diversification, growth and capital optimisation

The diversification of the Group's loan books and funding sources, delivered by organic growth and acquisition, has been a core part of our strategy over the past five years. As a specialist bank, we differentiate our offer through having better understanding of our markets, our customers, our products and the application of credit risk. Our broadly-based funding approach 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, whilst always operating within our conservative risk appetite.

Following completion of the PM12 residual sale, the Board determined that the capital released by that transaction should in part be distributed by way of a share buy-back programme. £26.7 million was invested during the period. This was the Group's first residual sale and aligns with our strategy to focus increasingly on specialist lending whilst optimising capital, raising margins and improving returns on equity.

The Group has continued to develop its application for IRB status to form the basis for its capital requirements during 2019. In September, the Bank of England issued a consultation paper (CP21/19) detailing the requirements for established and aspirant IRB firms to embed certain future regulation within their models during 2020. The more material items are already included in the Group's buy-to-let models, but the Board has concluded that it wishes the Paragon models to be compliant with the CP before submitting a formal IRB application.

6. Outlook

It is well-documented that the political and economic environment remains uncertain, but the Group has prepared accordingly and in addition, has a high quality loan portfolio and a strong new business pipeline. Our diversified model and mobility of capital allows us to redirect our resources to deliver the optimal combination of growth, returns and risk. We are confident that we will continue to grow lending and improve the Group's net interest margin. We look forward to the year ahead with confidence in our strategy and the strength of our franchise.

Financial highlights:

Profit before tax		2019	2018	Increase
• Underlying income growth more than absorbs impact of Idem Capital portfolio amortisation and sales • Net interest margin improved, despite loan sale and conservative liquidity position maintained in light of Brexit-related economic uncertainties • Costs reflect technology enhancements, development of IRB framework and overheads of businesses acquired in 2018	**Underlying (£m)**	**164.4**	**156.5**	**5.0%**
• Impairment costs remain at low levels, now reported under IFRS 9 • Difference between underlying and statutory relates to fair values of hedging items, impacted by disruption in interest rates around period end, but which will revert to zero over time and the gain on the sale of the residual interest in PM12	**Statutory (£m)**	**159.0**	**181.5**	**(12.4%)**

Dividend per share		2019	2018	Increase
• 2.33 times cover ratio in year • Target cover ratio for future dividends remains around 2.5 times	**Statutory (p)**	**21.2**	**19.4**	**9.3%**

Basic earnings per share		2019	2018	Increase
• Underlying EPS excludes fair value movements and gain on disposal	**Underlying (p)**	**51.1**	**48.2**	**6.0%**
	Statutory (p)	**49.4**	**55.9**	**(11.6%)**

CET1 Ratio		2019	2018	Increase
• Fully loaded figure includes impact of IFRS 9 transition	**Basic**	**13.7%**	**13.8%**	**(10bp)**
	Fully loaded	**13.4%**	**13.8%**	**(40bp)**

RoTE		2019	2018	Increase
• Progress reflects earnings growth and capital optimisation	**Underlying**	**14.6%**	**14.0%**	**60bp**

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The Group will be holding a results presentation for analysts on Tuesday 26 November 2019 at 9:30am at UBS, 5 Broadgate, London EC2M 2QS. The presentation material will be available on its website at www.paragonbankinggroup.co.uk/investors from 7:00am on the same day.

MANAGEMENT REPORT

MANAGEMENT REPORT

1 STRATEGY REVIEW

During the year ended 30 September 2019 the Group has maintained its specialist lending strategy, growing its loan books and improving margins whilst integrating new operations acquired or developed in the previous year.

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 an efficient operating platform and resilient technology. 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.

Our focus on risk and disciplined underwriting will not change going forward, while our position in the markets we serve will allow us to continue to deliver strong growth. A focus on the delivery of our organic strategy being augmented by the expansion of our proposition, where such developments provide an attractive risk and return profile.

Lending

Strong lending growth was achieved across the Group's businesses, with total new lending of £2,532.4 million, an increase of 8.5% on the previous year (2018: £2,333.2 million). Combined with the disposal of the Group's residual interest in the PM12 securitisation, these left the loan book 0.5% higher at £12,186.1 million at 30 September 2019 (2018: £12,127.8 million). More than half of this balance is now represented by loans originated since Paragon Bank was formed in 2014.

Volumes within the Mortgages segment remained broadly stable, with £1,564.4 million of advances and a portfolio acquisition of £4.2 million (2018: £1,623.2 million), with the majority of the decrease attributable to first charge owner-occupied business as the Group refocussed its efforts in that area in the light of adverse market conditions. Overall the mortgage segment loan book reduced by 1.2% year-on-year to £10,344.0 million (2018: £10,473.5 million), including the £24.0 million impact of IFRS 9 transition and the disposal of £695.8 million of PM12 assets. The post-2010 buy-to-let portfolio grew by 21.1% to £5,427.7 million (2018: £4,481.8 million).

Within the buy-to-let business the strategic focus remains on specialist landlords who are becoming the core investors in the UK private rented sector. The proportion of completions where the customers were specialist landlords (operating through corporate structures and / or running large portfolios) increased from 79.3% to 88.8% of the total with a corresponding fall in simple completions. This effect is also seen in the pipeline at 30 September 2019, with 91.4% of the £911.7 million total relating to specialist cases (2018: £778.9 million with 87.8% specialist).

Commercial Lending advances increased by 36.3%, to £968.0 million, compared to the previous year (2018: £710.0 million). Within this:

- The Group's development finance operation, incorporating the Titlestone business acquired in July 2018, advanced £362.9 million (2018: £136.8 million, £320.8 million on a proforma basis)
- Structured lending, launched in the second half of 2018 saw £49.7 million of new loans (2018: £40.6 million)
- SME lending, including the Iceberg professions finance operation acquired in December 2017, advanced £406.5 million, 14.6% up on the £354.7 million for 2018, at improved margins
- Motor finance lending reduced from £177.9 million to £148.9 million following a strategic focus on margin improvement

1 STRATEGY REVIEW (CONTINUED)

Overall, the Commercial Lending portfolio increased by 28.1% year-on-year to £1,452.1 million (2018: £1,133.2 million).

During 2018 the Group sold a material Idem Capital portfolio, recycling the capital generated to support the Titlestone acquisition which generates attractive, sustainable growth and returns. This process has continued during 2019, where strong cash flow has continued to amortise the Idem Capital balances. In the absence of new Idem Capital deals that generate an acceptable risk / reward combination, capital has again been refocused to support growth in the Commercial Lending division.

Funding

The Group continues to pursue its flexible integrated funding strategy with the increase in lending balances funded principally through an increase in the Group's retail deposit balances to £6,391.9 million, 20.7% higher than the £5,296.6 million balance at the end of 2018. This included increased diversification in the savings operation's route to market, with presences developed on external wealth management and digital banking platforms. Average pricing in the portfolio at 30 September 2019 was 1.81%, slightly higher than the 1.76% reported at 30 September 2018 but in line with the level at 31 March 2019. Retail deposits therefore represent a highly cost-effective and stable funding source.

In wholesale funding, the Group:

- launched its first SONIA referenced securitisation, raising £364.3 million through the Paragon Mortgages (No. 26) transaction
- disposed of its residual interest in the Paragon Mortgages (No. 12) PLC ('PM12') securitisation, releasing £49.8 million of cash resources and generating a profit of £9.7 million
- closed out several other legacy transactions, releasing cash to the Group

Retail deposits represent the Group's primary source of funding for new lending, whilst securitisation or other wholesale channels are used as and when conditions in those markets are attractive, and terms are appropriate.

Results

Underlying profits (before the effect of fair value movements on hedging items and the gain on PM12) increased by 5.0% to £164.4 million, from £156.5 million in 2018. Net interest income was 8.5% higher on an underlying basis at £278.4 million, 9.3% higher on a statutory basis, driven upwards by both a higher net interest margin ('NIM') and year-on-year increases in loan balances.

The Group's new mortgage lending delivers higher margins than its legacy, pre-2010 portfolio. Therefore, the run-off of the legacy assets and their replacement with new loans enhances margins overall. Together with wider margins earned through the businesses within the Commercial Lending segment, the Group's new lending activities create a structurally improving margin. NIM in the period was 2.29%, compared to 2.21% in 2018.

The Group has continued to hold strong levels of liquidity, both actual and contingent, during the period in response to the economic and political uncertainties inherent in the UK's Brexit process. Brexit has had a negative impact on sentiment across the Group's markets during the period and appears set to continue as the economic and political situation develops.

1 STRATEGY REVIEW (CONTINUED)

The Group's cost:income ratio in the year on a statutory basis was 40.7%, compared to 37.8% in 2018. On an underlying basis (excluding fair value movements and gains) the cost:income ratio was 42.1%, increased from 40.6% in the previous year. The cost base increased by £13.3 million year-on-year, including a full year of costs from 2018 acquisitions, the increased outsourced costs of the larger savings book and significant project-related costs (including expenses associated with the Group's IRB application). The Group continued to make significant investments in technology, developing systems to provide improved service offerings to its customers and enhance operational resilience, the costs of which contributed to the increase in operational expenses in the period.

Careful cost management remains a key objective of the Group. Investments in new businesses, technologies and our IRB framework mitigate against a near term reduction in the cost:income ratio, as does the amortisation of the Idem Capital portfolio. The Board still expects to achieve significant operational leverage within the business, but now over the longer term.

The Group's loan impairment costs are now reported under IFRS 9. The overall effect of the transition to the new standard was to increase the opening provisions on the Group's loan assets by £27.2 million and reduce equity by £22.2 million, net of tax, although these changes did not impact the Group's results for the period.

IFRS 9, through its focus on expected loss levels rather than the incurred loss approach of IAS 39, accelerates provision for losses, increasing profit and loss charges on growing books, such as many of the Group's portfolios. The forward-looking calculation basis requires estimates to be made of likely future economic conditions. During the year the Group adopted a more pessimistic weighting of the economic scenarios it considers in its calculations, in response to the increased levels of economic uncertainty, which, under IFRS 9, will increase provision charges. Despite these factors, the bad debt charge increased to £8.0 million in the period, compared to £7.4 million, on an IAS 39 basis, in 2018. The bad debt charge was lower in the Mortgage division, but rose in Commercial Lending, reflecting its relative growth rate, and the consequent level of provision on performing new loans required by IFRS 9.

Buy-to-let credit performance remained strong with arrears at 30 September 2019 at 0.18%, significantly less than the market average (2018: 0.11%). Commercial Lending bad debt rates also increased slightly, although still represent a very small number of cases. Overall, our behavioural scoring models, which act as a lead indicator of financial stress in the loan books, were stronger in all significant portfolios across the period.

Throughout the year the UK interest rate outlook and capital markets were affected by Brexit-led macro-economic uncertainties, impacting on fair value exercises carried out for accounting purposes at the year end. This created a charge of £15.1 million in respect of the revaluation of derivatives held for hedging (2018: gain of £1.2 million) in the income statement and an increase in the pension scheme liability in the balance sheet of £15.0 million since 30 September 2018, with, as a consequence, a reduction of capital.

This fair value adjustment, combined with the inclusion of a £28.0 million gain on the disposal of an Idem Capital portfolio in the 2018 result, led to statutory profit before tax decreasing to £159.0 million from £181.5 million in 2018, with profit after tax reducing from £145.8 million to £127.4 million, after provision for tax at a rate of 19.9% (2018: 19.7%).

1 STRATEGY REVIEW (CONTINUED)

This result translates to basic earnings per share ('EPS') on an underlying basis of 51.1 pence per share, a year-on-year increase of 6.0% (2018: 48.2 pence per share) (Appendix A). On the statutory basis basic EPS reduced by 11.6% to 49.4 pence per share as a result of the fair value losses in the current period and one-off gains in the prior year (2018: 55.9 pence per share). Underlying return on tangible equity ('RoTE') at 14.6% (2018: 14.0%) continued to make progress towards the Group's long-term target of over 15% (Appendix A).

Capital and distributions

The Group maintains a strong capital position, even after the reductions in equity from IFRS 9 and the revaluation of the pension liability. On an IFRS 9 transitional basis the Group's CET1 capital ratio was 13.7% and its total capital ratio 15.9% (2018: 13.8% and 16.2%) with the pension deficit reducing the ratio at 30 September 2019 by 20 basis points. The fully loaded CET1 and total capital ratios at 30 September 2019, excluding the IFRS 9 transitional capital relief were 13.4% and 15.7% respectively. The UK leverage ratio remained strong at 6.7% on the transitional basis, 6.6% fully loaded (2018: 6.4%).

The Company's dividend policy is underpinned by the principle of enhancing shareholder returns on a sustainable basis. The Board proposes a dividend for the year of 21.2 pence for 2019, an increase of 9.3% from the 19.4 pence in 2018. This results in a dividend cover ratio of 2.33 times, which is below the normal target of around 2.5 times but which reflects the scale of non-cash, fair value items in the 2019 results.

Following the PM12 residual sale the Company announced a share buy-back programme in July 2019, with £26.5 million (exclusive of costs) having been invested by the year end. The Company will seek the normal shareholder approval at its February 2020 Annual General Meeting ('AGM') to allow such programmes to take place in future if surplus capital becomes available.

The business has successfully pursued the strategy set out to investors, focussing on its specialist markets and maintaining a strong capital and funding base. It is well placed to deliver further progress and provide sustainable returns to shareholders. Its operating model and wide experience mean that 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:

2. Lending review	3. Funding review	4. Capital review	5. Financial review	6. Operational review
Lending, performance and markets	Retail deposits and wholesale funding	Capital management, liquidity and distributions	Results for the period, assets and liabilities	Governance, people, risk and regulation

2 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	
	2019	**2018**	**2019**	**2018**
	£m	**£m**	**£m**	**£m**
Mortgages	1,568.6	1,623.2	10,344.0	10,473.5
Commercial Lending	968.0	710.0	1,452.1	1,133.2
Idem Capital	-	83.4	389.9	521.1
	2,536.6	2,416.6	12,186.1	12,127.8

The Group's loan book increased by 0.5% in the year, with new lending 8.5% higher than in the previous financial year and total advances and investments 5.0% higher.

2.1 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, proven rating methodology, and robust and informed approach to property risk differentiate it from mass market and other specialist lenders.

Housing and mortgage market

The performance of the UK mortgage and housing markets has remained subdued in the face of economic concerns arising from Brexit and the wider economy. New mortgage approvals, reported by the Bank of England, in the year ended 30 September 2019, at £262.9 billion had increased by only 2.6% from the previous year, (2018: £256.3 billion), with remortgaging decreasing by 0.6% and house purchase mortgages increasing by 4.9%. This level of transactions remains some 30.0% below the peak in the market when £375.8 billion of mortgages were advanced in the year ended 30 September 2007. At the same time margins on mainstream mortgage lending have been squeezed as large lenders seek to preserve volumes.

The Nationwide House Price Index reported negligible annual growth of only 0.2%, sharply reduced from the 2.0% seen in 2018, with London and the South Eastern regions of England seeing a decline in prices, although house prices there remain close to their 2017 peak. Across England, Nationwide report house prices only 17%, on average, higher than their level in 2007 with prices outside the South East, having appreciated less. Growth has been at current levels for the past two years, with expectations of future increases remaining modest.

2 LENDING REVIEW (CONTINUED)

The latest survey data, as at 30 September 2019, from the Royal Institution of Chartered Surveyors (‘RICS’) UK Residential Market Survey, confirms this subdued position with market confidence drifting downwards, and negative short-term expectations on demand and prices, with some of this attributed to Brexit-related concerns amongst potential buyers. However, RICS expect some improvement in the longer term.

Buy-to-let and the private rented sector

The Group’s deep understanding and long-term experience of the buy-to-let mortgage market mean that it is well placed to serve the particular needs of specialist landlord customers. The impact of regulatory and tax changes on landlords in recent years has led to lenders’ strategies for buy-to-let polarising, with many large lenders not offering professional buy-to-let loans. This has left the Group amongst a small number of specialist lenders addressing the professional buy-to-let mortgage market. UK Finance (‘UKF’) has observed that landlords with portfolios of four or more properties comprise over a quarter of the buy-to-let lending market.

The private rented sector (‘PRS’) lettings market remains robust with RICS reporting both demand and rental levels increasing due to restricted supply, partially as a result of amateur landlords seeking to exit the market in response to fiscal and regulatory changes over recent years. However, the English Housing Survey for 2018, published in January 2019, continues to show the PRS representing around 19-20% of households, as it has for the past five years.

These factors have led to an expectation of increasing rents, with RICS members predicting a 2% increase over the next twelve months, accelerating to 3% per annum up to 2024. This follows average rent increases of 1.3% in the year ended September 2019, reported by the Office of National Statistics (2018: 0.9%), with September data from ARLA Propertymark (‘ARLA’), the landlord’s trade body, showing 58% of tenants witnessing rent increases in the year (2018: 27%). ARLA data also shows more tenants renting for longer periods. These factors should benefit the Group’s customers and the affordability of their loans. However, reduced supply and increased rents may present difficulties for tenants and those seeking rented accommodation.

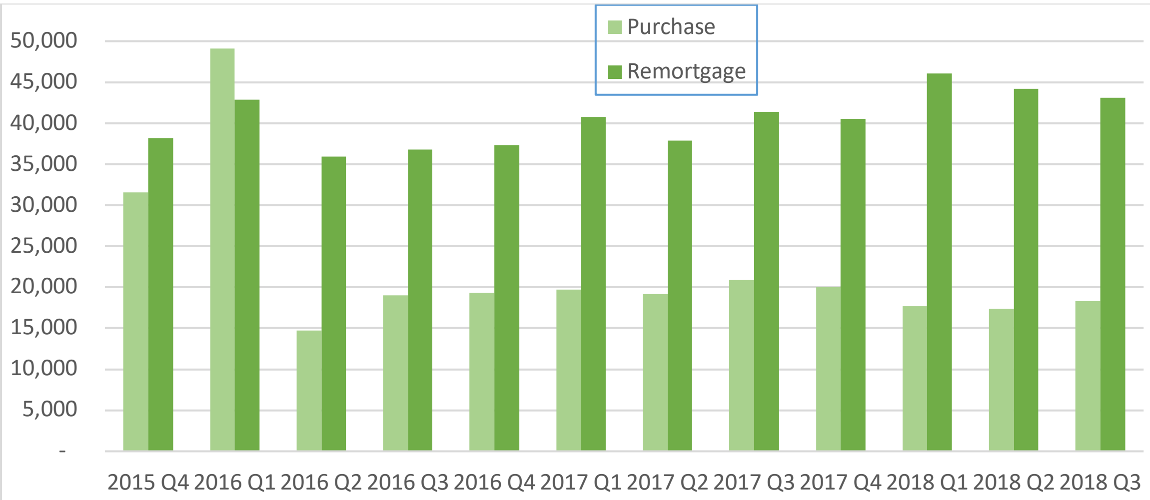
Buy-to-let lending in the year remained stable with UKF reporting new advances of £39.9 billion, the same value as in the previous year. Much of this activity represents refinancing by landlords, with 71.4% of new advances by value representing remortgages (2018: 70.4%). The trend in favour of longer-term fixed interest rates has also continued, both across the industry and in the Group’s own lending, with over half of new lending at rates fixed for five years. This trend is expected to reduce remortgage activity in the short-term as product maturity terms increase.

2 LENDING REVIEW (CONTINUED)

The numbers of new buy-to-let mortgages reported by UKF over the past four years are set out below.

Number of new buy-to-let mortgages

UKF



These overall movements do, however, conceal a more mixed picture, with smaller landlords less active while activity amongst specialist landlords remains more positive.

The Group considers that its support for the PRS, through the buy-to-let mortgage market, contributes to housing provision for a significant number of families and it seeks to use its position as a lender to drive up standards of housing provision through its interaction with its landlord customers.

Lending activity

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

	2019 £m	2018 £m
Originated assets		
First charge buy-to-let	1,480.5	1,495.5
First charge owner-occupied	11.9	56.5
Second charge	72.0	71.2
	1,564.4	1,623.2
Acquired assets	4.2	-
	1,568.6	1,623.2

Total mortgage originations in the Group reduced by 3.6% in the year. The majority of this decrease arose from owner-occupied lending, where the offering was scaled back in the year. This reflects the Group's focussed approach to balancing acceptable levels of risk and return in lending decisions.

In addition to the loans originated a further portfolio of seasoned, largely performing, buy-to-let loans was purchased from a third party in June 2019 for £4.2 million. This purchase was facilitated by the Idem Capital team but is reported within the Mortgages division as the assets are similar to the segment's other assets and administered by the mortgage servicing team.

2 LENDING REVIEW (CONTINUED)

Buy-to-let

The Group's buy-to-let lending, at £1,480.5 million, remained largely stable year-on-year, reducing by 1.0% from 2018 levels (2018: £1,495.5 million). The pipeline of buy-to-let loans in process at the year end was £911.7 million, an increase of 17.0% on the position a year earlier (2018: £778.9 million).

In the professional buy-to-let market the Group's strategy of focussing on specialist customers (those operating through corporate structures and those with larger portfolios) has delivered positive results. These are the customers best suited to the Group's service model and this targeting, coupled with a disciplined approach to underwriting and valuation, has enabled margins and retention rates to be increased while providing the customers with a high standard of support for their business needs. The analysis of the Group's new buy-to-let business by customer type is set out below.

	30 September 2019 £m	30 September 2019 %	30 September 2018 £m	30 September 2018 %
Buy-to-let advances				
Corporate customers	812.4	54.9%	656.7	43.9%
Other specialist customers	502.7	33.9%	528.8	35.4%
Total specialist	1,315.1	88.8%	1,185.5	79.3%
Non-specialist	165.4	11.2%	310.0	20.7%
	1,480.5	100.0%	1,495.5	100.0%

These advances show the impact 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 91.4% of pipeline cases relating to specialist landlord customers (2018: 87.8%). Within this, the trend for portfolio landlords to incorporate their businesses, partly as a response to recent changes in the tax regime for buy-to-let, also continued.

This trend can be seen in the analysis of the Group's buy-to-let pipeline numbers over the last three years.

Percentage of specialist pipeline cases

Number outstanding at date

2 LENDING REVIEW (CONTINUED)

The Group seeks to mitigate exposure to climate change related issues which might impact on security values, through its lending criteria. This includes ensuring that any property proposed as security generally has an Energy Performance Certificate ('EPC') rating of E or better (on a scale of A to G), and considering any property's exposure to flooding risk before it is accepted as security. A detailed review of the buy-to-let loan book in the year indicated that less than 2.5% of security properties for which data was available were situated in postcodes with medium or high flood risk

The Group sources the majority of its new buy-to-let lending through specialist intermediaries and significant investment has been made to ensure they receive excellent service. It was therefore gratifying that in feedback from intermediaries in the period, 84% were satisfied with the process of arranging a loan offer, delivering a net promoter score at offer stage of +60. Continued improvement is expected in the coming financial year as intermediaries and customers benefit from the Group's investment in its service proposition and the enhanced technology to support it

Other mortgage lending

The division's other first and second charge mortgage lending has been carefully managed to ensure that only lending with appropriate risks and returns is undertaken.

The Group's second charge mortgage lending has increased marginally by 1.1% during the year, but remains at modest levels. The second charge market is currently not large, with total lending in the financial year reported by the Finance and Leasing Association ('FLA') of £1,207 million (2018: £1,031 million). However, much of the increase has come from sub-prime activity, which falls outside the Group's risk appetite. 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 for second charge lending.

In residential mortgage lending, margins have been generally compressed and the Group has maintained credit discipline at acceptable yields, meaning that the amount of new business has fallen. The opportunities for the Group in this area principally relate to highly specialised propositions, where the Group's operational approach can be beneficial, including lending to the existing specialist landlord customer base. In the short term only small volumes of lending are expected in this area.

Performance

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

	30 September 2019 £m	30 September 2018 £m
Post-2010 assets		
First charge buy-to-let	5,427.7	4,481.8
First charge owner-occupied	68.3	59.4
Second charge	171.5	141.3
	5,667.5	4,682.5
Legacy assets		
First charge buy-to-let	4,674.2	5,779.8
First charge owner-occupied	2.3	11.2
	10,344.0	10,473.5

2 LENDING REVIEW (CONTINUED)

At 30 September 2019, the balance on the Group's mortgage portfolio was 1.6% less than a year earlier, with £695.8 million of the reduction being due to the PM12 disposal. Excluding movements in the PM 12 portfolio in the year, the mortgage book grew by 6.2%. Within those amounts the post-2010 buy-to-let book grew by 21.1%.

The annualised redemption rate on post-2010 buy-to-let mortgage assets at 10.7% (2018: 16.7%), has reduced from the high level seen in 2018. This higher level of customer retention is a result of the extending profile of product maturities and the changing focus towards specialist landlord customers. The annualised redemption rate on pre-crisis lending, at 6.7%, is similar to that seen in the year ended 30 September 2018 (2018: 6.0%), reflecting the pricing of those loans relative to current market offerings.

Arrears on the buy-to-let book as a whole have marginally increased in the year to 0.18% (2018: 0.11%), with arrears on post-2010 lending standing at 0.03% (2018: 0.01%). 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 2019 (2018: 0.42%). This strong 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 0.38% from 0.21% in the year, as the book continues 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 683 properties were managed by a receiver on the customer's behalf, a reduction of 11.3% since 2018 (2018: 770 properties) as cases on the old book resolve and post-2010 cases perform well.

Outlook

The Group has established a significant market position in specialist buy-to-let which offers good prospects for future earnings and profitability, though significant expansion of volumes is not anticipated in the year ending 30 September 2020.

Although the general UK economic outlook remains uncertain, the underlying metrics within the PRS are more positive for the Group's landlord customers, with market commentators largely positive. The Group is also confident that its robust approach to valuation and the loan to value coverage in its buy-to-let book, at 67.3% (2018: 65.7%) provide significant security in the event of a downturn.

Looking forward, the Group intends to broaden its offerings to its core professional landlord customers and the intermediaries supporting them to provide both an enhanced service and additional products tailored to their needs. Despite the political uncertainties, professional landlords continue to develop their businesses and expand their portfolios. With the PRS representing a fifth of households, professional landlords are vital to the UK's housing provision and the Group sees significant business opportunities in providing them with the financial support that they require.

2 LENDING REVIEW (CONTINUED)

2.2 Commercial Lending

The Group's Commercial Lending division's focus is to support UK SMEs and small corporates through the provision of various financing solutions. The division has seen significant levels of investment since 2015 through both acquisition and organic business growth.

The proposition is delivered through four key business lines: SME lending, providing finance leasing for business assets and unsecured cash flow lending to professional services firms amongst other products; development finance, including the operation acquired in 2018; structured lending; and motor finance.

The asset leasing market in the UK is substantial, covering some £79.3 billion of outstanding balances at 30 September 2019 (2018: £75.8 billion) and £33.2 billion of advances in the year then ended (2018: £30.1 billion). However, a large proportion of this business is commodity lending in the hands of a small number of very large finance houses. 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.

The Group's commercial lending offerings target markets where there has historically been a shortage of credit, such as its development finance business which primarily supports smaller housebuilders, whose difficulties in funding new-builds have been widely reported, and the structured lending business which funds small non-bank lending operations. In each of these markets the Group's competitors are other smaller banks and similar sized lenders. They are markets in which the largest lenders have little presence, creating a credit availability issue for customers and significant opportunities for the Group.

The division's businesses comprise specialist teams, developed internally or sourced externally to provide bespoke focus to their respective markets. This was highlighted in the year when the Group's SME lending business was named as 'Best Commercial Lender' at the 2019 Leasing World Awards and 'Best Specialist Finance Solutions Provider' in the SME News Magazine's 2019 UK Legal Awards, while being shortlisted in several other categories. Also at the Leasing World Awards, the structured lending business was named 'Best Specialist Commercial Lender' for 2019.

The common themes of these business lines are a deep understanding of their markets and their customer needs together with expertise in security valuation, collections and asset recovery. 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.

Lending activity

A deceleration in global economic growth and continued political uncertainty in the UK during the year have had an adverse impact on UK business investment, however this has not led to a reduction in the Group's volumes.

The Group's focus across all the Commercial Lending business lines in the year has been on growing the scope of its operations to address a wider range of funding propositions for SME customers, while enhancing service, maintaining credit discipline and improving yields.

The SME leasing operation has strengthened its position in core hard-assets and expanded into soft-asset financing. The Group's development finance and structured lending businesses have also increased their scope.

2 LENDING REVIEW (CONTINUED)

The UK government retains its target of delivering 300,000 new homes by the mid-2020s, which will require a significant uplift in current construction levels (in 2017/18 222,000 new homes were built), providing opportunities for the Group's customers in the construction and property development fields.

The Group's Commercial Lending exposure has increased overall by 28.1% in the year to £1,452.1 million (2018: £1,133.2 million). The new lending activity in the segment during the year is set out below.

	2019 £m	2018 £m
Development finance	362.9	136.8
SME lending	406.5	354.7
Structured lending	49.7	40.6
Motor finance	148.9	177.9
	968.0	710.0

Development finance

The Group's development finance business was significantly expanded by the acquisition of Titlestone in July 2018. The period since then has been positive with the Group's organically developed activities being integrated with the acquisition to deliver operational efficiencies, and the focus of the combined business refined.

The Group's target customer in this market is a small to medium sized developer of UK residential property. The projects funded have an average size of approximately £5 million and are generally focussed on the more liquid parts of the residential market, avoiding developments with high unit values. While the business has been concentrated in the South-East of England to date, with 51.7% of balances at 30 September 2019 located in London and the South-East, the Group's strategic objective is to lend more widely across the UK. Central London property hot-spots have been largely avoided.

Activity in the Group's target market has held up well in the year, with enquiry levels consistent with previous periods. However, economic uncertainty has led to some developers taking longer to commence projects and there has been additional caution amongst larger scale developers, evidenced in lengthening periods between facility agreement and the first drawdown.

The successful combination of the Group's original Paragon development finance business with Titlestone has seen lending volumes increase from £136.8 million in 2018 to £362.9 million in 2019. However, the 2018 figure only includes post-acquisition advances. On a proforma, like-for-like basis, the 2018 volumes were £320.8 million. The underlying £42.1 million (13.1%) increase represents the distribution benefits from the combination and the maintenance of the Group's strong credit standards in this market.

Prospects for the new financial year remain encouraging, with undrawn amounts on live facilities at 30 September 2019 of £294.8 million (2018: £215.2m) and a post-offer pipeline of £160.9 million (2018: £151.5m), a large proportion of which would be expected to flow in to future completions. Market fundamentals remain strong, albeit tempered by short-term economic anxieties, and the Group's extensive property experience can be used to leverage future growth.

2 LENDING REVIEW (CONTINUED)

SME lending

The SME lending operation has strengthened its position in its core hard-asset leasing market during the period and sought to expand its soft-asset offering. It has maintained its focus on margins and sought to support its business levels through strong customer relationships and service standards.

Business generation has benefitted from an enhanced proposition and operational efficiencies arising from increasing centralisation of operations at the Group's SME lending hub in Southampton. New loan volumes in the leasing business have grown by 11.4% compared to 2018, reaching £288.7 million (2018: £259.2 million). A further £11.6 million of operating lease assets were also acquired in the year (2018: £19.3 million).

The short-term professions finance business, which includes the Iceberg operation acquired in December 2017, grew broadly in line with expectations during the period.

As part of the centralisation process significant investments have been made in technology, while the sales teams have also been strengthened across the various specialist areas of the business. These developments form the first phase of a programme of business enhancements which will sustain growth into the future.

Structured lending

The Group's structured lending business, which made its first loans in the second half of 2018 has made further progress in the year. 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 structured using established and robust methodologies and secured on underlying assets, with a substantial amount of over-collateralisation. 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.

The team, which has built a solid reputation in the market, expanded in the year, allowing more prospects to be addressed. The structured lending business generally has a longer pipeline than other operations, with detailed negotiations required before a new loan can be agreed. There are now eight transactions in place, compared to three at the previous year end, with more prospects at various stages of development. The deals currently in progress are expected to provide further lending into the new financial year, while the business as a whole has good prospects for further expansion.

Motor finance

The Group continues to target its motor finance offerings on those specialist propositions which are not addressed the by mass-market lenders who control the majority of the market. This limits the potential to grow market share and the level of advances in 2019 has been below that achieved in 2018, in part due to a continued level of new business pricing discipline. The Group has reviewed its business model for motor finance following the publication of the FCA's review of the sector. It has identified the changes required by the FCA's proposed new rules and considers that is well placed to comply, compared to other market participants.

2 LENDING REVIEW (CONTINUED)

Across all business lines growth has been carefully controlled with credit quality and margins prioritised over expanding lending volumes 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.

Performance

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

	30 September 2019 £m	30 September 2018 £m
Asset leasing	492.2	403.4
Professions finance	46.2	42.6
Invoice finance	18.5	21.8
Unsecured business lending	19.3	17.3
Total SME lending	576.2	485.1
Development finance	506.5	352.8
Structured lending	88.1	38.7
Motor finance	281.3	256.6
	1,452.1	1,133.2

Margins in the segment have remained strong and have reflected both the changing business mix and strategic initiatives to improve yields across the main product lines.

Credit quality in the development finance book 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 2019 very few cases had been classified 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 and where refinements in fair values at the acquisition date have been reflected in the goodwill valuation during the year.

The average loan to gross development value for the portfolio at the year end, a measure of security cover, was 64.8% (2018: 63.2%).

Credit performance on the division's finance leasing portfolios remains stable, with arrears in asset leasing at 0.43% and motor finance at 1.27% (2018: 0.78% and 0.93% respectively). These compare favourably to those in the wider sector, with the FLA reporting average arrears for business leasing at 1.10% and car finance at 2.70% at 30 September 2019 (2018: 0.70% and 2.50%).

Performance in the structured lending operation has been in line with expectations with satisfactory pricing and no serious concerns with the operation of any of the deals.

Outlook

The Commercial Lending segment has seen the greatest level of investment by the Group in the recent past, most notably through its acquisition activity in the SME lending and development finance markets. The Group has demonstrated its ability to support the needs of underserved customers in these important parts of the UK economy.

2 LENDING REVIEW (CONTINUED)

Whilst further bolt-on acquisitions to enhance existing operations remain a possibility, the Group's focus, having integrated and embedded the acquired elements into its core risk, operational and systems processes, is now to invest in technological, distribution and servicing enhancements for its commercial activities, optimising its proposition to customers.

The division seeks to be responsive and flexible in addressing the SME market, but its UK focus means that it is exposed to a downturn in business investment nationally. Overall, the Group has a good platform for continuing growth and increasing scale and diversity will enable a better return to be generated from its resources, control framework and investments in systems.

2.3 Idem Capital

The Group's Idem Capital division includes its acquired loan portfolios, together with its pre-2010 legacy consumer accounts. Its strategic focus is on the acquisition of more specialist loan portfolios where it can enhance value through leveraging the Group's origination and collections expertise 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.

The division's profitability relies on providing a high quality service to customers when collecting on acquired assets. Many of these borrowers may have historically experienced financial difficulties, and its focus in collections activity is to generate fair outcomes for these customers, while being mindful of potential vulnerabilities.

As part of the banking group it is able to deploy expertise in a wide variety of asset classes and access the systems development resource and support functions of the wider business, enabling more complex portfolios to be addressed. It also has significant experience in working in partnership, either as an investor or administrator, giving it access to transactions which may be unattractive on a standalone basis.

As part of a wider Group, Idem Capital evaluates investments on the potential return which can be achieved on Group capital compared to alternative opportunities in other divisions, imposing a bidding discipline on potential purchases, but is also not constrained to pursue volumes in order to retain critical mass, as a monoline asset purchaser might be.

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

New Business

The UK loan portfolio purchase market has remained active throughout the year despite the current levels of economic uncertainty, and the Group has accessed all the significant tender processes in the period. However, conditions in the market are difficult with levels of demand and pricing remaining high, and several very large investors being prepared to accept returns on capital below those required by the Group.

In the face of these conditions the Group has maintained its disciplined approach to pricing and quality. It continues to target only those deals where its wider capabilities in administration and funding can provide a real benefit to the project and where the projected return is attractive in comparison to the other opportunities for the deployment of its capital.

2 LENDING REVIEW (CONTINUED)

During the period no new deals were completed which were subsequently included on the division's balance sheet (2018: one deal) although the Idem Capital team was active in facilitating the £4.2 million asset purchase undertaken by the Mortgages division in the year, as noted above. In addition, the division undertook a limited number of reviews of opportunities that were ultimately not progressed.

Aside from these, the main focus of the business was on monitoring the performance of the extant portfolio and the integration of the £83.4 million motor finance portfolio purchased towards the end of the previous financial year.

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 principal UK vendors.

Performance

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

	30 September 2019 £m	30 September 2018 £m
Second charge mortgage loans	217.7	274.6
Unsecured consumer loans	134.7	173.7
Motor finance	37.6	72.8
	389.9	521.1

The reduction in balances is a result of the scale of collections from the brought forward loan portfolios, particularly the unsecured and motor finance balances, together with some minor asset disposals. 120 month Estimated Remaining Collections ('ERC') on acquired consumer assets reduced from £489.6 million at 30 September 2018 to £366.4 million at the year end, for the same reasons.

Overall collections from customers have held up well in the year, despite the generally negative economic forecasts for the UK. Whilst the division's second charge assets are over 10 years seasoned, offering resilience to any potential downturn, the unsecured assets are less-seasoned, and their performance will continue to be carefully monitored over the coming year.

Arrears on the segment's secured lending business have risen slightly to 17.2% (2018: 15.8%), the increase arising from redemptions amongst the better performing accounts in the year. These arrears levels remain higher than the average for the sector, but this reflects the seasoning of the balances, 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 8.7% at 30 September 2019 were reported by the FLA (2018: 9.4%).

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 2019 such collections were 109.8% of those forecast to that point (2018: 109.7%).

2 LENDING REVIEW (CONTINUED)

The motor finance book acquired at the end of the previous financial year has been bedded in successfully, with collections currently ahead of plan, resulting in a reduction of 48.4% in the carrying balance, year-on-year, and only 12.1% of remaining cases in arrears at the year end. The success of this acquisition reflects the Group's strategy of targeting more specialist portfolios.

Operational improvements have continued to be made in systems, processes and employment patterns which are expected to generate operational efficiencies and improve both customer service and customer experience in future periods.

Outlook

The loan purchase market continues to offer opportunities for Idem Capital to invest in portfolios, either by itself or with partners, where its ability to leverage the skill base of the wider group can generate good returns. These deals are likely to be larger, more idiosyncratic and less frequently available than the average, which leads to an irregular flow of new accounts to the division.

The Group regards such investments as essentially opportunistic, and its firm belief is that the maintenance of strict discipline in this area is the best route to delivering an appropriate return on its investments. The division is well placed to continue the effective management of its asset base and to address appropriate business opportunities as they arise, however, in the absence of an acceptable return on investment, the Group expects to focus its capital allocation on its other operating divisions in the near term.

3 FUNDING REVIEW

The Group's strategic funding objective is to maintain a diversified and sustainable funding base. It accesses differing mixes of funding options from time to time to ensure that pricing and availability issues in any particular funding market can be mitigated, while maintaining the flexibility to fund new business opportunities when required.

During the year the Group has continued to emphasise the central role of retail deposits within its funding mix. This has resulted in savings deposits accounting for almost half the Group's funding by the year end.

In the wholesale markets the Group issued its first SONIA referenced securitisation transaction, Paragon Mortgages (No. 26) PLC during the year. It also disposed of its residual interests in the Paragon Mortgages (No. 12) PLC securitisation and repaid several other securitisation deals, financing them on balance sheet.

In the uncertain economic climate, which has continued throughout the year, the Group maintained its policy of holding strong levels of contingent liquidity and of holding larger cash balances than might otherwise be the case, with £872.6 million of cash available for liquidity and other purposes at 30 September 2019 (2018: £962.9 million). Further contingent liquidity was provided by undrawn warehouse facilities of £200.0 million (2018: £200.0 million) and assets pre-positioned to access Bank of England facilities. The contingent liquidity policy will be kept under review in the light of the emerging economic and political environment.

The Group has also explored new routes to the savings market in the period in order to broaden its distribution, increase the market addressed and create the capacity for more flexibility in its funding.

The Group's funding at 30 September 2019 is summarised as follows:

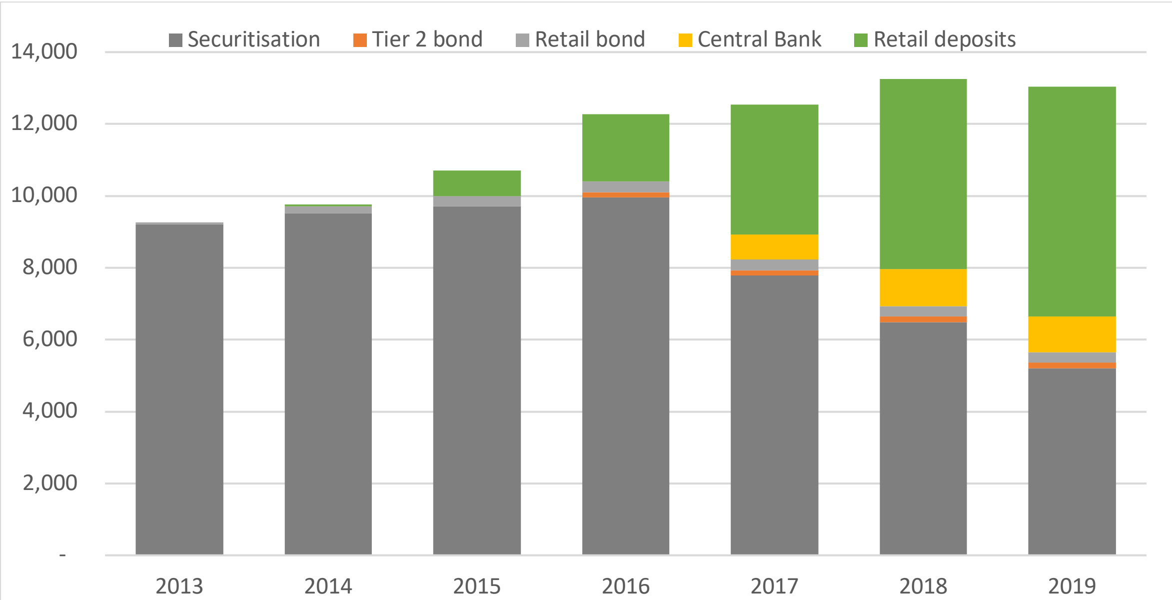
	2019 £m	**2018 £m**	**2017 £m**
Retail deposit balances	6,391.9	5,296.6	3,615.4
Securitised and warehouse funding	5,206.9	6,490.3	7,781.8
Central bank facilities	994.4	1,024.4	700.0
Tier 2 and retail bonds	446.1	445.4	444.8
Total on balance sheet funding	13,039.3	13,256.7	12,542.0
Off balance sheet central bank facilities	109.0	108.7	109.0
	13,148.3	13,365.4	12,651.0

3 FUNDING REVIEW (CONTINUED)

The Group's funding has become increasingly diversified in the years following the authorisation of Paragon Bank in 2014. This is illustrated by the chart below which shows, for each of the year ends since 2013, the outstanding funding balance by type.

Funding by type (£m)

30 September 2013 – 2019



The Group continues to hold both assets and liabilities where the interest rate is set by reference to LIBOR, which will be withdrawn in 2021. A working group is in place to oversee a transition plan managing impacts on both sides of the balance sheet.

It is likely that a market consensus solution for LIBOR-linked instruments will emerge, which will then need to be implemented on a case by case basis. The position with regard to LIBOR linked assets, where the Group has a substantial position relating to legacy mortgage lending is likely to be more complex, with regulatory expectations playing a significant role. No new LIBOR-linked lending is undertaken without specific contractual terms addressing replacement benchmarks. The Group continues to carefully monitor emerging regulatory and market developments so that it minimises, as far as possible, any disruption on LIBOR withdrawal.

3.1 Retail funding

Paragon Bank'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'). While the business currently sources the majority of deposits through its own website, it also has an increasing presence on wealth management platforms and is expanding to offer postal accounts.

Retail deposits continue to represent a reliable, cost-effective and scalable source of finance for the Group. The volume of retail deposits has continued to grow significantly during the period, in line with the Group's funding strategy, with balances at 30 September 2019, at £6,391.9 million, having increased by 20.7% over the year (2018: £5,296.6 million).

3 FUNDING REVIEW (CONTINUED)

The Group's share of the overall UK savings market remains small, with opportunities identified to expand the franchise. Household savings balances reported by the Bank of England increased by 3.7% in the year ended 30 September 2019 to £1,220.9 billion (2018: £1,177.3 billion), although these deposits remain overwhelmingly with clearing banks and building societies. While this market position enhances the Group's funding flexibility, it does mean that rates may be influenced by the funding needs of other, larger, participants in the market, which are beyond the Group's control.

New entrants in the banking market have sought to access similar segments of the savings market as the Group, and therefore competition for internet-sourced deposits has increased. However, the Group's competitive position on pricing, products and service, have meant that it has been able to achieve its required funding levels at attractive prices.

Savings balances at the year end are analysed below.

	Average interest rate		Average initial balance		Proportion of deposits	
	2019	2018	2019	2018	2019	2018
	%	%	£000	£000	%	%
Fixed rate deposits	2.02%	1.94%	16	19	65.0%	68.8%
Variable rate deposits	1.43%	1.36%	16	16	35.0%	31.2%
All balances	1.81%	1.76%	16	18	100.0%	100.0%

The average initial term of fixed rate deposits was 28 months (2018: 27 months).

Market rates for new easy access accounts and one year deposits reported by the Bank of England have increased year-on-year, with rates on longer dated products falling, which is consistent with the picture shown above.

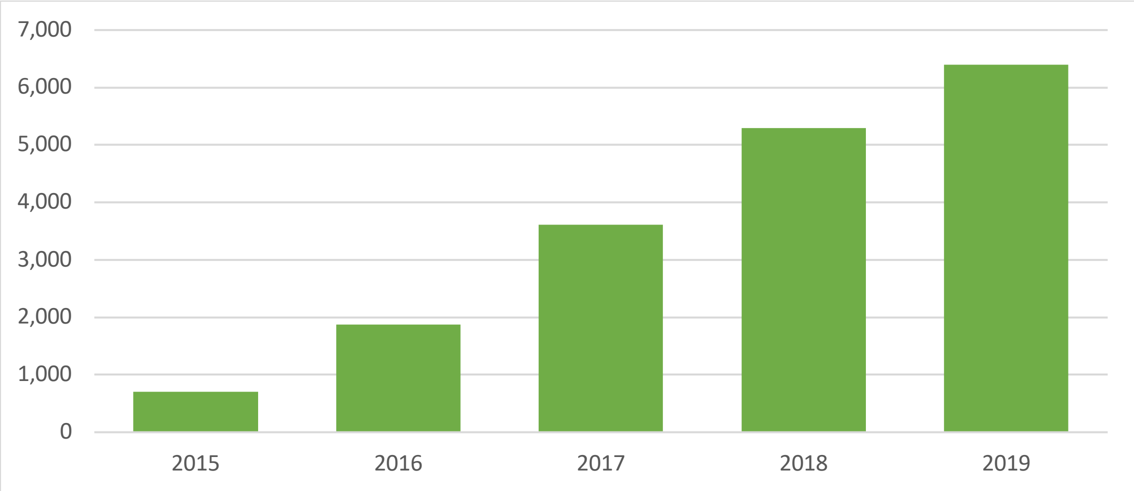
At 30 September 2019 the proportion of easy access deposits, which are repayable on demand, at 27.8% was a little higher than its level at the beginning of the year (30 September 2018: 25.5%), and represented £1,778.0 million of the balance (2018: £1,384.7 million). This percentage can be expected to rise going forward as the Group generates richer behavioural data to support its liquidity requirement assumptions for easy access business.

3 FUNDING REVIEW (CONTINUED)

The growth of the retail funding balance since the authorisation of Paragon Bank as a deposit taker in 2014 is shown below.

Retail deposits (£m)

At 30 September 2015 - 2019



The core route to market for the deposit proposition is through its online presence, with traffic driven by strong repeat business flows, organic searches, a presence on price comparison websites and recommendations from industry savings experts. This has been enhanced in the period by the launch of alternative deposit sources, such as investment platforms outside the main business flow.

The first of these alternative sources, the Hargreaves Lansdown Active Savings platform came on stream in November 2018, with further relationships with Flagstone, a wealth management solution and Monzo, the digital bank, launched later in the year. These arrangements allow the Group to access an additional customer base, as the platforms target different demographics to its online direct savings channel. The Group will seek to develop such relationships further in future periods.

The Group's products, process and approach have been recognised in the industry and by customers winning the 'Best Monthly Interest Provider' award in the 2019 Moneynet awards, its second consecutive victory in this category. It was also named as 'Best Online Cash ISA Provider' in the 2019 YourMoney.com Awards and 'Best Savings Provider for Existing Customers' in the 2019 Savings Champion awards.

In customer feedback 89% 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 (2018: 90%). The net promoter score in the same survey was +65, up from +61 for the 2018 financial year.

When customers with maturing savings balances in the year were surveyed 91% stated that they would 'probably' or 'definitely' consider taking out a replacement product with the Group (2018: 90%) with a net promoter score at maturity of +53, up from +50 for the 2018 financial year. This performance is particularly valuable to the Group, given the benefits of customer and deposit retention.

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. The Group has a close relationship with the service provider through which it seeks to enhance both its offerings and its customer service levels.

3 FUNDING REVIEW (CONTINUED)

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. This will be driven through expanding distribution and developing the product range to serve additional customer groups. 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 more resilient than average in such circumstances.

Overall, the savings proposition 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, giving the funding channel flexibility and manageability. The additional routes to market enhance this flexibility.

3.2 Wholesale funding

The Group's wholesale funding comprises securitisation funding, warehouse debt and retail and corporate bonds. It has been one of the principal issuers of residential mortgage backed securities ('RMBS') in the UK over many years. Its Long-Term Issuer Default Rating was affirmed at BBB by Fitch in the period, albeit with a negative outlook which was applied to all the major UK banks as a result of the uncertainty surrounding the Brexit process. Fitch have stated that, all other things being equal, this would be removed in the event of a resolution.

The capital markets were largely quiet in the first six months of the period with rates less appealing than in previous periods. This was attributable to two factors, the general economic environment in the UK and the impending withdrawal of the LIBOR reference rate, which has formed the basis for interest charging on the majority of asset backed securities since the inception of that market. LIBOR is due to be withdrawn in 2021, within the lifetime of a newly issued four-year security, and UK regulators have mandated the Bank of England Sterling Overnight Index Average ('SONIA') to replace it.

No significant SONIA-linked bonds were issued before April 2019, with much of the market waiting for a standard approach to emerge. However, the first issuers came to market after that point and the levels of pricing and liquidity returned to a more normal level for the rest of the year, despite the general economic pressures.

The Group issued its first SONIA linked transaction, Paragon Mortgages (No. 26) PLC ('PM26') in June 2019. PM26, backed by seasoned buy-to-let mortgage assets, raised £364.3 million of external funding in sterling Mortgage Backed Floating Rate Notes. The senior notes, the only notes issued externally, were rated AAA by Fitch and Aaa by Moodys and bear interest at compounded SONIA plus a margin of 1.05%. It should be noted that margins above SONIA are typically larger than those above LIBOR, reflecting the risk-free nature of the SONIA rate. The deal also generated internally held rated notes which may either be sold later or used as collateral for Bank of England or other repo facilities, giving the Group enhanced funding and liquidity options.

On 27 June 2019 the Group sold its remaining investments and residual interest in the Paragon Mortgages (No. 12) PLC securitisation. While the transaction remains in place and the Group continues to manage the assets, it has no further interest in their performance and both the assets and the associated funding have been derecognised from the Group's balance sheet, realising a net profit of £9.7 million as well as crystallising its loan participation in cash. This removed £695.8 million of low yielding securitised assets from the Group's balance sheet and, consequently, reduced its encumbrance ratio, while improving yields.

3 FUNDING REVIEW (CONTINUED)

During the year the Group paid down five further securitisation transactions. These included two funding legacy mortgages and the Group's remaining consumer finance transaction. These transactions between them had £95.8 million of notes outstanding at 30 September 2018 and had some of the highest funding costs among the legacy arrangements. Additionally, two transactions funding post-2010 mortgages were paid down, having reached their optional call dates. After the year end notice was given on a further post-2010 mortgage transaction. Further such refinancing transactions should be expected over the coming years.

A further funding option is provided by wholesale warehouse funding, which provides standby capability, particularly in the event of market disruption elsewhere, where funds need to be deployed rapidly or as an alternative to retail deposit funding for liquidity purposes or in the process of building a portfolio of loan assets for securitisation. During the period a new £200.0 million facility was agreed with Bank of America Merrill Lynch, carrying an interest rate of LIBOR plus 0.95%.

3.3 Central bank facilities

The Group has continued to make use of facilities offered by the Bank of England to support its lending to households and businesses. Its drawings under the Term Funding Scheme ('TFS') remain in place and provide £944.4 million of the Group's funding (2018: £944.4 million), with all drawings remaining in place until at least 2021. The Group also utilised the Indexed Long-Term Repo scheme ('ILTR') for six-month borrowings, with £50.0 million outstanding at the period end (2018: £80.0 million).

The Group's liquidity drawdown under the Funding for Lending Scheme ('FLS'), which provides liquidity of £109.0 million (2018: £108.7 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, providing access to liquidity of up to £1,095.0 million. It can also use the retained notes in recent securitisation transactions, which are externally rated, for this purpose.

The Group will continue to utilise central bank facilities in future, subject to availability, as part of its integrated funding framework.

3.4 Summary

The Group's diversified funding position, with strong wholesale and retail franchises gives it a strong position in the face of economic uncertainties. This reduces its exposure to issues affecting any particular funding source and allows it the flexibility to raise funds in accordance with its own market assessments, rather than being forced into sub-optimal transactions for short term reasons. This base delivers a robust and adaptable position going forward, supporting the Group's overall business strategy and aspirations.

4 CAPITAL REVIEW

The Group's capital policy aims to provide appropriate returns to shareholders, whilst maintaining prudent levels of capital to support its strategic objectives going forward. The maintenance of strong regulatory capital and liquidity positions to safeguard its depositors is also a principal strategic objective.

For regulatory purposes the Group's capital comprises shareholders' equity and tier 2 bonds. It has no outstanding AT1 issuance, but has the capacity to issue such securities, if considered appropriate, under an authority granted by shareholders at the 2019 AGM, which will be proposed for renewal at the forthcoming meeting.

4.1 Dividends and distribution policy

The Company's previously announced dividend policy of paying out approximately 40% of consolidated earnings to shareholders remains in place, achieving a dividend cover ratio of around 2.5 times, in ordinary circumstances. During July 2019 an interim dividend of 7.0 pence per share was paid, determined, in accordance with the Group's stated policy, as 50% of the previous year's final dividend.

Following the completion of the PM12 residual sale on 27 June 2019 the Board considered the profit generated and the capital released by that transaction and determined that it was appropriate to return a portion of this capital to shareholders by way of a share buy-back programme. During the year the Group bought back 6.0 million of its ordinary shares at a cost of £26.7 million, including stamp duty and transaction expenses (note 20); £26.5 million excluding costs, these shares being held in treasury. Treasury shares may subsequently be cancelled.

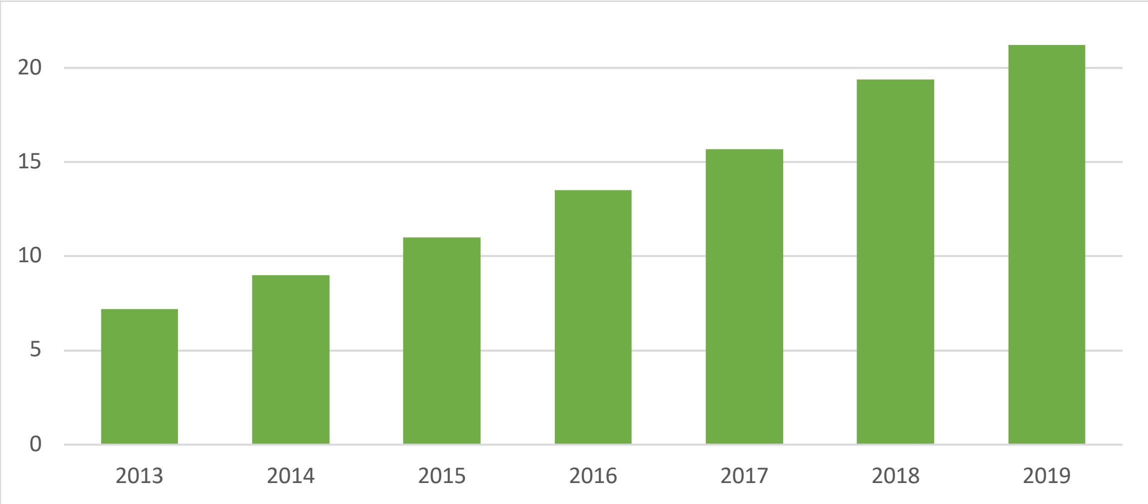
In determining the level of dividend for the year, the Board has considered the dividend policy, and has also taken into account the impact of the buy-back programme, together with the Group's strategy, capital requirements, principal risks, the level of available retained earnings in the Company, its cash resources and the objective of enhancing shareholder value. The dividend policy is underpinned by the principle of enhancing shareholder returns on a sustainable basis and the Board is proposing, subject to approval at the Annual General Meeting on 13 February 2020, a dividend for the year of 21.2 pence for 2019, an increase of 9.3% from the 19.4 pence in 2018. This results in a dividend cover ratio of 2.33 times, which is below the normal target of around 2.5 times but which reflects the scale of non-cash, fair value items in the 2019 results.

4 CAPITAL REVIEW (CONTINUED)

The progress of the dividend for the year is shown in the chart below.

Dividend for the year (pence)

In respect of the years 2013 - 2019



The directors have considered the distributable reserves of the Company and concluded that such a dividend is appropriate.

4.2 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 an individual capital requirement 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 total risk exposure in order to safeguard depositors in the event of severe losses being incurred by the Group.

The Group maintains strong capital and leverage ratios, with a total capital ratio of 15.9% at 30 September 2019 (2018: 16.2%) and a UK leverage ratio at 6.7% (2018: 6.4%) (note 27(d)). The CET1 ratio, 13.7% at 30 September 2019, marginally reduced during the period (2018: 13.8%), reflecting primarily the growth in the balance sheet, offset by the impact of distributions to shareholders through buy-backs and dividends.

The Group's principal capital measures are set out below. It has been granted transitional relief on the adoption of IFRS 9, with the impact on capital being phased in over a five-year period, with only 5% of the effect being recognised in the first year. However, firms are also required to disclose capital measures as if the relief has not been given (referred to as the 'fully loaded' basis).

		2019 IFRS 9 £m	2018 IFRS 9 £m	2018 IAS 39 £m
CET1 capital	Basic	922.0	889.6	890.8
	Fully loaded	900.8	868.4	890.8
Total Regulatory Capital ('TRC')	Basic	1,072.0	1,039.6	1,045.7
	Fully loaded	1,050.8	1,018.4	1,045.7

4 CAPITAL REVIEW (CONTINUED)

The Group's CET1 capital comprises its equity shareholders' funds, adjusted as required by the CRD IV rules. TRC, in addition, includes tier 2 capital representing the Tier 2 Bonds. Additional tier 2 capital arising from credit loss allowances is no longer included in regulatory capital following the introduction of IFRS 9.

The Group's capital requirements include the Pillar 1 + 2a amount which is specific to the Group and is set by the regulator. This may include both variable and fixed components. At 30 September 2019 this requirement was £742.9 million on the transitional basis and £741.8 million on the fully loaded basis (2018: IAS 39 £727.7 million), with the increased requirement principally driven by the growth in the Group's asset base.

The Group's capital must also cover the CRD IV buffers, the Counter-Cyclical ('CCyB') and Capital Conservation ('CCoB') buffers. These apply to all firms and are based on a percentage of total risk exposure. These buffers were both increased in the period, with the CCoB increasing from 1.875%, to 2.500%, its long-term rate, from January 2019 and the CCyB increasing from 0.5% to 1.0%, from November 2018. These increases in standard CRD IV buffers have added over £75.0 million to the Group's capital requirement. Further buffers may be set by the PRA on a firm-by-firm basis but may not be disclosed.

The Group continues to maintain a healthy capital surplus, although this has been eroded by the 1.125 percentage point increase in the CRD IV buffers in the period, the introduction of IFRS 9 and the increase in the deficit on the Group's defined benefit pension plan.

The Group's capital ratios are set out below.

		2019 IFRS 9	**2018 IFRS 9**	**2018 IAS 39**
CET1 ratio	Basic	13.7%	13.8%	13.8%
	Fully loaded	13.4%	13.5%	13.8%
Total capital ratio	Basic	15.9%	16.2%	16.2%
	Fully loaded	15.7%	15.8%	16.2%
UK leverage ratio	Basic	6.7%	6.4%	6.4%
	Fully loaded	6.6%	6.3%	6.4%

Capital ratios remain largely in line with previous performance, with IFRS 9 transition not having a major impact.

During the year the Group has undertaken a thorough review of the risk weightings applied to its assets for capital purposes, partly in response to market concerns across the sector. This exercise confirmed the weightings being applied under the Standardised Approach for credit risk ('SA') and the appropriateness of the Group's risk weighted asset values and hence its capital measures.

The regulatory authorities in the UK and EU have also continued their work to put in place the December 2017 amendments to the Basel III capital adequacy regime, published in the BCBS document 'Basel III: Finalising post-crisis reforms'. This addresses both the 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.

These proposals are expected to increase capital requirements under the SA for a number of asset classes, including buy-to-let lending, and stricter parameters within which IRB approaches must operate. The Group has monitored developments during the year and revised its capital strategy where necessary.

4 CAPITAL REVIEW (CONTINUED)

The Group's project to develop an Internal Ratings Based ('IRB') approach to credit risk for capital adequacy purposes has continued throughout the year. A considerable amount of work has been completed, using both internal and external resources, generating system enhancements as well as progressing the application process. However, in September 2019 the PRA published a consultation paper (CP 21/19) which would enact significant new EBA regulations governing IRB techniques in the UK. At the same time the CP highlighted a need for firms applying for IRB accreditation to comply with certain future regulatory requirements where the authorisation process is expected to extend beyond 2020.

The Group's models already reflect the most material requirements arising from the CP, however, whilst only a consultation at this stage, the Board has decided to ensure its IRB models are fully compliant with the requirements of the CP before delivering the first part of its the application to the PRA.

4 CAPITAL REVIEW (CONTINUED)

4.3 Liquidity

The Group's operational capital and funding requirements are also influenced by the Group's policy to hold 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	2019	2018	Regulatory minimum
LCR – Liquidity coverage ratio	138%	144%	100%
NSFR – Net stable funding requirement	115%	113%	100% *

* Not yet a binding requirement

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

4.4 Capital outlook

The Board keeps the appropriate level and form of capital required by the Group under review to ensure that, in the light of the Group's strategic objectives and the economic environment in which it operates, and more specifically where there are changes in the business or in regulatory expectations, the capital position remains prudent and sustainable, for the benefit of all stakeholders.

5 FINANCIAL REVIEW

The underlying economic uncertainty in the UK over the past year has been reflected in significant shifts in the interest rate yield curve which have affected the Group's results, generating fair value volatility in the profit and loss account and increasing the deficit in the Group's pension plan. However, the underlying position remained positive as the Group's long term strategy continued to bear fruit.

The Group's underlying profit in the financial year ended 30 September 2019 (appendix A) increased by 5.0% to £164.4 million (30 September 2018: £156.5 million) while on the statutory basis, including the effect of fair value losses profit before tax decreased by 12.4% to £159.0 million (30 September 2018: £181.5 million). The underlying result also excludes a gain of £9.7 million resulting from the disposal of the Group's residual interest in the PM12 securitisation in June 2019 (the 'PM12 disposal') (2018: £28.0 million gains on asset disposals).

Earnings per share on the statutory basis reduced to 49.4 pence (30 September 2018: 55.9 pence) while increasing by 6.0% to 51.1 pence on an underlying basis (30 September 2018: 48.2 pence).

5.1 Results for the year

CONSOLIDATED RESULTS
For the year ended 30 September 2019

	2019	2018
	IFRS 9	IAS 39
	£m	£m
Interest receivable	505.7	451.9
Interest payable and similar charges	(227.3)	(197.3)
Net interest income	**278.4**	**254.6**
Net leasing income	3.8	3.8
Gain on derecognition of financial assets	9.7	28.0
Other income	15.4	15.5
Total operating income	**307.3**	**301.9**
Operating expenses	(125.2)	(114.2)
Provisions for losses	(8.0)	(7.4)
	174.1	180.3
Fair value net (losses) / gains	(15.1)	1.2
Operating profit being profit on ordinary activities before taxation	**159.0**	**181.5**
Tax charge on profit on ordinary activities	(31.6)	(35.7)
Profit on ordinary activities after taxation	**127.4**	**145.8**

	2019	2018
Dividend – rate per share for the year	21.2p	19.4p
Basic earnings per share	49.4p	55.9p
Diluted earnings per share	48.2p	54.2p

5 FINANCIAL REVIEW (CONTINUED)

Income

Underlying net interest income increased by 8.5% to £278.4 million from the £256.5 million for the year ended 30 September 2018 (2018 statutory basis: £254.6 million). The growth reflects improved yields in the loan book, together with the size of the average loan book, which rose by 4.5% to £12,143.4 million over the year (2018: £11,626.0 million) (appendix B).

Underlying net interest margin ('NIM') in the year ended 30 September 2019 increased to 2.29% compared to the 2.21% in the previous year (appendix B). This increase reflects the changes in product mix in the Group's balance sheet, with new buy-to-let margins exceeding those achieved on the legacy book and the growing Commercial Lending division operating on still wider margins. (appendix B).

During the year the Group disposed of its residual interest in the legacy PM12 securitisation (note 5), generating a cash inflow of £49.8 million. As a result, the assets and liabilities of PM12 were derecognised from the Group's balance sheet resulting in a net gain of £9.7 million.

Excluding the gain on disposal, other operating income was little changed at £19.2 million for the year, compared with £19.3 million in 2018.

Total underlying operating income increased by 7.9% to £297.6 million (2018: £275.8 million). Total operating income on the statutory basis, at £307.3 million (2018: £301.9 million) also included the gain on the PM12 disposal, whereas the 2018 result included a £28.0 million one-off gain on Idem Capital asset disposals arising during that year.

Costs

Underlying operating expenses increased by 11.9% to £125.2 million from £111.9 million reported in the previous year. These costs include a full year's costs relating to both the Titlestone business, acquired in the second half of the last financial year and the Iceberg business, acquired in December 2017. During the year the Group's average number of employees increased 1.2% to 1,365 (2018: 1,349) and with the Group's strategic initiatives seeing a significant level of higher-paid individuals joining the payroll in the year, employment costs increased by 6.7% year-on-year (note 10). The increase in the Group's savings balance in the period (20.7% year-on-year) also impacts operating costs, with the outsourced servicing fee set by reference to the balance outstanding, rather than simply rising in line with inflation.

The delivery of the Group's strategy depends heavily on its IT infrastructure, and during the year it made substantial investments in developments both to improve efficiency and to provide an enhanced experience to its customers, particularly in the SME market. These initiatives were ongoing at the year end and will be rolled out in the future. Further systems effort was deployed to enhance cyber-security and operational resilience. The period's costs also include expenditure of around £2.4 million on the development of the Group's IRB approach, both in internal resources and external advice, which should generate future benefits to the Group's capital position. Overall the Group estimates that these project costs comprise over £3.5 million of the cost base for the period.

This investment for the future increased the Group's underlying cost:income ratio in the period to 42.1% (appendix C) from the 40.6% recorded in 2018, although without the additional project costs and the impact of the acquisitions, this would have reduced. The control of operating costs remains a principal strategic priority of the Group and it applies a rigorous budgeting and monitoring process.

5 FINANCIAL REVIEW (CONTINUED)

Strategic disposals, such as the PM12 disposal and the Idem Capital sale in 2018 will have improved earnings per share and RoTE, however their impact has increased the cost:income ratio as a consequence. Over the medium term, the Group targets improvements in the cost:income ratio, from scale and efficiency gains, but increases in regulatory requirements, IT investments and the impact of new operations means that progress to a lower ratio is unlikely to be linear.

Total operating expenses, which in 2018 included the costs of the Iceberg and Titlestone acquisition transactions, increased by 9.6% to £125.2 million (2018: £114.2 million), giving a cost:income ratio on a statutory basis of 40.7% (2018: 37.8%) (appendix C), with the 2018 figure deflated due to the size of the gains on derecognition in that period.

Impairment provisions

The Group has applied IFRS 9 in calculating its provisions for impairment for the first time in the year. As prior year charges are not required to be restated, the 2019 charge is not strictly comparable to that for 2018. However, the charge of £8.0 million for loan impairment has remained broadly similar to that for the previous year under IAS 39 (2018: £7.4 million). The cost of risk (the impairment charge as a percentage of average loans to customers) (appendix B) remains stable at 0.07% compared to 0.06% in 2018.

Under IFRS 9 interest is only recognised on the net value of a credit impaired (Stage 3) loan, reducing both interest receivable and impairment charges. The value of this adjustment in the year was approximately £1.0 million, reducing NIM and cost of risk by approximately 1 basis point.

Careful management of all the Group’s loan books continues to be a strategic priority, for both retention and credit purposes. The credit performance of the books continues to be pleasing, with that of the buy-to-let book particularly strong, compared to market averages, with improvements in performance on acquired consumer portfolios year-on-year and credit metrics on the Group’s newer portfolios also strong and in line with expectations.

Fair value movements

Yield curve movements during the period resulted in hedging instrument fair value net losses of £15.1 million (2018: £1.2 million net gains), which do not affect cash flow. The size of the movement in the period is mostly a result of market turbulence throughout the year, with the yield curve showing large fluctuations, primarily downwards, especially at month ends. Commentators have ascribed some of this to heightened political uncertainties in the UK over Brexit during the period, with these uncertainties carrying on into the new financial year.

This impacted particularly on the carrying values of swaps held for the purpose of hedging pipeline loan commitments, which cannot be included in a hedge for accounting purposes.

The fair value movements of hedged assets or liabilities are expected to be profit neutral over time, as these instruments will be held to maturity. As such, this item represents a timing difference. The Group remains economically and appropriately hedged.

5 FINANCIAL REVIEW (CONTINUED)

Tax

Corporation tax has been charged at the rate of 19.9%, increased from 19.6% for the previous year. Materially all of the Group's operations fall within the scope of UK taxation and the standard rate of corporation tax applying to the Group in both years was 19.0%. The Group pays tax at a higher rate on profits arising within its banking subsidiary.

Profits after taxation of £127.4 million (2018: £145.8 million) have been transferred to consolidated equity, which totalled £1,108.6 million at the year end (2018: £1,095.9 million), representing a tangible net asset value of £3.64 per share (2018: £3.59 per share) and an unadjusted net asset value of £4.39 per share (2018: £4.25 per share) (appendix D).

5.2 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 asset leasing and motor finance 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 2 and are summarised below.

	2019 £m	2018 £m
Segmental profit		
Mortgages	167.9	144.8
Commercial Lending	43.8	19.8
Idem Capital	48.0	78.2
	259.7	242.8
Gains on disposals	9.7	28.0
Unallocated central costs and other one-off items	(95.3)	(90.6)
	174.1	180.3

5 FINANCIAL REVIEW (CONTINUED)

Mortgages

The Mortgages division continues to maintain a strong market position in its core specialist buy-to-let loan market. Strategically targeted operational initiatives have improved retention and enhanced NIM, while provisions remain low. As a result, the segmental profit increased 16.0% to £167.9 million, (2018: £144.8 million). Net interest income increased by 12.8% to £177.8 million (2018: £157.6 million), although growth in the average loan book was only 1.8%, a result of the PM12 disposal in the year. The Group's legacy mortgage assets are lower yielding than newer business therefore asset turnover will be beneficial to margins. These effects combined to deliver a 17 basis point improvement in segmental NIM in the period.

The PM12 disposal also provided an additional one-off gain of £9.7 million, included in unallocated items above.

The costs of the division increased as a result of higher activity levels while other income reduced marginally during the period. The overall result was also affected by a reduction of the impairment charge to £1.0 million (2018 (IAS 39): £5.5 million), following the transition to IFRS 9, where an additional write down of £24.0 million was posted against reserves.

Commercial Lending

In the Commercial Lending segment, the level of new advances generated a substantial increase in loan assets, with the segment's loans to customers at 30 September 2019, at £1,452.2 million, increasing 28.4% from the position twelve months earlier (2018 (IFRS 9): £1,131.3 million). Growth was seen across all the major product lines with the development finance portfolio increasing 43.2% year-on-year, asset leasing 21.3% and structured lending 127.6%.

NIM in the division rose by 124 basis points compared with the year ended 30 September 2018, driven by the additional high-yielding development finance assets and a focus on enhancing yields elsewhere.

Segmental profit in Commercial Lending increased 120.1% in the year to £43.8 million (2018: £19.9 million). This is attributable to the contribution of operations acquired in the previous year and maturing new business lines, together with growth and enhanced focus in the ongoing sectors.

Idem Capital

The Idem Capital division's portfolios continued to generate strong operational cash flows in the year ended 30 September 2019. No new deals were completed and hence the average outstanding loan balance reduced through run-off in the period, falling by 25.0% in the last twelve months to £389.9 million (2018 (IFRS 9): £519.8 million). NIM reduced in the segment, a result of the recent strategic focus on acquiring performing books, which may have lower yields; the impact of the portfolio sale of higher yielding assets in September 2018 and strong natural portfolio amortisation. This impacted on segmental profit, which fell by 38.6% to £48.0 million (2018: £78.2 million).

5 FINANCIAL REVIEW (CONTINUED)

5.3 Assets and liabilities

The Group's assets and liabilities at the year end are summarised in the balance sheet below.

SUMMARY BALANCE SHEET
30 September 2019

	2019 IFRS 9 £m	2018 IFRS 9 £m	2018 IAS 39 £m
Intangible assets	171.1	169.3	169.3
Investment in customer loans	12,186.1	12,100.6	12,127.8
Derivative financial assets	592.4	855.7	855.7
Free cash	225.7	238.0	238.0
Other cash	999.7	1,072.6	1,072.6
Other assets	220.5	51.7	51.7
Total assets	14,395.5	14,487.9	14,515.1
Equity	1,108.6	1,073.5	1,095.9
Retail deposits	6,391.9	5,296.6	5,296.6
Other borrowings	6,648.4	7,961.2	7,961.2
Pension deficit	34.5	19.5	19.5
Other liabilities	212.1	137.1	141.9
Total equity and liabilities	14,395.5	14,487.9	14,515.1

The size of the Group's balance sheet has remained broadly similar through the year although the underlying balances evidence the continuing reshaping of its operations, with increased diversity of assets and growth in the retail deposit franchise.

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 leasing and motor finance loans in the Commercial Lending segment, with similar purchased accounts in the Idem Capital segment
- Professions finance, invoice finance and other finance for SME businesses in the Commercial Lending segment
- Development finance loans in the Commercial Lending segment
- Structured lending loans in the Commercial Lending segment

5 FINANCIAL REVIEW (CONTINUED)

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

	2019 IFRS 9 £m	2018 IFRS 9 £m	2018 IAS 39 £m
Mortgages	10,344.0	10,449.5	10,473.5
Commercial Lending	1,452.2	1,131.3	1,133.2
Idem Capital	389.9	519.8	521.1
	12,186.1	12,100.6	12,127.8

During the year the mix of the Group's assets has been altered by the PM12 disposal, increased volumes in development finance and structured lending and the continuing run-off of Idem Capital assets. Movements in the Group's loan asset balances are discussed in the lending review section (Section 2.2) while an analysis of the Group's financial assets by type is shown in note 10.

Derivatives

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 while the exchange movements have a broadly equal and opposite impact on borrowings.

The interest rate movements mentioned above have also driven significant changes in the valuation of derivatives held for hedging fixed rate loan assets or deposit liabilities, with the net carrying value switching from a £21.3 million asset at 30 September 2018 to a £71.0 million liability at the period end. For those derivatives forming part of a hedge for accounting purposes this movement is offset by the movement in the fair value adjustments against loans to customer and retail deposits.

Funding

Movements in the Group's funding, including retail deposit balances and wholesale borrowings, are discussed in the funding review section (Section 3.3), with retail deposits now forming almost half of the Group's total funding. The Group has pursued a conservative liquidity policy in the period, resulting in a focus on contingent liquidity arrangements and strong levels of liquid assets being held throughout the period.

Pension obligations

The accounting value of the deficit in the Group's defined benefit pension plan (the 'Plan') has increased over the year ended 30 September 2019. Gilt yields fell sharply over the year, resulting in a discount rate of 1.85%, 110 basis points less than at 30 September 2018. This effect was mitigated, to some extent, by the adoption of more recent market mortality assumptions and a strong performance by the Plan's investments. Together these resulted in the deficit under International Accounting Standard ('IAS') 19 increasing to £34.5 million (2018: £19.5 million). These movements also generated an actuarial loss of £16.5 million before tax which was recognised in other comprehensive income (2018: gain of £8.9 million).

5 FINANCIAL REVIEW (CONTINUED)

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 increased to £29.2 million at 30 September 2019 (30 September 2018: £15.2 million), representing an 80% funding level (30 September 2018: 87%).

Other assets and liabilities

Sundry assets have increased as a result of the Group's deferred tax balance becoming an asset (a result of IFRS 9 transition adjustments and the movement in the pension plan liability), together with the inclusion of £72.2 million of collateral which was required to be placed with banks as security for the Group's swap liabilities (30 September 2018: £3.8 million).

Within sundry liabilities the largest movement has been the increase in derivative liabilities to £80.5 million from £4.7 million at 30 September 2018, principally as a result of interest rate movements.

5.4 Accounting changes

On 1 October 2018 the Group adopted IFRS 9 in place of IAS 39. The new standard changes the basis of provision from incurred loss to expected loss, which means that although a broadly similar bad debt charge will be posted over the life of a credit impaired account, it will be recognised earlier. The consequence of this is that a growing portfolio, such as most of the Group's loan books, will attract a higher provision charge than it would have done under the previous methodology. This has required the development of models and methodologies over a period of years, utilising the Group's historic data and its experience in modelling and analytics.

The Group published a report on its transition to IFRS 9 on 22 March 2019 which is available from the investor section of the Group's website at www.paragonbankinggroup.co.uk.

The change impacted on loan asset values on the Group's balance sheet on transition but has not had a significant impact on the profit and loss charge in the year. This was anticipated, as the accounting change is principally an acceleration of the impairment charge and is therefore a timing difference, rather than an additional loss. Within the charge, however, amounts which would have been provided in the year under IAS 39 were included in provision brought forward under the new standard, while additional provisions, particularly for new originations, were required where no provision under IAS 39 would have been booked.

The other new requirements of IFRS 9 have not had a significant impact on the Group's accounting but have required the presentation of significant additional or expanded disclosures. At the same time the Group adopted IFRS 15 – 'Revenue', but this did not have a significant impact.

The total effect of these changes was an increase in the Group's impairment provisions at 1 October 2018 of £27.2 million and a reduction in equity of £22.4 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 was negligible. On a fully loaded basis the transition to IFRS 9 resulted in the Group's CET1 ratio at 1 October 2018 reducing from 13.8% to 13.5%.

The Group will continue to develop, test and validate its IFRS 9 approach as more data becomes available and market practice continues to develop.

5 FINANCIAL REVIEW (CONTINUED)

The Group has adopted IFRS 16 – 'Leases' with effect from 1 October 2019. However, this change will have minimal impact on the Group's results and balance sheet, increasing both assets and liabilities by around £9.0 million and not impacting on reserves or capital.

6 OPERATIONAL REVIEW

6.1 Management and people

The Group's people are its most significant cost, whilst also key to its future growth and development and the medium through which its culture is manifested. Over 1,300 people worked for the Group throughout the period, at its Solihull headquarters and other locations across the UK. Training and development, together with a rigorous recruitment and selection process are a key part of the Group's organic growth strategy, underpinning the strong progress made to date, and the Group's Investors in People Champion status.

Governance and management

During the period the Company continued to comply with the principles of the UK Corporate Governance Code (the 'Code'). On 31 December 2018 Alan Fletcher and Patrick Newberry stepped down from the Board. Alan served as a director from 2009, including a lengthy term as Chair of the Remuneration Committee. Pat served first as an independent director of Paragon Bank PLC from its earliest months of operation in 2014, serving as chair of its audit committee, and joined the Board of Paragon Banking Group in 2017. Both left with the thanks of the Group and the Board for their support and dedication.

Peter Hartill, a non-executive director since 2011, and Chair of the Audit Committee and Senior Independent Director, will be retiring at the 2020 Annual General Meeting having served on the Board for nine years. The Group has progressed its search for a new Audit Committee Chair and, at the date of signing this report, hopes to be in a position to announce a new appointment, after the AGM in February 2020, subject to regulatory and Board approval.

John Heron, Director of Mortgages, has also signalled his intention to retire and will be leaving in early 2020. John joined the Group in 1986 and, as well as being the Group's longest-serving employee, he has been instrumental in establishing and building our buy-to-let mortgage offering. A robust and extensive recruitment process has completed, and the Group looks forward to welcoming Richard Rowntree to run the Mortgages division during the first quarter of 2020, subject to regulatory approval.

During the period the Group has continued its review of the requirements of the new edition of the Code, which came into force for the Company from 1 October 2019. At the same time the Group has considered the forthcoming changes in UK rules for the disclosure of Chief Executive remuneration and the director's consideration of wider stakeholder interests ('section 172') and new requirements for corporate governance and other new disclosures in subsidiary entities. No significant implementation issues were identified and appropriate measures to comply with the new rules have been put in place.

The Board has also considered the governance and committee structures in preparation for the Group's IRB application, as well as providing oversight to that development more generally.

The Group's third annual statement under the Modern Slavery Act 2015 was published on its website in March 2019. 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.

6 OPERATIONAL REVIEW (CONTINUED)

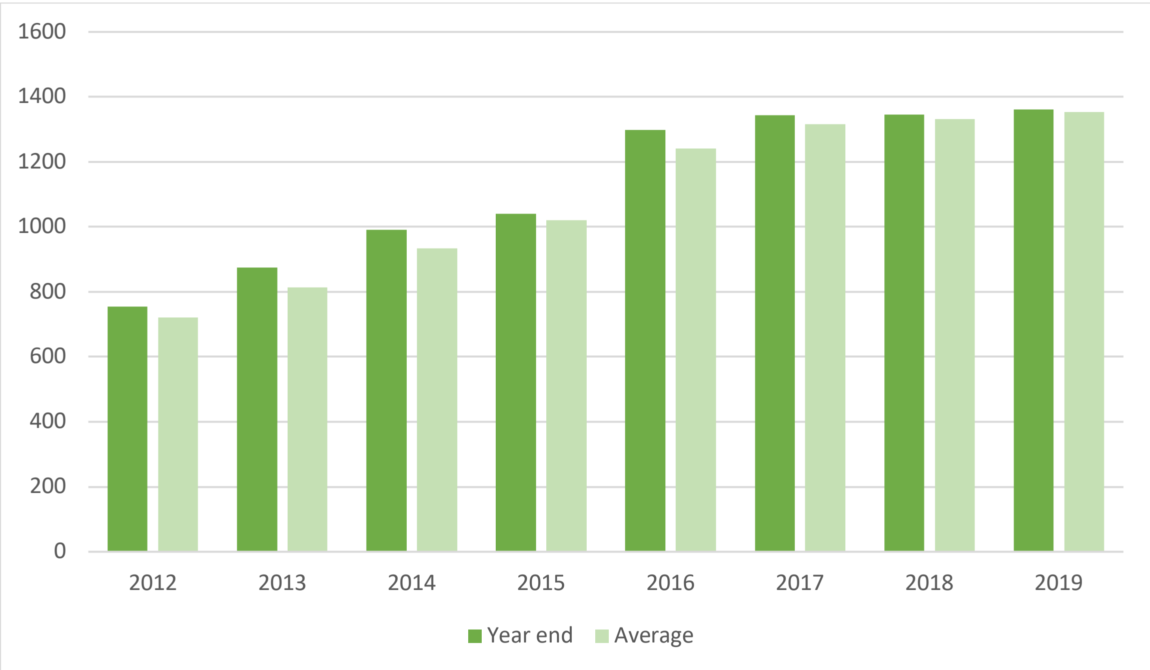
People, diversity and development

The Group continues to focus on maintaining an efficient and effective workforce, increasing employee numbers by 1.3% over 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 its high levels of employee retention and long service. Its annual employee attrition rate of 11.5% is below the national average and 27.3% of its people have over ten years' service, with 11.5% 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.

Employee numbers

At 30 September and average for the year



The Group has been a signatory of the Women in Finance Charter, sponsored by HM Treasury, since 2016. The Charter's objectives reflect the Group's own aspirations for gender diversity and the Group published its first set of internal targets under the Charter in January 2017.

The Group submitted its latest progress report at 30 September 2019 confirming that the Group is making excellent progress towards its targets. In particular:

- 42.7% of employees receiving management career development/leadership training are female (target 50%)
- 35.8% of the workforce are on flexible working contracts (target 10%)
- 65.9% of the flexible working available is on a part-time basis (target 50%)

Activities under the Women in Finance initiative in the year have included participating in cross-company mentoring programmes to nurture female talent and diversity training for all employees. Initiatives are also in hand to reduce the scope for unconscious bias in recruitment processes.

6 OPERATIONAL REVIEW (CONTINUED)

The Hampton-Alexander ('HA') Review published its latest report on gender diversity in the leadership of FTSE 350 entities in November 2019. 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 35.9% (2018: 29.1%). The Group is delighted to achieve its target of 35% well ahead of the original target date of 31 January 2022.

The Group has calculated its gender pay gap at April 2019. This calculation shows that median female pay in the Group was 31.0% less than the median male pay (2018: 30.7%). This is broadly in line with the results reported by other financial services companies and narrower than the 39.1% gap for the sector reported by the Office of National Statistics in their Annual Survey of Hours and Earnings published in October 2019. Analysis of the gender pay gap data indicates that the Group's gap arose principally as a result of the distribution of roles between the genders, highlighting the importance of the Women in Finance initiative in addressing these issues.

The Nomination Committee, as the board committee with responsibility for diversity under the new Code, has identified action on the diversity agenda as an important objective and during the year has taken a detailed interest in progress in these areas.

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, assessed 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.

In addition, the Group has introduced a specific senior leadership development programme focussed on those identified with high potential for future roles, to strengthen the succession plan and increase the overall talent pool required to deliver the Group's medium to long term strategy. This area will remain a priority for the Board, with the assistance of the Nomination Committee, during the forthcoming year.

The Group was proud to be reaccredited with the Investors in People Gold Standard in February 2019 for a further three years. It was particularly pleasing to note the improvement noted by the external assessors in the areas of building capability, empowering and involving people and recognising and rewarding performance, as well as maintaining overall strengths in living the organisation's values and behaviours, delivering continuous improvement and creating sustainable success. It retains its status as an Investors in People Champion, providing advice and support to other organisations.

During the year, the Group's long-standing People Forum has had its membership and terms of reference refreshed to reflect the current organisational structure. This will also provide a renewed focus on the Forum's objectives of giving all employees a voice, nurturing good employment relations, driving employee engagement and improving overall employee communications. In addition, the Forum's role is being enhanced in the light of the new Code requirements on workforce engagement and will have direct access to the Board. Regular meetings with non-executive directors will commence from November 2019, with specific outcomes from the engagement activities being reported from next year.

6 OPERATIONAL REVIEW (CONTINUED)

6.2 Risk

The effective management of risk is crucial to the achievement of the Group's strategic objectives. It operates a risk governance framework designed 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 has continued to enhance its ability to manage all categories of risk. In particular it has focussed on:

- The development of advanced models to enhance credit risk management and support the Group's IRB application process
- Enhancement of stress testing procedures to ensure the robustness of capital and liquidity positions
- The continuing evolution and embedding of its risk appetite framework
- The enhancement of its operational risk capabilities, including the assessment of critical business services and tolerances and the embedding of its operational risk management system in business areas for use on a day-to-day basis
- The maintenance and further development of effective cyber-security controls
- The integration of the businesses acquired in the previous year to ensure they are fully captured by the risk management framework
- Continuing the embedding of robust data protection processes and controls to ensure compliance with the Data Protection Act 2018

During the year the Group has continued to review its exposure to emerging developments in the Brexit process, and the political uncertainties surrounding it, both in terms of impacts on its own activities and on the potential effect on its businesses from wider economic consequences. While the Group does not have operations outside the UK, this analysis addressed, in detail, the capital, liquidity and operational implications of the stresses which might be caused by the process. The Board assessed the output of this analysis throughout the year as the position and potential outcomes developed. The Group considers itself well placed to address the challenges arising, but the position remains uncertain and will continue to be subject to detailed monitoring going forward.

The principal challenges in the risk environment faced by the Group during the year and moving forward into 2020 include:

- The level of change in products, funding and operations which will be required in preparation for the withdrawal of LIBOR in 2021
- 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 increased focus on the impact of climate change on managing financial risks

6 OPERATIONAL REVIEW (CONTINUED)

6.3 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.

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

- The Senior Managers and Certification Regime ('SMCR') will be extended to cover a wider section of persons employed in the financial services sector in December 2019, with the establishment from March 2020 of a Directory of Certified Regime (CR) staff. 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.
- SONIA (the Sterling Overnight Index Average) administered by the Bank of England is to be established as the primary sterling interest rate benchmark by the end of 2021, in place of LIBOR. The Bank of England and the FCA are leading efforts to develop proposals to establish and transition to the new regime. Appropriate steps are being considered and will be taken to manage the transition from LIBOR where it impacts the Group's business, particularly regarding LIBOR linked lending products and borrowings.
- The Bank of England, PRA and FCA published a discussion paper in July 2018 emphasising the importance of a firm understanding and ensuring its operational resilience across critical business services and processes. The Group has implemented a formal programme to both address the specificities of the paper and to align existing workstreams and activities to support wider resilience activities already being undertaken. The appointment of a dedicated Operational Resilience manager has enabled a coordinated approach to improving resilience capability.
- Vulnerable customers continue to be a strong focus for the FCA, and the Group takes its responsibilities in this regard seriously. The Group welcomes the recently issued improved FCA guidance is reviewing its current arrangements against that guidance.
- In March 2019 the FCA published the results of its review of the motor finance industry, identifying concerns about some commission models used and lenders' assessments of affordability. This was followed in October 2019 by the publishing of new regulations addressing these issues. The Group has reviewed the FCA's findings and identified the required changes in its motor finance lending models. The Group believes it is well placed to accommodate these changes.
- The FCA has proposed changes to its responsible lending and affordability rules to enable 'mortgage prisoners' to more easily switch mortgages, and to require inactive lenders, and administrators acting for unregulated entities, to write to certain customers highlighting the rule change, directing them to relevant sources of information. The Group has a number of accounts likely to fall into these categories, and when the FCA final rules are available will take the appropriate action.

6 OPERATIONAL REVIEW (CONTINUED)

- The PRA published policy and supervisory statements in April 2019, addressing climate change and its associated impact on the management of the financial risks within firms. These will require firms to proactively identify such risks and establish appropriate systems to ensure these exposures are managed and governed. The Group is currently in the process of establishing its strategy in respect of climate change, using the PRA's suggested approach, to ensure it is well-positioned to address the challenges as they become better understood.
- 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. During the period the EU, PRA and EBA have continued the process to embed the Basel III revisions into the UK regulatory framework and determine how their respective discretions should be applied. The proposed changes had been anticipated within the Group's IRB project.

Certain regulations applying in the financial services sector only affect entities over a certain size, which the Group might meet within its current planning horizon. 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.

The Group, along with the rest of the UK corporate sector, continues to lack clear visibility on potential regulatory changes that may be introduced following the UK's exit from the EU, if and when that occurs. However, given the nature and scope of its operations, it does not have any EU passporting issues that need to be considered.

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.

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

7 CONCLUSION

We are delighted to report another excellent financial and operational performance, underpinned by our effective diversification strategy and focus on specialist lending. Volumes, profits and dividends are up strongly, and we are moving closer to our medium-term target of over 15% return on tangible equity.

The Group's transformation to a broadly based specialist banking group has continued over the last year. Our customers have increasingly complex needs which are supported by ongoing technology investments and the deep experience of our employees. This approach, alongside a disciplined and prudent risk appetite, has enabled us to achieve strong lending growth at improving margins, whilst maintaining an exemplary credit performance.

Whilst there is uncertainty in the environment we have prepared well and look forward with optimism to the opportunities ahead.

NIGEL TERRINGTON

Chief Executive

26 November 2019

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 2018. 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 regarding the UK's withdrawal from the European Union ('EU'), and the unstable UK political climate. 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 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.

Category	Risk	Description
	Capital	Proposals by the PRA, EBA, and EU to implement changes in the Basel Capital Regime, including changes affecting 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.

DIRECTORS' RESPONSIBILITIES

The responsibility statement below has been prepared in connection with the full annual accounts of the Company for the year ended 30 September 2019. Certain parts of those accounts are not presented within this announcement.

The directors are responsible for preparing this Annual Report, including the consolidated and company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare consolidated financial statements for the Group and separate financial statements for the Company in respect of each financial year. In respect of the financial statements for the year ended 30 September 2019, that law includes the Companies Act 2006 ('the Act') and Article 4 of the IAS Regulation. That law requires the directors to prepare the consolidated financial statements in accordance with IFRS as adopted by the EU and they have also elected to prepare the financial statements of the Company in accordance with IFRS as adopted by the EU.

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.

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. In preparing each of the Consolidated and Company financial statements the directors are also required to:

- select suitable accounting policies and apply them consistently
- make judgements and estimates that are reasonable, relevant and reliable
- state whether the consolidated financial statements have been prepared in accordance with IFRS as adopted by the EU and whether the company financial statements have been prepared in accordance with the Act.
- assess the ability of the Group and the Company to continue as a going concern, disclosing, as applicable, matters related to going concern
- use the going concern basis of accounting unless they intend to liquidate the Company and / or the Group or to cease operation or they have no realistic alternative to doing so
- 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

The directors are responsible for keeping adequate accounting records for the Company are sufficient to record and explain its transactions, disclose with reasonable accuracy at any time its financial position and enable them to ensure that its financial statements comply with the requirements of the Act.

They are responsible for the implementation of such internal control processes as they deem necessary to enable the preparation of financial statements which are free from material misstatements, whether due to fraud or error, and have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Under applicable law and regulations the directors are also responsible for the preparation of a strategic report, directors' report, directors' remuneration report and corporate governance statement which comply with that law and those regulations.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website (www.paragonbankinggroup.co.uk). Legislation in the UK governing the preparation and dissemination of financial statements differs from legislation in other jurisdictions.

Confirmation by the Board of Directors

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, and includes a fair review of the development and performance of the business and the consolidated position of the Group taken as a whole, together with a description of the principal risks and uncertainties that it faces
- The Annual Report (including the consolidated and company financial statements), 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

26 November 2019

Board of Directors

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

PRELIMINARY FINANCIAL INFORMATION

CONSOLIDATED INCOME STATEMENT
For the year ended 30 September 2019

	Note	2019 IFRS 9 £m	2019 IFRS 9 £m	2018 IAS 39 £m	2018 IAS 39 £m
Interest receivable	3		505.7		451.9
Interest payable and similar charges	4		(227.3)		(197.3)
Net interest income			278.4		254.6
Other leasing income		18.3		16.3	
Related costs		(14.5)		(12.5)	
Net leasing income		3.8		3.8	
Gain on derecognition of financial assets	5	9.7		28.0	
Other income	6	15.4		15.5	
Other operating income			28.9		47.3
Total operating income			307.3		301.9
Operating expenses			(125.2)		(114.2)
Provisions for losses	11		(8.0)		(7.4)
Operating profit before fair value items			174.1		180.3
Fair value net (losses) / gains	7		(15.1)		1.2
Operating profit being profit on ordinary activities before taxation			159.0		181.5
Tax charge on profit on ordinary activities			(31.6)		(35.7)
Profit on ordinary activities after taxation for the financial year			127.4		145.8.

	Note	2019	2018
Earnings per share			
- basic	8	49.4p	55.9p
- diluted	8	48.2p	54.2p

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

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
For the year ended 30 September 2019

		2019 IFRS 9		2018 IAS 39	
	Note	**£m**	**£m**	**£m**	**£m**
Profit for the year			127.4		145.8
Other comprehensive income					
Items that will not be reclassified subsequently to profit or loss					
Actuarial (loss)/gain on pension scheme	17	(16.5)		8.9	
Tax thereon		2.4		(1.7)	
			(14.1)		7.2
Items that may be reclassified subsequently to profit or loss					
Cash flow hedge (gains)/losses taken to equity		0.5		1.0	
Tax thereon		(0.1)		(0.2)	
Reclassification on derecognition	5	(0.9)		-	
Tax thereon		0.2		-	
			(0.3)		0.8
Other comprehensive income for the year net of tax			(14.4)		8.0
Total comprehensive income for the year			113.0		153.8

CONSOLIDATED BALANCE SHEET
For the year ended 30 September 2019

	Note	2019 IFRS 9 £m	2018 IFRS 9 £m	2018 IAS 39 £m	2017 IAS 39 £m
Assets					
Cash – central banks	9	816.4	895.9	895.9	615.0
Cash – retail banks	9	409.0	414.7	414.7	881.9
Short term investments		-	-	-	-
Loans to customers	10	12,250.3	12,076.5	12,103.7	11,115.4
Derivative financial assets	12	592.4	855.7	855.7	906.6
Sundry assets		92.8	19.0	19.0	12.7
Deferred tax assets		6.2	-	-	-
Property, plant and equipment		57.3	56.8	56.8	46.2
Intangible assets	13	171.1	169.3	169.3	104.4
Total assets		14,395.5	14,487.9	14,515.1	13,682.2
Liabilities					
Short term bank borrowings		1.0	1.1	1.1	0.6
Retail deposits	14	6,395.8	5,292.4	5,292.4	3,611.9
Derivative financial liabilities	12	80.5	4.7	4.7	7.1
Asset backed loan notes	34	4,419.4	5,554.7	5,554.7	6,475.8
Secured bank borrowings	34	787.5	935.6	935.6	1,306.0
Retail bond issuance		296.5	296.1	296.1	295.7
Corporate bond issuance		149.6	149.3	149.3	149.1
Central bank facilities		994.4	1,024.4	1,024.4	700.0
Sundry liabilities		112.7	114.4	114.4	74.6
Current tax liabilities		15.2	21.4	21.4	17.4
Deferred tax liabilities		-	0.8	5.6	4.8
Retirement benefit obligations	17	34.5	19.5	19.5	29.8
Total liabilities		13,287.1	13,414.4	13,419.2	12,672.8
Called up share capital	18	261.6	281.6	281.6	281.5
Reserves	19	887.3	895.9	918.3	811.0
Own shares	20	(40.5)	(104.0)	(104.0)	(83.1)
Total equity		1,108.4	1,073.5	1,095.9	1,009.4
Total liabilities and equity		14,395.5	14,487.9	14,515.1	13,682.2

Approved by the Board of Directors on 26 November 2019.

Signed on behalf of the Board of Directors

N S Terrington
Chief Executive

R J Woodman
Chief Financial Officer

CONSOLIDATED CASH FLOW STATEMENT
For the year ended 30 September 2019

	Note	£m	£m
Net cash generated by operating activities	22	397.9	1,074.4
Net cash generated / (utilised) by investing activities	23	8.3	(282.8)
Net cash (utilised) by financing activities	24	(491.3)	(978.4)
Net (decrease) in cash and cash equivalents		(85.1)	(186.8)
Opening cash and cash equivalents		1,309.5	1,496.3
Closing cash and cash equivalents		1,224.4	1,309.5
Represented by balances within:			
Cash	9	1,225.4	1,310.6
Short term bank borrowings		(1.0)	(1.1)
		1,224.4	1,309.5

CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY
For the year ended 30 September 2019

Year ended 30 September 2019 (IFRS 9)

	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	-	-	-	-	-	127.4	-	127.4
Other comprehensive income	-	-	-	-	(0.3)	(14.1)	-	(14.4)
Total comprehensive income	-	-	-	-	(0.3)	113.3	-	113.0
Transactions with owners								
Dividends paid (note 21)	-	-	-	-	-	(54.0)	-	(54.0)
Shares cancelled	(21.6)	-	21.6	-	-	(95.5)	95.5	-
Own shares purchased	-	-	-	-	-	-	(34.3)	(34.3)
Exercise of share awards	1.6	2.5	-	-	-	(2.5)	2.3	3.9
Charge for share based remuneration	-	-	-	-	-	5.9	-	5.9
Tax on share based remuneration	-	-	-	-	-	0.4	-	0.4
Net movement in equity in the year	(20.0)	2.5	21.6	-	(0.3)	(32.4)	63.5	34.9
Opening equity								
As previously reported	281.6	65.8	28.7	(70.2)	3.3	890.7	(104.0)	1,095.9
Change of accounting policy (note 31)	-	-	-	-	-	(22.4)	-	(22.4)
As restated	281.6	65.8	28.7	(70.2)	3.3	868.3	(104.0)	1,073.5
Closing equity	261.6	68.3	50.3	(70.2)	3.0	835.9	(40.5)	1,108.4

CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY (Continued)
For the year ended 30 September 2019

Year ended 30 September 2018 (IAS 39)

	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 21)	-	-	-	-	-	(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

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2019

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 2017, 30 September 2018 or 30 September 2019, 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 2017 and 30 September 2018 have been delivered to the Registrar of Companies and those for the year ended 30 September 2019 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 and the Group undertakes no obligation to update these forward-looking statements. 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 2019 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.

The remaining notes to the preliminary financial information are organised in to three sections:

- Analysis – providing further analysis and information on the amounts shown in the condensed primary financial statements
- Capital and Credit Risk Management – providing information of the Group's management of operational and regulatory capital and its principal sources of credit risks
- Basis of preparation – providing details of the Group's accounting policies and of how they have been applied in the preparation of the preliminary financial information

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

The notes set out below give more detailed analysis of the balances shown in the primary financial statements and further information on how they relate to the operations, results and financial position of the Group and the Company.

2. 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 equipment leasing activities, development finance, structured lending and other offerings targeted towards SME customers, together with its motor finance business
- 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.

Gains on derecognition of financial assets have not been allocated to segment results, nor have the costs arising in the year ended 30 September 2018 from the Iceberg and Titlestone acquisitions of £2.2m as those are not directly related to customer facing activity.

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.

Other assets and liabilities are not allocated between segments.

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.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

2. SEGMENTAL INFORMATION (CONTINUED)

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 2019 (IFRS 9)

	Mortgages £m	Commercial Lending £m	Idem Capital £m	Unallocated Items £m	Total Segments £m
Interest receivable	342.1	95.7	61.3	6.6	505.7
Interest payable	(164.3)	(30.7)	(7.0)	(25.3)	(227.3)
Net interest income	177.8	65.0	54.3	(18.7)	278.4
Other operating income	6.8	11.0	1.4	9.7	28.9
Total operating income	184.6	76.0	55.7	(9.0)	307.3
Direct costs	(15.7)	(25.0)	(7.9)	(76.6)	(125.2)
Provisions for losses	(1.0)	(7.2)	0.2	-	(8.0)
	167.9	43.8	48.0	(85.6)	174.1

Year ended 30 September 2018 (IAS 39)

	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

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

	2019 £m	2018 £m
Results shown above	174.1	180.3
Fair value items	(15.1)	1.2
Operating profit	159.0	181.5

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

2. SEGMENTAL INFORMATION (CONTINUED)

The assets and liabilities attributable to each of the segments at 30 September 2019, 1 October 2018 and 30 September 2018 on the basis described above were:

	Note	Mortgages £m	Commercial Lending £m	Idem Capital £m	Total Segments £m
30 September 2019 (IFRS 9)					
Segment assets					
Loans to customers	10	10,344.1	1,452.1	389.9	12,186.1
Operating lease assets		-	36.3	-	36.3
Cross-currency basis swaps	12	582.7	-	-	582.7
Securitisation cash	9	352.6	-	-	352.6
		11,279.4	1,488.4	389.9	13,157.7
Segment liabilities					
Allocated deposits		5,367.2	1,822.5	303.1	7,492.8
Securitisation funding		5,206.9	-	-	5,206.9
		10,574.1	1,822.5	303.1	12,699.7

	Note	Mortgages £m	Commercial Lending £m	Idem Capital £m	Total Segments £m
1 October 2018 (IFRS 9)					
Segment assets					
Loans to customers	10	10,449.5	1,131.3	519.8	12,100.6
Operating lease assets		-	35.4	-	35.4
Cross-currency basis swaps	12	829.7	-	-	829.7
Securitisation cash	9	319.0	-	19.8	338.8
		11,598.2	1,166.7	539.6	13,304.5
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 – ANALYSIS
For the year ended 30 September 2019

2. SEGMENTAL INFORMATION (CONTINUED)

	Note	Mortgages £m	Commercial Lending £m	Idem Capital £m	Total Segments £m
30 September 2018 (IAS 39)					
Segment assets					
Loans to customers	10	10,473.5	1,133.2	521.1	12,127.8
Operating lease assets		-	35.4	-	35.4
Cross-currency basis swaps	12	829.7	-	-	829.7
Securitisation cash	9	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

An analysis of the Group's financial assets by type and segment is shown in note 10. 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 £11.6m (2018: £19.3m) 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.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

2. SEGMENTAL INFORMATION (CONTINUED)

	2019 IFRS 9 £m	2018 IFRS 9 £m	2018 IAS 39 £m
Total segment assets	13,157.7	13,304.5	13,331.7
Unallocated assets			
Central cash and investments	872.8	971.8	971.8
Unallocated derivatives	9.7	26.0	26.0
Operational property, plant and equipment	21.0	21.4	21.4
Intangible assets	171.3	169.3	169.3
Other	163.2	(5.1)	(5.1)
Total assets	14,395.7	14,487.9	14,515.1

	2019 IFRS 9 £m	2018 IFRS 9 £m	2018 IAS 39 £m
Total segment liabilities	12,699.7	13,047.2	13,047.2
Unallocated liabilities			
Unallocated retail deposits	(1,100.9)	(1,260.3)	(1,260.3)
Derivative financial instruments	80.5	4.7	4.7
Central borrowings	1,441.5	1,470.9	1,470.9
Tax liabilities	15.2	22.2	27.0
Retirement benefit obligations	34.5	19.5	19.5
Other	116.6	110.2	110.2
Total liabilities	13,287.1	13,414.4	13,419.2

3. INTEREST RECEIVABLE

	2019 IFRS 9 £m	2018 IAS 39 £m
Interest receivable in respect of		
Loan accounts	449.3	408.9
Finance leases	44.5	34.4
Factoring income	3.1	2.2
Interest on loans to customers	496.9	445.5
Other interest receivable	8.8	6.4
Total interest on financial assets	505.7	451.9

In 2018, under the requirements of IAS 39, interest receivable on loans to customers included £2.3m charged on accounts where an impairment provision had been made.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

4. INTEREST PAYABLE AND SIMILAR CHARGES

	Note	2019 £m	2018 £m
On retail deposits		114.2	83.1
On asset backed loan notes		63.4	60.3
On bank loans and overdrafts		9.6	16.5
On corporate bonds		10.9	10.9
On retail bonds		18.6	18.6
On central bank facilities		8.0	5.2
Total interest on financial liabilities		224.7	194.6
On pension scheme deficit	17	0.5	0.8
Discounting on contingent consideration		0.5	0.5
Other finance costs		1.6	1.4
		227.3	197.3

All interest payable on financial liabilities relates to financial liabilities held at amortised cost.

5. GAIN ON DISPOSAL OF FINANCIAL ASSETS

During the year, on 26 June 2019, the Group disposed of its residual interest in the Paragon Mortgages (No. 12) PLC securitisation transaction for a cash payment, in order to optimise capital usage. This participation, which exposed the Group to materially all of the credit risk in the securitised assets and entitled it to any net yield from these assets, was determined to give the Group control of the entity, as defined by IFRS 10. On disposal of the participation, this control ceased and hence the assets and the related external funding were derecognised.

The cash flow hedge relationship, including the derivatives and asset backed loan notes ceased on their derecognition and consequently an amount of £0.9m, less related tax of £0.2m, was recycled to profit and loss, and is included in other comprehensive income.

During the year ended 30 September 2018, 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.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

6. OTHER INCOME

	2019 £m	2018 £m
Loan account fee income	7.2	9.0
Broker commissions	2.2	2.1
Third party servicing	5.0	3.4
Other income	1.0	1.0
	15.4	15.5

7. FAIR VALUE NET (LOSSES) / GAINS

The fair value net (loss) / gain represents the accounting volatility on derivative instruments which are matching risk exposure on an economic basis generated by the hedge accounting requirements of IAS 39, which is still applied by the Group, as permitted by IFRS 9. 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 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.

8. EARNINGS PER SHARE

Earnings per ordinary share is calculated as follows:

		2019	2018
Profit for the year (£m)		127.4	145.8
Basic weighted average number of ordinary shares ranking for dividend during the year (million)		257.6	260.8
Dilutive effect of the weighted average number of share options and incentive plans in issue during the year (million)		6.7	8.4
Diluted weighted average number of ordinary shares ranking for dividend during the year (million)		264.3	269.2
Earnings per ordinary share	- basic	49.4p	55.9p
	- diluted	48.2p	54.2p

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

9. CASH AND CASH EQUIVALENTS

	2019 £m	2018 £m	2017 £m
Deposits with the Bank of England	816.4	895.9	615.0
Balances with central banks	816.4	895.9	615.0
Deposits with other banks	409.0	393.1	758.8
Money Market Fund investments	-	21.6	123.1
Balances with other banks	409.0	414.7	881.9
Cash and cash equivalents	1,225.4	1,310.6	1,496.9

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:

	2019 £m	2018 £m	2017 £m
Free cash	225.7	238.0	305.5
Securitisation cash	353.1	338.8	574.0
Liquidity buffer	646.4	724.9	615.0
ESOP cash	0.2	8.9	2.4
	1,225.4	1,310.6	1,496.9

'Cash and Cash Equivalents' includes current bank balances, money market placements and fixed rate sterling term deposits with London banks, and balances with the Bank of England.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

10. LOANS TO CUSTOMERS

	Note	2019 IFRS 9 £m	2018 IFRS 9 £m	2018 IAS 39 £m	2017 IAS 39 £m
Loans to customers		12,186.1	12,100.6	12,127.8	11,124.1
Fair value adjustments from portfolio hedging		64.2	(24.1)	(24.1)	(8.7)
		12,250.3	12,076.5	12,103.7	11,115.4

The Group's loans to customers at 30 September 2019, analysed between the segments described in note 2 are as follows:

	Mortgages £m	Commercial Lending £m	Idem Capital £m	Total £m
At 30 September 2019 (IFRS 9)				
First mortgages	10,172.5	-	-	10,172.5
Consumer loans	171.6	-	352.3	523.9
Motor finance	-	281.3	37.6	318.9
Asset finance	-	492.2	-	492.2
Development finance	-	506.5	-	506.5
Other commercial loans	-	172.1	-	172.1
Loans to customers	10,344.1	1,452.1	389.9	12,186.1
At 1 October 2018 (IFRS 9)				
First mortgages	10,308.3	-	-	10,308.3
Consumer loans	141.2	-	447.0	588.2
Motor finance	-	256.4	72.8	329.2
Asset finance	-	402.3	-	402.3
Development finance	-	352.9	-	352.9
Other commercial loans	-	119.7	-	119.7
Loans to customers	10,449.5	1,131.3	519.8	12,100.6
At 30 September 2018 (IAS 39)				
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 commercial loans	-	120.4	-	120.4
Loans to customers	10,473.5	1,133.2	521.1	12,127.8

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS

This note sets out information on the Group's impairment provisioning under IFRS 9 for the loans to customers balances set out in note 10, including both finance leases, accounted for under IAS 17, and loans held at amortised cost, accounted for under IFRS 9, as both groups of assets are subject to the IFRS 9 impairment requirements.

The disclosures are set out under the following headings:

- Basis of provision
- Impairments by stage and division
- Movements in impairment provision in the period
- Impairments charged to income
- Economic inputs to provision calculations

Basis of provision

IFRS 9 requires that impairment is evaluated on an expected credit loss ('ECL') basis. ECLs are based on an assessment of the probability of default ('PD') and loss given default ('LGD'), discounted to give a net present value. The estimation of ECL should be unbiased and probability weighted, considering all reasonable and supportable information, including forward looking economic assumptions and a range of possible outcomes. Provision may be based on either twelve month or lifetime ECL, dependant on whether an account has experienced a significant increase in credit risk ('SICR').

Calculation of expected credit loss ('ECL')

For the majority of the Group's loan assets, the ECL is generated using statistical models applied to account data to generate PD and LGD components.

PD on both a twelve month and lifetime basis is estimated based on statistical models for the Group's most significant asset classes. The PD calculation is a function of current asset performance, customer information and future economic assumptions. The structure of the models was derived through analysis of correlation in historic data, which identified which current and historical customer attributes and external economic variables were predictive of future loss. PD measures are calculated for the full contractual lives of loans with the models deriving probabilities that, at a given future date, a loan will be in default, performing or closed. The Group utilised all reasonably available information in its possession for this exercise.

LGD for each account is derived by calculating a value for exposure at the point of default (which will include consideration of future interest, account charges and receipts) and reducing this for security values, net of likely costs of recovery. These calculations allow for the Group's potential case management activities. This evaluation includes the potential impact of economic conditions at the time of any future default or enforcement. The derivation of the significant assumptions used in these calculations is discussed below.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

In certain asset classes a fully modelled approach is not possible. This is generally where there are few assets in the class, where there is insufficient historical data on which to base an analysis or where certain measures, such as days past due are not useful (e.g. where the loan agreement does not require regular payments of pre-determined amounts). In these cases, which represent a small proportion of the total portfolio, alternative approaches are adopted. These rely on internal credit monitoring practices and professional credit judgement.

Notwithstanding the mechanical procedures discussed above, the Group will always consider whether the process generates sufficient provision for particular loans, especially large exposures, and will provide additional amounts as appropriate.

Significant Increase in Credit Risk ('SICR')

Under IFRS 9, SICR is not defined solely by account performance, but on the basis of the customer's overall credit position, and this evaluation should include consideration of external data. The Group's aim is to define SICR to correspond, as closely as possible, to that population of accounts which are subject to enhanced administrative and monitoring procedures operationally. The Group assesses SICR in its modelled portfolios primarily on the basis of the relative difference in an account's lifetime PD between origination and the reporting date. The levels of difference required to qualify as an SICR may differ between portfolios and will depend, to some extent, on the level of risk originally perceived and are monitored on an ongoing basis to ensure that this calibrates with actual experience.

It should be noted that the use of the current PD, which includes external factors such as credit bureau data, means that all relevant information in the Group's hands concerning the customers present credit position is included in the evaluation, as well as the impact of future economic expectations.

Where for non-modelled portfolios, the SICR assessment is based on the credit monitoring position of the account in question and for all portfolios a number of qualitative indicators which provide evidence of SICR have been considered.

In all cases accounts which are more than one month in arrears, where this is a meaningful measure, are considered to have an SICR. However, in certain loan portfolios, regular monthly payments of pre-set amounts are not required and hence this criterion cannot be used.

The Group uses arrears multiples as a proxy for days past due, as this measure is commonly used in its arrears reporting. A loan will generally be one month in arrears from the point it is one day past due until it is thirty days past due.

Definitions of default

As the IFRS 9 definition of ECL is based on PD, default must be defined for this purpose. The Group's definitions of default for its various portfolios are aligned to its internal operational procedures and the regulatory definitions of default used internally. In particular the Group's receiver of rent cases are defined as defaulted for modelling purposes as the behaviour of the case after that point is significantly influenced by internal management decisions.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

IFRS 9 provides a rebuttable presumption that an account is in default when it is ninety days overdue and this was used as the basis of the Group's definition. A combination of qualitative and quantitative measures were used in developing the definitions. These include account management activities and internal statuses.

Credit Impaired loans

IFRS 9 defines a credit impaired account as one where an account has suffered one or more event which has had a detrimental effect on future cash flows. It is thus a backward looking definition, rather than one based on future expectations.

Credit impaired assets are identified either through quantitative measures or by operational status. Designations of accounts for regulatory capital purposes are also taken into account. Assets may also be assigned to Stage 3 if they are identified as credit impaired as a result of management review processes.

All loans which are in the process of enforcement, from the point where this becomes the administration strategy, are classified as credit impaired.

During the year the Group revised certain of its default definitions for regulatory purposes. Where appropriate, IFRS 9 definitions have been amended to harmonise with the new definition and hence the staging at 1 October 2018 set out above differs from that presented in the Group's transition report.

As a result of this harmonisation all default cases are considered to be credit impaired, including all receiver of rent cases and all cases with at least one payment more than ninety days overdue, even where such cases are being managed in the expectation of realising all of the carrying balance. In order to provide better information for users, additional analysis of credit impaired accounts has been presented below distinguishing between receiver of rent account, accounts subject to realisation / enforcement procedures and long term managed accounts, all of which are treated as credit impaired.

IFRS 9 Staging

IFRS 9 calculations and related disclosures require loan assets to be divided into three stages, with accounts which were credit impaired on initial recognition representing a fourth class.

The three classes comprise: those where there has been no SICR since advance or acquisition (Stage 1); those where there has been a SICR (Stage 2); and loans which are impaired (Stage 3).

- On initial recognition, and for assets where there has not been an SICR, provisions will be made in respect of losses resulting from the level of credit default events expected in the twelve months following the balance sheet date
- Where a loan has experienced an SICR, whether or not the loan is considered to be credit impaired, provisions will be made based on the ECLs over the full life of the loan
- For credit impaired assets, provisions will also be made on the basis of ECLs.

For assets which were 'Purchased or Originated as Credit Impaired' ('POCI') accounts (i.e. considered as credit impaired at the point of first recognition), such as certain of the Group's acquired assets in Idem Capital, the carrying valuation is based on expected cash flows discounted by the EIR determined at the point of acquisition.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Impairments by stage

An analysis of the Group's loan portfolios between the stages defined above is set out below.

	Stage 1	Stage 2 *	Stage 3 *	POCI	Total
	£m	£m	£m	£m	£m
30 September 2019					
Gross loan book					
Mortgages	9,847.7	378.2	129.3	15.7	10,370.9
Commercial Lending	1,376.7	64.6	8.2	13.3	1,462.8
Idem Capital	158.2	15.7	30.4	190.0	394.3
Total	11,382.6	458.5	167.9	219.0	12,228.0
Impairment provision					
Mortgages	(0.4)	(2.0)	(24.4)	-	(26.8)
Commercial Lending	(5.4)	(1.3)	(4.0)	-	(10.7)
Idem Capital	(0.2)	(0.4)	(3.8)	-	(4.4)
Total	(6.0)	(3.7)	(32.2)	-	(41.9)
Net loan book					
Mortgages	9,847.3	376.2	104.9	15.7	10,344.1
Commercial Lending	1,371.3	63.3	4.2	13.3	1,452.1
Idem Capital	158.0	15.3	26.6	190.0	389.9
Total	11,376.6	454.8	135.7	219.0	12,186.1
Coverage ratio					
Mortgages	-	0.53%	18.87%	-	0.26%
Commercial Lending	0.39%	2.01%	48.78%	-	0.73%
Idem Capital	0.13%	2.55%	12.50%	-	1.12%
Total	0.05%	0.81%	19.18%	-	0.34%

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

	Stage 1 £m	Stage 2 * £m	Stage 3 * £m	POCI £m	Total £m
1 October 2018					
Gross loan book					
Mortgages	9,961.6	369.9	142.4	11.7	10,485.6
Commercial Lending	1,106.4	8.2	5.8	17.5	1,137.9
Idem Capital	278.9	19.7	40.0	192.7	531.3
Total	11,346.9	397.8	188.2	221.9	12,154.8
Impairment provision					
Mortgages	(0.3)	(1.7)	(34.1)	-	(36.1)
Commercial Lending	(4.2)	(0.4)	(2.0)	-	(6.6)
Idem Capital	(0.4)	(0.5)	(10.6)	-	(11.5)
Total	(4.9)	(2.6)	(46.7)	-	(54.2)
Net loan book					
Mortgages	9,961.3	368.2	108.3	11.7	10,449.5
Commercial Lending	1,102.2	7.8	3.8	17.5	1,131.3
Idem Capital	278.5	19.2	29.4	192.7	519.8
Total	11,342.0	395.2	141.5	221.9	12,100.6
Coverage ratio					
Mortgages	-	0.46%	23.95%	-	0.34%
Commercial Lending	0.38%	4.88%	34.48%	-	0.58%
Idem Capital	0.14%	2.54%	26.50%	-	2.16%
Total	0.04%	0.65%	24.81%	-	0.45%

* Stage 2 and 3 balances are analysed in more detail below.

In terms of the Group’s credit management processes, Stage 1 cases will fall within the appropriate customer servicing functions and Stage 2 cases will be subject to account management arrangements. Stage 3 cases will include both those subject to recovery or similar processes and those which, though being managed on a long-term basis, are included with defaulted accounts for regulatory purposes. However, these broad categorisations may vary between different product types.

POCI balances included in the Commercial Lending segment arise principally from acquired businesses, where those assets were identified as credit impaired at the point of acquisition when the acquired portfolios as a whole were evaluated.

Idem Capital loans include acquired consumer and motor finance loans together with legacy (originated pre-2010) second charge mortgage and unsecured consumer loans. Legacy assets and acquired loans which were performing on acquisition are included in the staging analysis above. Acquired portfolios which were largely non-performing at acquisition, and which were purchased at a deep discount to face value are shown as POCI assets above. Although no provision is shown above for such assets, the effect of the discount on purchase is included in the gross value ensuring that the carrying value is substantially less than the current balances due from customers and the level of cover is considerable.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Analysis of Stage 2 loans

The table below analyses the accounts in Stage 2 between those not more than one month in arrears where an SICR has nonetheless been identified from other information and accounts more than one month in arrears, which are automatically deemed to have an SICR.

Coverage for Stage 2 cases remains broadly similar year-on-year in both the Mortgages and Idem Capital divisions. Within the Commercial Lending, the '<1 month' total in 2019 includes increased balances from the maturing structured lending and development finance portfolios, where security levels are high and hence provision requirements are generally lower than for other businesses within the division. The '>1 month <=3 months' total in Commercial Lending includes very few cases and hence the coverage ratio may vary depending on the cases currently in progress.

	< 1 month arrears	> 1 <= 3 months arrears	Total
	£m	£m	£m
30 September 2019			
Gross loan book			
Mortgages	336.3	41.9	378.2
Commercial Lending	57.2	7.4	64.6
Idem Capital	7.7	8.0	15.7
Total	401.2	57.3	458.5
Impairment provision			
Mortgages	(1.3)	(0.7)	(2.0)
Commercial Lending	(1.0)	(0.3)	(1.3)
Idem Capital	(0.2)	(0.2)	(0.4)
Total	(2.5)	(1.2)	(3.7)
Net loan book			
Mortgages	335.0	41.2	376.2
Commercial Lending	56.2	7.1	63.3
Idem Capital	7.5	7.8	15.3
Total	398.7	56.1	454.8
Coverage ratio			
Mortgages	0.39%	1.67%	0.53%
Commercial Lending	1.75%	4.05%	2.01%
Idem Capital	2.60%	2.50%	2.55%
Total	0.62%	2.09%	0.81%

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

	< 1 month arrears £m	> 1 <= 3 months arrears £m	Total £m
1 October 2018			
Gross loan book			
Mortgages	306.3	63.6	369.9
Commercial Lending	4.0	4.2	8.2
Idem Capital	8.8	10.9	19.7
Total	319.1	78.7	397.8
Impairment provision			
Mortgages	(0.8)	(0.9)	(1.7)
Commercial Lending	(0.1)	(0.3)	(0.4)
Idem Capital	(0.2)	(0.3)	(0.5)
Total	(1.1)	(1.5)	(2.6)
Net loan book			
Mortgages	305.5	62.7	368.2
Commercial Lending	3.9	3.9	7.8
Idem Capital	8.6	10.6	19.2
Total	318.0	77.2	395.2
Coverage ratio			
Mortgages	0.26%	1.42%	0.46%
Commercial Lending	2.50%	7.14%	4.88%
Idem Capital	2.27%	2.75%	2.54%
Total	0.34%	1.91%	0.65%

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Analysis of Stage 3 loans

The table below analyses the accounts in Stage 3 between accounts in the process of enforcement or where full recovery is considered unlikely ('Realisations' in the table), loans being managed on a long term basis where full recovery is possible but which are considered in default for regulatory purposes and buy-to-let mortgages where a receiver of rent ('RoR') has been appointed by the Group to manage the property on the customer's behalf. RoR accounts in Stage 3 may be fully up-to-date with full recovery possible. These accounts are included in Stage 3 as they are classified as defaulted for regulatory purposes.

Coverage for Stage 3 Mortgages has reduced over the year as a number of heavily provided legacy receiver of rent cases have been resolved, as discussed further below. The coverage ratio for Commercial Lending is subject to large fluctuations, as the number and absolute value of Stage 3 cases are relatively low and hence the specific details of individual cases will influence the ratio. In Idem Capital, the principal impact on the values shown above was a major operational review of legacy balances during the year which resulted in a chance in the collection strategy and a consequent writing off of a large proportion of the balances shown at 1 October 2018.

	> 3 month arrears £m	RoR managed £m	Realisations £m	Total £m
30 September 2019				
Gross loan book				
Mortgages	8.3	106.3	14.7	129.3
Commercial Lending	1.7	-	6.5	8.2
Idem Capital	26.0	-	4.4	30.4
Total	36.0	106.3	25.6	167.9
Impairment provision				
Mortgages	(0.4)	(19.3)	(4.7)	(24.4)
Commercial Lending	(0.5)	-	(3.5)	(4.0)
Idem Capital	(1.9)	-	(1.9)	(3.8)
Total	(2.8)	(19.3)	(10.1)	(32.2)
Net loan book				
Mortgages	7.9	87.0	10.0	104.9
Commercial Lending	1.2	-	3.0	4.2
Idem Capital	24.1	-	2.5	26.6
Total	33.2	87.0	15.5	135.7
Coverage ratio				
Mortgages	4.82%	18.16%	31.97%	18.87%
Commercial Lending	29.41%	-	53.85%	48.78%
Idem Capital	7.31%	-	43.18%	12.50%
Total	7.78%	18.16%	39.45%	19.18%

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

	> 3 month arrears £m	RoR managed £m	Realisations £m	Total £m
1 October 2018				
Gross loan book				
Mortgages	5.0	116.3	21.1	142.4
Commercial Lending	1.1	-	4.7	5.8
Idem Capital	29.0	-	11.0	40.0
Total	35.1	116.3	36.8	188.2
Impairment provision				
Mortgages	-	(26.8)	(7.3)	(34.1)
Commercial Lending	(0.4)	-	(1.6)	(2.0)
Idem Capital	(1.7)	-	(8.9)	(10.6)
Total	(2.1)	(26.8)	(17.8)	(46.7)
Net loan book				
Mortgages	5.0	89.5	13.8	108.3
Commercial Lending	0.7	-	3.1	3.8
Idem Capital	27.3	-	2.1	29.4
Total	33.0	89.5	19.0	141.5
Coverage ratio				
Mortgages	-	23.04%	34.60%	23.95%
Commercial Lending	36.36%	-	34.04%	34.48%
Idem Capital	5.86%	-	80.91%	26.50%
Total	5.98%	23.04%	48.37%	24.81%

The RoR managed accounts are being managed to ensure the optimal resolution for landlords, tenants and lenders and this long-term, stable situation underpinned their treatment as not impaired under IAS 39, but the existence of the RoR arrangement causes the accounts to be treated as defaulted for regulatory purposes. The Group's RoR arrangements are described in more detail below.

Idem Capital balances with over three months arrears comprise principally second charge mortgage accounts originated over ten years ago which have been over three months in arrears for some time. These accounts are generally making regular payments and have significant levels of equity in the underlying property which reduces the required provision to the value shown above. It is expected that a high proportion of these accounts will eventually redeem naturally, either on the sale of the property or by the satisfaction of the amount due through instalment payments.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Buy-to-let receiver of rent cases (Stage 3)

Where a buy-to-let mortgage customer in England or Wales falls into arrears on their account the Group has the power to appoint a receiver of rent under the Law of Property Act. The receiver will then manage the property on behalf of the customer, collecting rents and remitting them to make payments on the account. While the receiver has the power to sell the property, in many cases they will operate it as a buy-to-let on at least a short to medium term basis, potentially longer, depending on the individual circumstances of the case. This causes less disruption to the tenants and may result in the mortgage account returning to performing status and the property being handed back to the customer.

The following table analyses the number and gross carrying value of RoR managed accounts shown above by the date of the receivers' appointment, illustrating this position.

	30 September 2019		1 October 2018	
	No.	£m	No.	£m
Managed accounts				
Appointment date				
2010 and earlier	402	70.5	464	83.0
2011 to 2013	86	17.3	107	21.8
2014 to 2016	31	4.5	40	5.9
2016 and later	84	14.0	44	5.6
Total managed accounts	603	106.3	655	116.3
Accounts in the process of realisation	80	11.9	115	16.9
	683	118.2	770	133.2

Receiver of rent accounts in the process of realisation at the period end are included under that heading.

Movements in impairment provision

The movements in the impairment provision calculated under IFRS 9, analysed by business segments, are set out below.

	Mortgages	Commercial Lending	Idem Capital	Total
	£m	£m	£m	£m
At transition – 1 October 2018	36.1	6.6	11.5	54.2
Provided in period	1.2	7.2	0.3	8.7
Amounts written off	(9.1)	(3.1)	(7.4)	(19.6)
Assets derecognised	(1.4)	-	-	(1.4)
At 30 September 2019	26.8	10.7	4.4	41.9

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

The principal factors generating the reduction in the loss allowance in the period are the derecognition of the PM12 assets, shown above as 'assets derecognised', a major account review exercise relating to unsecured legacy assets, resulting in the cessation of collection on a large number of accounts and a write off of £5.8m and realisations on RoR cases where provisions of £7.3m were utilised.

Accounts are considered to be written off for accounting purposes if a balance remains once standard enforcement processes have been completed, subject to any amount retained in respect of expected salvage receipts. This has no effect on the net carrying value, only on the amounts reported as gross loan balances and accumulated impairment provisions.

Impairments charged to income

The amounts charged to the profit and loss account in the period are analysed as follows.

	Mortgages	Commercial Lending	Idem Capital	2019 IFRS 9	2018 IAS 39
	£m	£m	£m	£m	£m
Provided in period	1.2	7.2	0.3	8.7	9.1
Recovery of written off amounts	(0.2)	-	(0.5)	(0.7)	(1.7)
	1.0	7.2	(0.2)	8.0	7.4
Of which					
Loan accounts	1.0	2.8	(0.2)	3.6	5.6
Finance leases	-	4.4	-	4.4	1.8
	1.0	7.2	(0.2)	8.0	7.4

Economic impacts

Impairment provision under IFRS 9 is calculated on a forward-looking ECL basis, based on expected economic conditions in multiple internally coherent scenarios. The Group uses four distinct economic scenarios chosen to represent the range of possible outcomes and allow for the impact of economic asymmetry in the calculations.

As the Group does not have an internal economics function, in developing its economic scenarios it considers analysis from reputable external sources to form a general market consensus which inform its central scenario. These sources included forecasts produced by the Office of Budget Responsibility ('OBR') and the PRA as well as private sector economic research bodies.

The outlook in the central scenario at 30 September 2019 is broadly similar to that a year earlier, although both the forecast level of bank rates and consumer lending growth are reduced, reflecting a more pessimistic economic outlook. However, the house price growth forecast over the five year period is a little stronger.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

The central scenario is the economic forecast used within the Group for planning purposes and represents its expectation of the most likely outcome. The upside and downside scenarios are less likely variants developed from this base case. The final scenario represents a protracted slump and is derived from the Bank of England's annual stress testing scenarios. Each scenario comprises a number of economic parameters and while models for different portfolios may not use all of the variables, the set, as a whole, is defined for the Group and must be consistent.

The Group defines its upside and downside scenarios by reference to the central scenario. It is therefore necessary for management to consider the relative weightings that should apply to each of these scenarios when ECLs are calculated. At 30 September 2019, the directors considered the movements already reflected in the scenarios and the levels of uncertainty in the UK political and economic climate more generally and concluded that, while the central scenario still provided an appropriate basis for planning purposes, the downside risks had increased over the twelve months. The directors therefore determined that the weighting attributed to the downside scenario should be increased, and that to the upside scenario reduced.

The economic variables comprising each scenario, and their projected average rates of increase (or decrease) for the first five years of the forecast period are set out below.

30 September 2019

	Central scenario	Upside scenario	Downside scenario	Severe downside scenario
Weighting applied	*40%*	*20%*	*35%*	*5%*
Economic driver				
Gross Domestic Product ('GDP') (increase)	1.7%	2.2%	1.0	(0.1)%
House Price Index ('HPI') (increase)	3.3%	5.5%	(0.1)%	(5.3)%
Bank Base Rate ('BBR')	0.8%	1.9%	0.5%	0.0%
Consumer Price Inflation ('CPI')	2.1%	1.8%	2.5%	3.1%
Unemployment (rate)	3.9%	3.5%	5.6%	8.0%
Secured lending (annual change)	3.6%	4.2%	2.7%	1.4%
Consumer credit (annual change)	6.1%	7.6%	3.8%	0.3%

1 October 2018

	Central scenario	Upside scenario	Downside scenario	Severe downside scenario
Weighting applied	*40%*	*30%*	*25%*	*5%*
Economic driver				
Gross Domestic Product ('GDP') (increase)	1.6%	2.0%	0.9%	(0.1)%
House Price Index ('HPI') (increase)	3.0%	5.1%	(0.3)%	(5.2)%
Bank Base Rate ('BBR')	1.2%	1.7%	0.7%	0.0%
Consumer Price Inflation ('CPI')	2.1%	1.8%	2.6%	3.3%
Unemployment (rate)	3.9%	3.6%	5.7%	8.3%
Secured lending (annual change)	3.2%	3.6%	2.5%	1.5%
Consumer credit (annual change)	8.6%	10.5%	5.3%	0.6%

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Superseded disclosures

Further information relating to comparative disclosures under IAS 39 which are no longer relevant under IFRS 9 is included in note 26.

12. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING

The analysis below splits derivatives between those accounted for within portfolio fair value hedges, or as cash flow hedges and those which, despite representing an economic hedge, are not accounted for as hedges. There were no individual interest rate risk hedging arrangements in place either in the year ended 30 September 2019 or the preceding year.

	2019 Assets £m	2019 Liabilities £m	2018 Assets £m	2018 Liabilities £m
Derivatives in hedge accounting relationships				
Fair value hedges				
Interest rate swaps	7.8	(78.5)	23.9	(4.5)
Cash flow hedges				
Cross-currency basis swaps	582.7	-	829.7	-
Total derivatives in hedge accounting relationships	590.5	(78.5)	853.6	(4.5)
Other derivatives				
Interest rate swaps	1.9	(2.0)	2.1	(0.2)
Currency futures	-	-	-	-
Total recognised derivative assets/(liabilities)	592.4	(80.5)	855.7	(4.7)

The accounting treatment of these derivative assets and liabilities remain the same under IFRS 9. All hedging relationships and strategies at 30 September 2018 have continued in the period.

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.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

13. INTANGIBLE ASSETS

Intangible assets at net book value comprise:

	2019 £m	2018 £m	2017 £m
Goodwill	164.4	162.2	98.1
Computer software	2.4	2.1	2.0
Other intangibles	4.3	5.0	4.3
Total assets	171.1	169.3	104.4

The movements in goodwill shown above include the adjustments to acquisition accounting described in note 33.

14. 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:

	2019 £m	2018 £m	2017 £m
Fixed rate	4,154.4	3,643.1	2,675.9
Variable rates	2,237.5	1,653.5	939.5
	6,391.9	5,296.6	3,615.4

The weighted average interest rate on retail deposits at 30 September 2019, analysed by charging method, was:

	2019 %	2018 %	2017 %
Fixed rate	2.02	1.94	1.89
Variable rates	1.43	1.36	1.21
All deposits	1.81	1.76	1.71

The contractual maturity of these deposits is analysed below.

	2019 £m	2018 £m	2017 £m
Amounts repayable			
In less than three months	466.6	256.8	211.4
In more than three months, but not more than one year	2,088.4	2,024.7	1,399.6
In more than one year, but not more than two years	1,158.0	1,010.6	770.0
In more than two years, but not more than five years	900.9	655.3	629.7
Total term deposits	4,613.9	3,947.4	3,010.7

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Repayable on demand	1,778.0	1,349.2	604.7
	6,391.9	5,296.6	3,615.4
Fair value adjustments for portfolio hedging	3.9	(4.2)	(3.5)
	6,395.8	5,292.4	3,611.9

15. BORROWINGS

On 27 March 2019, Fitch Ratings confirmed the Group's Long-Term Issuer Default Rating and its senior unsecured debt rating at BBB. Consequentially the rating of the Group's £150.0m Tier 2 Bond was also maintained at BBB-.

All borrowings described in the Group Accounts for the year ended 30 September 2018 remained in place throughout the period, except as noted below.

During the period the Group continued to access the Indexed Long-Term Repo ('ILTR') scheme provided by the Bank of England.

On 3 July 2019, a Group company, Paragon Mortgages (No. 26) PLC, issued £364.3m of sterling mortgage backed floating rate notes to external investors at par. All of the notes were class A notes, rated AAA by Fitch and Aaa by Moody's. The interest rate above SONIA on the notes was 1.05%. The proceeds were used to refinance existing short-term liabilities. The Group retained £273.9m of notes of various classes meaning that its investment represented 43.0% of the issued notes.

During the year, the Group redeemed all of the outstanding notes of the following securitisation at par:

- Paragon Secured Finance (No. 1) PLC on 15 November 2018
- First Flexible (No. 5) PLC on 3 December 2018
- Paragon Mortgages (No. 21) PLC on 17 December 2018
- Paragon Mortgages (No. 22) PLC on 17 June 2019
- First Flexible (No. 7) PLC on 17 June 2019

The underlying assets were subsequently funded by other Group companies.

On 25 September 2019, notice was given of the Group's intention to redeem all of the outstanding notes of Paragon Mortgages (No. 23) PLC at par, and this took place on 15 October 2019, after the year end.

On 26 June 2019, the Group disposed of its beneficial interest in the Paragon Mortgages (No. 12) PLC securitisation as described in note 5. At that point, the FRN liabilities were derecognised by the Group, although the notes remain in issue.

On 14 November 2018, a new £200.0m warehouse funding facility was agreed between Paragon Seventh Funding Limited and Bank of America Merrill Lynch. The facility is secured over all of the assets of Paragon Seventh Funding Limited, with a 12 month commitment period. Interest is payable at 0.95% over three month LIBOR.

Repayments made in respect of the Group's borrowings are shown in note 24.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

16. SUNDRY LIABILITIES

Sundry liabilities include £38.8m of amounts falling due after more than one year (2018: £40.8m; 2017: £23.5m). Contingent consideration of £21.3m, falling due after more than one year, is included in the sundry liabilities balance (2018: £25.7m, 2017: £14.0m).

17. RETIREMENT BENEFIT OBLIGATIONS

For accounting purposes, the valuation at 31 March 2016 was updated to 30 September 2019 in accordance with the requirements of IAS 19 (revised) by Mercer, the Group's independent consulting actuary. Since the last IAS 19 actuarial valuation at 30 September 2018 there have been movements in financial conditions, requiring an adjustment to the actuarial assumptions underlying the calculation of the defined benefit obligation at 30 September 2019. In particular, over the period since the 30 September 2018 actuarial valuation, the discount rate has decreased by 110 basis points per annum, whereas expectations of long term inflation have fallen by only 40 basis points per annum.

The net effect of these changes, together with the Group's contribution and the performance of the plan assets, has resulted in the value of the defined benefit obligation at 30 September 2019 increasing substantially from that at 30 September 2018. The impact of allowing for the change in actuarial assumptions has been recognised as an actuarial loss in other comprehensive income.

The movements in the deficit on the defined benefit plan during the year ended 30 September 2019 are summarised below.

	2019	**2018**
	£m	**£m**
Opening pension deficit	19.5	29.8
Current service cost	1.6	1.8
Past service cost	0.3	-
Net funding cost	0.5	0.8
Administrative expenses	0.7	0.5
Employer contributions	(4.6)	(4.5)
Amounts posted to other comprehensive income		
Return on plan assets not included in interest	(6.6)	(7.4)
Actuarial (gain) arising from demographic assumptions	(1.4)	(6.7)
Actuarial loss / (gain) arising from experience adjustments	24.5	(4.2)
Actuarial (gain) from changes in financial assumptions	-	(10.7)
Closing pension deficit	34.5	19.5

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For the year ended 30 September 2019

18. 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:

	2019 Number	2018 Number
Ordinary shares		
At 1 October 2018	281,596,936	281,489,701
Shares issued	1,606,849	107,235
Shares cancelled	(21,630,434)	-
At 30 September 2019	261,573,351	281,596,936

During the year the Company issued 1,606,849 shares (2018: 107,235) to satisfy options granted under Sharesave schemes for a consideration of £4,075,843 (2018: £360,031).

On 31 July 2019, 21,630,434 shares held in treasury were cancelled by the Company.

19. RESERVES

	2019 IFRS 9 £m	2018 IFRS 9 £m	2018 IAS 39 £m	2017 IAS 39 £m
Share premium account	68.3	65.8	65.8	65.5
Capital redemption reserve	50.3	28.7	28.7	28.7
Merger reserve	(70.2)	(70.2)	(70.2)	(70.2)
Cash flow hedging reserve	3.0	3.3	3.3	2.5
Profit and loss account	835.9	868.3	890.7	784.5
	887.3	895.9	918.3	811.0

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

20. OWN SHARES

	2019 £m	2018 £m
Treasury shares		
At 1 October 2018	91.8	66.6
Shares purchased	26.7	25.2
Shares cancelled	(95.5)	-
At 30 September 2019	23.0	91.8
ESOP shares		
At 1 October 2018	12.2	16.5
Shares purchased	7.6	6.2
Options exercised	(2.3)	(10.5)
At 30 September 2019	17.5	12.2
Balance at 30 September 2019	40.5	104.0
Balance at 1 October 2018	104.0	83.1

At 30 September 2019 the number of the Company's own shares held in treasury was 5,218,702 (2018: 20,800,284). These shares had a nominal value of £5,218,702 (2018: £20,800,284). 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 2019, the trust held 3,912,516 ordinary shares (2018: 2,874,825) with a nominal value of £3,912,516 (2018: £2,874,825) and a market value of £18,873,977 (2018: £13,764,662). Options, or other share-based awards, were outstanding against all of these shares at 30 September 2019 (2018: all). The dividends on all of these shares have been waived (2018: all).

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

21. EQUITY DIVIDEND

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

	2019 Per share	2018 Per share	2019 £m	2018 £m
Equity dividends on ordinary shares				
Final dividend for the year ended 30 September 2018	13.9p	11.0p	35.9	28.9
Interim dividend for the year ended 30 September 2019	7.0p	5.5p	18.1	14.2
	20.9p	16.5p	54.0	43.1

Amounts paid and proposed in respect of the year:

	2019 Per share	2018 Per share	2019 £m	2018 £m
Interim dividend for the year ended 30 September 2018	7.0p	5.5p	18.1	14.2
Proposed final dividend for the year ended 30 September 2019	14.2p	13.9p	35.8	35.8
	21.2p	19.4p	53.9	50.0

The proposed final dividend for the year ended 30 September 2019 will be paid on 17 February 2020, subject to approval at the Annual General Meeting, with a record date of 10 January 2020. The dividend will be recognised in the accounts when it is paid.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

22. NET CASH FLOW FROM OPERATING ACTIVITIES

	2019 £m	2018 £m
Profit before tax	159.0	181.5
Non-cash items included in profit and other adjustments:		
Depreciation of operating property, plant and equipment	1.5	1.9
Profit on disposal of operating property, plant and equipment	-	(0.2)
Amortisation of intangible assets	2.4	2.1
Foreign exchange movement on borrowings	(124.8)	(67.6)
Other non-cash movements on borrowings	3.6	6.0
Impairment losses on loans to customers	8.0	7.4
Charge for share based remuneration	5.9	6.1
Gain on derecognition	(9.7)	-
Derecognition of cash flow hedge	(0.9)	-
Net (increase) / decrease in operating assets:		
Operating lease assets	(0.9)	(12.0)
Loans to customers	(792.0)	(781.7)
Derivative financial instruments	169.7	50.9
Fair value of portfolio hedges	(88.3)	15.4
Other receivables	(73.8)	(6.1)
Net increase / (decrease) in operating liabilities:		
Retail deposits	1,095.3	1,681.2
Derivative financial instruments	75.8	(2.4)
Fair value of portfolio hedges	8.1	(0.7)
Other liabilities	(1.6)	24.6
Cash generated by operations	437.3	1,106.4
Income taxes (paid)	(39.4)	(32.0)
	397.9	1,074.4

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

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

23. NET CASH FLOW FROM INVESTING ACTIVITIES

	2019 £m	2018 £m
Proceeds from sales of operating property, plant and equipment	-	0.5
Purchases of operating property, plant and equipment	(1.1)	(0.8)
Purchases of intangible assets	(2.0)	(1.5)
Residual disposal (note 5)	11.4	-
Acquisitions (note 33)	-	(281.0)
Net cash generated / (utilised) by investing activities	8.3	(282.8)

24. NET CASH FLOW FROM FINANCING ACTIVITIES

	2019 £m	2018 £m
Shares issued (note 18)	3.9	0.4
Dividends paid (note 21)	(54.0)	(43.1)
Issue of asset backed floating rate notes	362.5	432.5
Repayment of asset backed floating rate notes	(591.1)	(1,289.7)
Movement on central bank facilities	(30.0)	324.4
Movement on other bank facilities	(148.3)	(371.1)
Purchase of shares (note 20)	(34.3)	(31.8)
Net cash (utilised) by financing activities	(491.3)	(978.4)

25. RELATED PARTY TRANSACTIONS

In the year ended 30 September 2019, the Group has continued the related party relationships described in note 66 on page 226 of the Annual Report and Accounts of the Group for the financial year ended 30 September 2018. Related party transactions in the period comprise the compensation of the Group's key management personnel, transactions with the Group Pension Plan, the acceptance of retail deposits from certain non-executive directors and fees paid to a non-executive director who retired during the year 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.

Except for the transactions referred to above, there have been no related party transactions in the year ended 30 September 2019.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

26. DISCLOSURES UNDER IAS 39

Certain disclosures made in respect of IAS 39 based amounts are not directly comparable to IFRS 9 disclosures, but still form part of the comparative financial information. To avoid confusion, these are presented below.

(a) Ageing of IAS 39 exposures

The payment status of the carrying balances of the Group's live loan assets, before provision for impairment, at 30 September 2018, split between those accounts considered as performing and those included in the population for impairment testing, is shown below. This disclosure is not required under IFRS 9, however comparative amounts are still required to be presented. Balances for immaterial asset classes are not shown. 'Asset finance loans' below includes other related loan balances. Fully provided non-live accounts 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
Not past due	10,211.1
Arrears less than 3 months	101.7
Performing accounts	10,312.8
Arrears 3 to 6 months	3.0
Arrears 6 to 12 months	2.2
Arrears over 12 months	5.7
Possessions and similar cases	22.1
Impairment population	33.0
Total gross balances	10,345.8
Impairment provision on live cases	(12.7)
Timing adjustments	(0.9)
Carrying balance	10,332.2

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

26. DISCLOSURES UNDER IAS 39 (CONTINUED)

Consumer and asset finance

	Second charge mortgage loans	Motor finance loans	Asset finance loans	Total
	£m	£m	£m	£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

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 – ANALYSIS
For the year ended 30 September 2019

26. DISCLOSURES UNDER IAS 39 (CONTINUED)

(b) Analysis of buy-to-let mortgages under IAS 39

The Group's outstanding exposure to buy-to-let loans with an appointed receiver at 30 September 2018 calculated on the basis of IAS 39 is set out below. A different analysis, based on the IFRS 9 staging approach, has been presented in note 11, superseding this disclosure.

	2018 Gross £m	2018 Provision £m	2018 Net £m
Performing loans			
Let with less than 3 months arrears	106.6	(1.1)	105.5
Impaired loans			
Let with over 3 months arrears	5.9	(2.5)	3.4
Vacant or on sale	20.7	(6.4)	14.3
Impairment population	26.6	(8.9)	17.7
Total balances	133.2	(10.0)	123.2

(c) Movement in impairment provision

The following amounts in respect of impairment provisions under IAS 39, net of allowances for recoveries of written off assets, have been deducted from the appropriate assets in the balance sheet. This disclosure has been superseded under IFRS 9, but disclosures for comparator periods are still required.

	First mortgages £m	Other loans and receivables £m	Finance leases £m	Total £m
At 1 October 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 are provided for in full.

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

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2019

26. DISCLOSURES UNDER IAS 39 (CONTINUED)

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

This impairment charge was analysed as set out below

	2018
	£m
Impairment of financial assets	
First mortgage loans	5.5
Second charge mortgage loans	(0.5)
Finance lease receivables	1.8
Development finance loans	-
Other loans	0.6
	7.4

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

The notes below describe the processes and measurements which the Group use to manage their capital position and its exposure to credit risk. It should be noted that certain capital measures, which are presented to illustrate the Group's position, are not subject to audit. Where this is the case, the relevant disclosures are marked as such.

27. CAPITAL MANAGEMENT

The Group's objectives in managing capital are:

- To ensure that the Group has sufficient capital to meet its operational requirements and strategic objectives
- To safeguard the Group's ability to continue as a going concern, so that it can continue to provide returns to shareholders and benefits for other stakeholders
- To provide an adequate return to shareholders by pricing products and services commensurately with the level of risk
- To ensure that sufficient regulatory capital is available to meet any externally imposed requirements

The Group sets its target amount of capital in proportion to risk, availability, regulatory requirements and cost. The Group manages the capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the underlying assets, having particular regard to the relative costs and availability of debt and equity finance at any given time. In order to maintain or adjust the capital structure the Group may adjust the amount of dividends paid to shareholders, return capital to shareholders, issue new shares, issue or redeem other capital instruments, such as retail or corporate bonds, or sell assets to reduce debt.

The Group is subject to regulatory capital rules imposed by the PRA on a consolidated basis as a group containing an authorised bank. This is discussed further below.

(a) Dividend policy

The Company is committed to a long-term sustainable dividend policy. Ordinarily, dividends will increase in line with earnings, subject to the requirements of the business and the availability of cash resources. The Board reviews the policy at least twice a year in advance of announcing its results, taking into account the Group's strategy, capital requirements, principal risks and the objective of enhancing shareholder value. In determining the level of dividend for any year, the Board expects to follow the dividend policy, but will also take into account the level of available retained earnings in the Company, its cash resources and the cash and capital requirements inherent in its business plans.

The distributable reserves of the Company comprise its profit and loss account balance (note 19) and, other than the requirement for the Bank to retain an appropriate level of capital, there are no restrictions preventing profits elsewhere in the Group from being distributed to the parent.

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

27. CAPITAL MANAGEMENT (CONTINUED)

Since the year ended 30 September 2018, the Company has adopted a policy of paying out approximately 40% of its basic earnings per share as dividend (a dividend cover ratio of around 2.5 times), in the absence of any idiosyncratic factors which might make such a dividend inappropriate. This policy is reviewed by the Board at least annually. 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.

To provide greater transparency, the Company has also indicated that in future 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. The interim dividend for the year ended 30 September 2019 was been declared in accordance with the policy.

The most recent policy review, in November 2019, confirmed this policy but concluded that the size and nature of the non-cash fair value losses in the year, together with the gain arising on the derecognition of PM12, would support a higher pay-out ratio.

For the purposes of dividend policy, the Group defines dividend cover based on basic 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	2019	2018
Earnings per share (p)	8	49.4	55.9
Adjustments (p)		-	(7.3)
Adjusted earnings per share (p)		49.4	48.6
Dividend cover target (times)		2.33	2.50
Proposed dividend per share in respect of the year (p)	21	21.2	19.4

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

27. CAPITAL MANAGEMENT (CONTINUED)

(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.

It effectively reflects a return on equity as if all intangible assets are eliminated immediately against reserves. As this is similar to the approach used for the capital of financial institutions it is widely used in the sector.

The Group's consolidated RoTE for the year ended 30 September 2019 is derived as follows:

	Note	2019 IFRS 9 £m	2018 IAS 39 £m
Profit for the year after tax		127.4	145.8
Amortisation of intangible assets		2.4	2.1
Adjusted profit		129.8	147.9
Divided by			
Opening equity		1,073.5	1,009.4
Opening intangible assets	13	(169.3)	(104.4)
Opening tangible equity		904.2	905.0
Closing equity		1,108.4	1,095.9
Closing intangible assets	13	(171.1)	(169.3)
Closing tangible equity		937.3	926.6
Average tangible equity		920.7	915.8
Return on Tangible Equity		14.1%	16.1%

This table is not subject to audit

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

27. 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 an individual capital requirement setting an amount of regulatory capital, which the Group is required to hold relative to its total risk exposure 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 introduction of IFRS 9 on 1 October 2018 impacted the Group's regulatory capital position. The principal impacts were:

- The reduction in reserves caused by increased provisions, net of associated future tax relief, reduces shareholders equity and hence regulatory capital
- The reduction in loans to customers generates a consequential reduction in risk weighted assets ('RWA'), the amount of which will vary by asset type
- Collectively assessed emergence provisions under IAS 39 qualified as tier 2 capital, with £4.9m being included in capital at 30 September 2018 in respect of such provisions. No such provisions are made under IFRS 9, therefore total capital is reduced

The Group has elected to take advantage of the transitional arrangements set out in Article 473a of the CRR, which allow the capital impact of expected credit losses to be phased in over a five-year period. The phase-in factors will allow for a 95% add back to CET1 capital and risk weighted assets in the financial year ended 30 September 2019, reducing to 85%, 70%, 50% and 25% for the financial years ending in 2020 to 2023, with full recognition of the impact on CET1 capital in the 2024 financial year. Where such relief is taken, firms are also required to disclose their capital positions calculated as if the relief were not available (the 'fully loaded' basis).

The capital position at 1 October 2018, immediately after transition, is set out in the notes below, marked 2018 IFRS 9.

The tables below demonstrate that at 30 September 2019 the Group's regulatory capital of £1,072.0m (2018: £1,044.8m) was comfortably in excess of the amounts required by the regulator, including £742.9m in respect of Pillar 1 and Pillar 2a capital (unaudited), which is comprised of fixed and variable elements. The CRR also requires firms to hold additional capital buffers, including a Capital Conservation Buffer of 2.5% of risk weighted assets (at 30 September 2019) (2018: 1.875%) and a Counter-Cyclical Buffer, currently 1.0% of risk weighted assets (2018: 0.5%). Firm specific buffers may also be required.

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

27. CAPITAL MANAGEMENT (CONTINUED)

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 2019 is set out below.

	Note	30 September 2019 £m	1 October 2018 £m	30 September 2018 £m
Total equity		1,108.4	1,073.5	1,095.9
Deductions				
Proposed final dividend	21	(35.8)	(35.8)	(35.8)
IFRS 9 transitional relief	*	21.2	21.2	-
Intangible assets	13	(171.1)	(169.3)	(169.3)
Prudent valuation adjustments	§	(0.7)	(0.9)	(0.9)
Common Equity Tier 1 ('CET1') capital		922.0	888.7	889.9
Other tier 1 capital		-	-	-
Total Tier 1 capital		922.0	888.7	889.9
Corporate bond		150.0	150.0	150.0
Less: amortisation adjustment	†	-	-	-
		150.0	150.0	150.0
Collectively assessed credit impairment allowances	‡	-	-	4.9
Total Tier 2 capital		150.0	150.0	154.9
Total regulatory capital		1,072.0	1,038.9	1,044.8

* Firms are permitted to phase in the impact of IFRS 9 transition over a five year period.

§ For capital purposes, assets and liabilities held at fair value, such as the Group's derivatives, are required to be valued on a more conservative basis than the market value basis set out in IFRS 13. This difference is represented by the prudent valuation adjustment above, calculated using the 'Simplified Approach' set out in the CRR.

This was first included in the Group's regulatory capital position in the year and has been included in comparative amounts for consistency.

† 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.

‡ Under IFRS 9 there are no collectively assessed credit impairment allowances which are eligible as tier 2 capital.

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

27. CAPITAL MANAGEMENT (CONTINUED)

The total risk 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.

	30 September 2019 £m	1 October 2018 £m	30 September 2018 £m
Credit risk			
Balance sheet assets	5,997.2	5,756.3	5,767.3
Off balance sheet	85.5	87.8	87.8
IFRS 9 transitional relief	10.5	10.5	-
Total credit risk	6,093.2	5,854.6	5,855.1
Operational risk	516.6	485.1	485.1
Market risk	-	-	-
Other	114.0	105.1	105.1
Total risk exposure amount	6,723.8	6,444.8	6,445.3
	%	**%**	**%**
Solvency ratios			
CET1	13.7	13.8	13.8
Total regulatory capital	15.9	16.2	16.2

This table is not subject to Audit

The CRD IV risk weightings for credit risk exposures are calculated using the Standardised Approach. The Basic Indicator Approach is used for operational risk.

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

27. CAPITAL MANAGEMENT (CONTINUED)

On a fully loaded basis (excluding the effect of IFRS 9 transitional relief) the Group's capital ratios would be:

	30 September 2019 £m	1 October 2018 £m	30 September 2018 £m
CET1 Capital	922.0	889.6	890.8
Add back: IFRS 9 relief	(21.2)	(21.2)	-
Fully loaded CET1 Capital	900.8	868.4	890.8
TRC	1,072.0	1,038.9	1,044.8
Add back: IFRS 9 relief	(21.2)	(21.2)	-
Fully loaded TRC	1,050.8	1,017.7	1,044.8
Total risk exposure	6,723.8	6,444.8	6,445.3
Add back: IFRS 9 relief	(10.5)	(10.5)	-
Fully loaded TRE	6,713.3	6,434.3	6,445.3
Fully loaded Solvency ratios	%	%	%
CET1	13.4	13.5	13.8
Total regulatory capital	15.7	15.8	16.2

This table is not subject to audit

The total regulatory capital at 30 September 2019 on the fully loaded basis of £1,050.8m was in excess of the Pillar 1 & 2a requirement of £741.8m on the same basis (amounts not subject to audit).

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

27. 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	2019 IFRS 9 £m	2018 IFRS 9 £m	2018 IAS 39 £m
Total balance sheet assets		14,395.5	14,487.9	14,515.1
Add: Credit fair value adjustments on loans to customers	10	-	24.1	24.1
Debit fair value adjustments on retail deposits	14	-	4.2	4.2
Adjusted balance sheet assets		14,395.5	14,516.2	14,543.4
Less: Derivative assets	12	(592.4)	(855.7)	(855.7)
Central bank deposits	9	(816.4)	(895.9)	(895.9)
CRDs		(11.4)	(6.2)	(6.2)
Accrued interest on sovereign exposures		(0.2)	(0.4)	(0.4)
On-balance sheet items		12,975.1	12,758.0	12,785.2
Less: Intangible assets	13	(171.1)	(169.3)	(169.3)
Total on balance sheet exposures		12,804.0	12,588.7	12,615.9
Derivative assets	12	592.4	855.7	855.7
Potential future exposure on derivatives		120.0	172.1	172.1
Total derivative exposures		712.4	1,027.8	1,027.8
Post offer pipeline at gross notional amount		903.4	817.7	817.7
Adjustment to convert to credit equivalent amounts		(739.2)	(569.2)	(569.2)
Off balance sheet items		164.2	248.5	248.5
Tier 1 capital		922.0	888.7	889.9
Total leverage exposure before IFRS 9 relief		13,680.6	13,865.0	13,892.2
IFRS 9 relief		25.8	25.8	-
Total leverage exposure		13,706.4	13,890.8	13,892.2
UK leverage ratio		6.7%	6.4%	6.4%

This table is not subject to audit

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

27. CAPITAL MANAGEMENT (CONTINUED)

The fully loaded leverage ratio is calculated as follows

	2019 IFRS 9 £m	2018 IFRS 9 £m	2018 IAS 39 £m
Fully loaded Tier 1 capital	900.8	868.4	890.8
Total leverage exposure before IFRS 9 relief	13,680.6	13,865.0	13,892.2
Fully loaded UK leverage exposure	6.6%	6.3%	6.4%

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.

The regulatory capital disclosures in these financial statements relate only to the consolidated position for the Group. Individual entities within the Group are also subject to supervision on a standalone basis. All such entities complied with the requirements to which they were subject during the year.

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

28. CREDIT RISK

The Group's credit risk is primarily attributable to its loans to customers and its 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 balance sheet loan assets at 30 September 2019 are analysed as follows:

	2019 IFRS 9		2018 IFRS 9		2018 IAS 39	
	£m	%	£m	%	£m	%
Buy-to-let mortgages	10,101.9	82.9%	10,227.4	84.5%	10,261.6	84.6%
Owner-occupied mortgages	70.6	0.6%	80.9	0.7%	70.6	0.6%
Total first charge residential mortgages	10,172.5	83.5%	10,308.3	85.2%	10,332.2	85.2%
Second charge mortgage loans	389.2	3.2%	414.4	3.4%	415.9	3.5%
Loans secured on residential property	10,561.7	86.7%	10,722.7	88.6%	10,748.1	88.7%
Development finance	506.5	4.1%	352.9	2.9%	352.8	2.9%
Loans secured on property	11,068.2	90.8%	11,075.6	91.5%	11,100.9	91.6%
Asset finance loans	472.9	3.9%	389.9	3.3%	391.0	3.3%
Motor finance loans	318.9	2.6%	329.2	2.7%	329.4	2.7%
Aircraft mortgages	19.3	0.2%	12.4	0.1%	12.4	0.1%
Structured lending	88.1	0.7%	38.7	0.3%	38.7	0.3%
Invoice finance	18.5	0.1%	21.7	0.2%	21.8	0.2%
Total secured loans	11,985.9	98.3%	11,867.5	98.1%	11,894.2	98.1%
Professions finance	46.2	0.4%	42.1	0.4%	42.6	0.4%
Other unsecured commercial loans	19.3	0.2%	17.2	0.1%	17.3	0.1%
Unsecured consumer loans	134.7	1.1%	173.8	1.4%	173.7	1.4%
Total loans to customers	12,186.1	100.0%	12,100.6	100.0%	12,127.8	100.0%

First and second charge mortgages are secured by charges over residential properties in England and Wales, or similar Scottish or Northern Irish securities.

Development finance loans are secured by a first charge (or similar Scottish security) over the development property and various charges over the build.

Asset finance loans and motor finance loans are effectively secured by the financed asset, while aircraft mortgages are secured by a charge on the aircraft funded.

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

28. CREDIT RISK (CONTINUED)

Structured lending and invoice finance balances are effectively secured over the assets of the customer, with security enhanced by maintaining balances at a level less than the total amount of the security (the advance percentage).

Professions finance includes loans originated are generally short term unsecured loans made to firms of lawyers and accountants for working capital purposes.

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

There are no significant concentrations of credit risk to individual counterparties due to the large number of customers included in the portfolios. All lending is to customers within the UK.

Credit characteristics by portfolio

Loans secured on residential property

First mortgage loans have a contractual term of up to thirty years and second charge mortgage loans up to twenty five years. In all cases the borrower is entitled to settle the loan at any point and in most cases early settlement does take place. All borrowers on these accounts are required to make monthly payments.

An analysis of the indexed loan to value ratio ('LTV') for those loan accounts secured on residential property by value at 30 September 2019 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.

	2019 First mortgages %	2019 Secured loans %	2018 First mortgages %	2018 Secured loans %
Loan to value ratio				
Less than 70%	54.3	66.5	60.6	66.1
70% to 80%	36.2	18.5	29.7	17.4
80% to 90%	7.2	8.9	7.1	9.3
90% to 100%	0.6	2.7	0.8	3.5
Over 100%	1.7	3.4	1.8	3.7
	100.0	100.0	100.0	100.0
Average loan to value ratio	67.3	65.7	66.0	65.9
Of which:				
Buy-to-let	67.4		66.1	
Owner-occupied	53.2		51.3	

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 0.2% in the year ended 30 September 2019 (2018: 2.0%).

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

28. CREDIT RISK (CONTINUED)

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.

The geographical distribution of the Group's residential mortgage assets by gross carrying value is set out below.

	First Charge		Second Charge	
	2019	**2018**	**2019**	**2018**
East Anglia	3.2%	3.0%	3.3%	3.5%
East Midlands	5.3%	5.2%	6.3%	6.5%
Greater London	18.9%	18.6%	7.8%	7.1%
North	3.3%	3.5%	4.2%	4.7%
North West	10.1%	10.2%	8.0%	8.5%
South East	31.9%	31.3%	37.7%	35.2%
South West	8.9%	9.2%	7.9%	8.0%
West Midlands	5.1%	4.8%	7.6%	8.0%
Yorkshire and Humberside	8.6%	9.4%	6.2%	6.7%
Total England	95.3%	95.2%	89.0%	88.2%
Northern Ireland	0.1%	0.1%	1.9%	2.1%
Scotland	1.4%	1.4%	5.6%	5.9%
Wales	3.2%	3.3%	3.5%	3.8%
	100.0%	100.0%	100.0%	100.0%

Development finance

Development finance loans have an average term of 20 months (2018: 21 months). Settlement of principal and accrued interest takes place once the development is sold or refinanced following its completion and the customer is not normally required to make payments during the term of the loan. The loans are secured by a legal charge over the site and / or property together with other charges and warranties related to the build.

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

28. CREDIT RISK (CONTINUED)

As customers are not required to make payments during the life of the loan, 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	2019 By value %	2019 By number %	2018 By value %	2018 By number %
50% or less	8.5	3.4	3.4	4.4
50% to 60%	18.2	15.5	18.9	22.8
60% to 65%	31.6	39.1	63.3	59.6
65% to 70%	32.3	32.4	7.1	9.6
70% to 75%	6.8	8.2	0.7	0.7
Over 75%	2.6	1.4	6.6	2.9
	100.0	100.0	100.0	100.0

The average LTGDV cover at the year end was 64.8% (2018: 63.2%).

The increase in LTGDV percentages over the year reflects the changing mix in the portfolio between those accounts originated using the initial cautious underwriting approach of the Group's in-house operation and those originated though the acquired operation. Following acquisition, risk appetites were adjusted to reflect the increased experience and maturity of the combined operation.

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 2019 the development finance portfolio comprised 207 accounts (2018: 136) with a total carrying value of £506.5m (2018: £352.8m). Of these accounts only six were included in stage 2 at 30 September 2019 (2018 IFRS 9: none). In addition, three accounts acquired in the Titlestone purchase had been classified as POCI (2018: four). An allowance for these losses was made in the IFRS 3 fair value calculation.

Asset finance and Motor finance

Asset and motor finance lending includes finance lease and hire purchase arrangements, which are accounted for as finance leases under IAS 17. The average contractual life of the asset finance loans was 56 months (2018: 52 months) while that of the motor finance loans was 57 months (2018: 55 months), but it is likely that a significant proportion of customers will choose to settle their obligations early.

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

28. CREDIT RISK (CONTINUED)

Asset finance customers are generally small or medium sized businesses. The nature of the assets underlying the Group's asset finance lending by gross carrying value is set out below.

	2019	2018
	%	%
Commercial vehicles	30.3	22.6
Construction plant	34.8	38.9
Technology	7.8	6.6
Manufacturing	6.1	5.2
Print and paper	4.8	7.1
Refuse disposal vehicles	5.2	6.7
Other vehicles	3.0	4.2
Agriculture	2.7	1.2
Other	5.3	7.5
	100.0	100.0

Motor finance loans are secured over cars, motorhomes and light commercial vehicles and represent exposure to consumers and small businesses.

Structured lending

The Group's structured lending division provides revolving loan facilities to support non-bank lending businesses. Loans are made to a Special Purpose Vehicle ('SPV') company controlled by the customer and effectively secured on the loans made by the SPV. Exposure is limited to a percentage of the underlying assets, providing a buffer against credit loss.

Summary details of the structured lending portfolio are set out below

	2019	2018
Number of transactions	8	3
Total facilities (£m)	135.0	52.5
Carrying value (£m)	88.1	38.7

The maximum advance under these facilities was 80% of the underlying assets.

These accounts do not have a requirement to make regular payments, operating on revolving basis. The performance of each loan is monitored monthly on a case by case basis by the Group's Credit Risk function, assessing compliance with covenants relating to both the customer and the performance and composition of the asset pool.

At 30 September 2019 there were no significant concerns regarding the credit performance of these facilities.

Unsecured consumer loans

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.

NOTES TO THE ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

28. CREDIT RISK (CONTINUED)

Arrears performance

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 2019 and 30 September 2018, compared to the industry averages at those dates published by UK Finance ('UKF') and the FLA, was:

	2019 %	2018 %
First mortgages		
Accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	0.18	0.11
Buy-to-let accounts excluding receiver of rent cases	0.07	0.03
Owner-occupied accounts	2.44	3.15
UKF data for mortgage accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	0.42	0.42
Buy-to-let accounts excluding receiver of rent cases	0.37	0.38
Owner-occupied accounts	0.81	0.88
All mortgages	0.73	0.79
Second charge mortgage loans		
Accounts more than 2 months in arrears		
All accounts	14.08	13.64
Post-2010 originations	0.38	0.21
Legacy cases (Pre-2010 originations)	19.85	17.91
Purchased assets	16.05	14.81
FLA data for secured loans	8.70	9.40
Car loans		
Accounts more than 2 months in arrears	5.25	3.91
FLA data for point of sale hire purchase	2.70	2.50
Asset finance loans		
Accounts more than 2 months in arrears	0.43	0.78
FLA data for business lease / hire purchase loans	1.10	0.70

No published industry data for asset classes comparable to the Group's other books has been identified. Where revised data at 30 September 2018 has been published by the FLA or UKF, the comparative industry figures above have been amended.

Arrears information is not given for development finance, structured lending or invoice finance 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 ACCOUNTS – CAPITAL AND CREDIT RISK
For the year ended 30 September 2019

28. 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.

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. The total amount of undiscounted ECL at initial recognition on POCI loans to customers initially recognised during the year ended 30 September 2019 was minimal due to the level of purchases.

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 IFRS 9 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. ERCs are set out both for all purchased consumer portfolios and for those classified as POCI under IFRS 9.

	2019	2018	2017
	£m	£m	£m
All purchased consumer assets			
Carrying value	291.1	364.2	503.5
84 month ERC	342.3	434.9	608.9
120 month ERC	387.5	489.6	688.8
POCI assets only			
Carrying value	168.3	204.4	302.9
84 month ERC	214.1	269.9	317.2
120 month ERC	246.0	306.2	359.9

Amounts shown above are disclosed as loans to customers (note 10). They include first mortgages, second charge loans and unsecured consumer loans.

Further information relating to comparative information prepared under IAS 39 is included in note 26.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

The notes set out below describe the accounting basis on which the Group prepares its accounts, the particular accounting policies adopted by the Group and the principal judgements and estimates which were required in the preparation of the financial statements.

They also include other information describing how the accounts have been prepared required by legislation and accounting standards.

29. BASIS OF PREPARATION

The annual financial statements of the Group for the year ended 30 September 2019 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 2018 except for the adoption of IFRS 9 – 'Financial Instruments' ('IFRS 9') and IFRS 15 – 'Revenue from Contracts with Customers' ('IFRS 15'), described in note 31.

Comparability of information

IFRS 9 does not require that the balance sheet information at 30 September 2017 and 30 September 2018 and the profit and loss information for the years ended on these dates is restated on the adoption of the Standard. The information presented for those periods in these financial statements is derived in accordance with IAS 39 'Financial Instruments: Recognition and Measurement' ('IAS 39'), and therefore may not be directly comparable with the balance sheet at 30 September 2019 and the profit and loss account for the year then ended which are prepared under IFRS 9.

In order to aid users of the accounts additional comparative balance sheet amounts at 1 October 2018, immediately following transition, have been provided where relevant. These are marked as 2018 IFRS 9.

30. GOING CONCERN BASIS

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 on pages 8 to 52. The principal risks and uncertainties affecting the Group are described on pages 53 and 54.

Note 7 to the accounts for the year ended 30 September 2018 includes an analysis of the Group's working capital position and policies, while notes 8 to 11 include 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. Note 6 to those accounts discusses critical accounting estimates affecting the results and financial position disclosed therein. The position and policies described in these notes remain materially unchanged to the date of this preliminary announcement, subject to the changes in funding described in note 15.

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.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

30. GOING CONCERN (CONTINUED)

The plans for the period commencing on 1 October 2019 have been approved by the Board and have been compiled taking into consideration the Group's cash flow, dividend cover, encumbrance, liquidity and capital requirements as well as other key financial ratios throughout the period.

The Group's retail deposits of £6,391.9 million (note 14), accepted through Paragon Bank, are repayable within five years, with 67.8% of this balance (£4.3 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 2019 Paragon Bank held £646.4 million of balance sheet assets for liquidity purposes, in the form of central bank deposits (note 9). A further £109.0 million of liquidity was provided by the Bank of England FLS, bringing the total to £755.4 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 £1,095.0 million. Holdings of the Group's own mortgage backed loan notes can also be used to access the Bank of England's liquidity facilities.

The Group's securitisation funding structures ensure that a substantial proportion of its originated loan portfolio is match-funded. This proportion was reduced by the PM12 disposal in June 2019, and increased by the issue of the PM26 securitisation in July 2019. 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 first of the Group's retail bond issues matures.

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

In addition to its expertise in the securitisation market, evidenced by the PM26 and new warehouse transactions in the year, 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, affirmed by Fitch Ratings in March 2019, and its status as an issuer is evidenced by the BBB- rating of its £150.0 million Tier-2 bond.

As described in note 27 the Group's capital base is subject to consolidated supervision by the PRA. Its capital at 30 September 2019 was in excess of regulatory requirements and its forecasts indicate this will continue to be the case.

Accounting standards require the directors to assess the Group's ability to continue to adopt the going concern basis of accounting. In performing this assessment, the directors consider all available information about the future, the possible outcomes of events and changes in conditions and the realistically possible responses to such events and conditions that would be available to them, having regard to the 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting' published by the FRC in September 2014.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

30. GOING CONCERN (CONTINUED)

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.

31. CHANGES IN ACCOUNTING STANDARDS

The Group is required to adopt IFRS 9 (and the consequent changes to IFRS 7) and IFRS 15 for the first time in preparing its financial statements for the year ended 30 September 2019.

IFRS 9 – Overview

IFRS 9 'Financial Instruments' replaces IAS 39 'Financial Instruments: Recognition and Measurement' ('IAS 39') and addresses the recognition, classification and measurement of financial assets and liabilities.

IFRS 9 – Classification

IFRS 9 changes the classification requirements for financial assets and liabilities. In order for financial assets to be carried at amortised cost under the new standard, they must be carried in a business model whose objective is to collect the contractual cash flows from the assets and where those cash flows comprise solely payments of principal and interest ('SPPI').

In accordance with the new rules:

- Cash balances and loans to customers (other than finance leases), which were classified as 'loans and receivables' under IAS 39 are classified as 'financial assets measured at amortised cost' under IFRS 9 and continue to be measured on the amortised cost basis
- Retail deposits and external borrowings, which were classified as 'other financial liabilities' under IAS 39 are classified as 'financial liabilities measured at amortised cost' and continue to be measured on the amortised cost basis
- Derivative financial assets and liabilities, which were carried at fair value under IAS 39 are classified as 'financial assets or liabilities at fair value through profit and loss' under IFRS 9 and continue to be measured on the same basis

The amortised cost and fair value measurement methodologies remain broadly the same in IFRS 9 as they were in IAS 39 and no measurement changes in the accounts of the Group have arisen as a result of these classification changes.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

31. CHANGES IN ACCOUNTING STANDARDS (CONTINUED)

The Group's financial asset and financial liability balances measured in accordance with IFRS 9 and the preceding standard, IAS 39, at the transition date (1 October 2018) are set out below:

	Post-transition £m	Pre-transition £m
Financial Assets		
Cash – central banks	895.9	895.9
Cash – retail banks	414.7	414.7
Loans to customers	12,100.6	12,127.8
Derivative financial assets	855.7	855.7
Sundry financial assets	15.3	15.3
	14,282.2	14,309.4
Financial Liabilities		
Short term bank borrowings	1.1	1.1
Retail deposits	5,296.6	5,296.6
Derivative financial liabilities	4.7	4.7
Asset backed loan notes	5,554.7	5,554.7
Secured bank borrowings	935.6	935.6
Retail bond issuance	296.1	296.1
Corporate bond issuance	149.3	149.3
Central bank facilities	1,024.4	1,024.4
Other financial liabilities	82.8	82.8
	13,345.3	13,345.3

The only changes arising from a change in measurement on transition to IFRS 9 relate to impairment provision on the Group's loans to customers. These are discussed further below.

IFRS 9 – Impairment

IFRS 9 changes the basis of impairment provision for all financial assets from an incurred loss to an expected credit loss ('ECL') basis. Therefore, the provisioning is dependent on an assessment of the probability of future default and the loss which might be incurred at that time. This introduces significant additional areas of estimation to the accounting.

This introduces a number of new concepts and changes to the approach required by IAS 39. ECLs are based on an assessment of the probability of default ('PD') and loss given default ('LGD'), discounted to give a net present value. The estimation of ECL should be unbiased and probability weighted, considering all reasonable and supportable information, including forward looking economic assumptions and a range of possible outcomes. This has the effect of recognising losses on loans earlier than at present, as IAS 39 requires provisions to be made only at the point where a loss has actually occurred and there is objective evidence of credit impairment.

The Standard also requires that companies calculate impairment under a variety of differing economic scenarios and combine these on a weighted average basis to arrive at the final provision, rather than base calculations on a central forecast, as is generally the case under IAS 39.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

31. CHANGES IN ACCOUNTING STANDARDS (CONTINUED)

IFRS 9 requires loan assets to be divided into three 'stages', with accounts which were credit impaired on initial recognition representing a fourth class.

The three classes comprise: those where there has been no Significant Increase in Credit Risk ('SICR') since advance or acquisition (Stage 1); those where there has been a SICR (Stage 2); and loans which are credit impaired (Stage 3). It is an important feature of the standard that SICR is not defined solely by the performance of the account, but also by other information available about the customer both internally and externally, such as credit bureau information.

- On initial recognition, and for assets where there has not been an SICR, provisions will be made in respect of losses resulting from the level of credit default events expected in the twelve months following the balance sheet date. These accounts would be largely unprovided for under IAS 39, although some cases with adverse qualitative indicators might have been addressed by a collective emergence provision. Such provisions under IAS 39 were designed to cover assets where a loss event had occurred before the reporting date, but this event had not yet affected performance
- Where a loan has experienced an SICR, whether or not the loan is considered to be credit impaired, provisions will be made based on the ECLs over the full life of the loan. This is likely to lead to an increase in provision in general, though the IAS 39 emergence provision would have also addressed some of this risk
- For credit impaired assets, provisions will be made on the basis of lifetime expected credit losses, taking account of forward-looking economic assumptions and a range of possible outcomes. Under IAS 39, provisions were based on the asset's carrying value and the present value of the estimated future cash flows. Despite IAS 39 not explicitly taking account of alternative economic scenarios, where loans had attracted a provision under IAS 39, the IFRS 9 provision on transition was, in most cases, broadly similar to the closing IAS 39 position

  Credit impaired assets are identified either through quantitative measures or by operational status. In determining indicators of credit impairment regard is also taken of definitions used for regulatory capital purposes. Assets may also be assigned to Stage 3 if they are identified as credit impaired as a result of management review processes
- For assets which were purchased or originated as credit impaired ('POCI') accounts (i.e. considered as credit impaired at the point of first recognition), such as certain of the Group's acquired assets in Idem Capital, the required treatment is largely similar under IAS 39 and IFRS 9. This classification also includes credit impaired assets recognised in corporate acquisitions under IFRS 3. Purchased performing accounts are not classified as POCI, but are first recognised in Stage 1

Under IAS 39 the Group treated all loan accounts as live where they remained open on its administration system. IFRS 9 requires a firm to consider the prospect of future recovery in its write off approach and the Group has adopted a revised accounting policy for write offs following transition.

Accounts are now written off for accounting purposes when standard enforcement processes have been completed, subject to any amount retained in respect of expected salvage receipts. This change has no effect on the net carrying value, only on the amounts reported as gross loan balances and accumulated impairment provisions, but provides a more informative value for the coverage ratio.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

31. CHANGES IN ACCOUNTING STANDARDS (CONTINUED)

All accounts which would have been written off for accounting purposes prior to the transition date under the new policy have been written off at transition. All of these cases were fully provided and therefore this has had no impact on reserves.

As disclosed in the transition report, the introduction of IFRS 9 resulted in an increase in the Group's impairment provision of £27.2m at the transition date, 1 October 2018. The impacts by business segment are set out below:

	IAS 39 £m	IFRS 9 £m	Change £m	Change %
Loans to customers				
Mortgages	10,473.5	10,449.5	(24.0)	(0.2) %
Commercial Lending	1,133.2	1,131.3	(1.9)	(0.2) %
Idem Capital	521.1	519.8	(1.3)	(0.2) %
Total	12,127.8	12,100.6	(27.2)	(0.2) %

The movement in impairment provisions in the Group's accounts between the balance disclosed under IAS 39 and the opening balance under IFRS 9 is set out below.

	£m
Loans to customers	
At 30 September 2018 under IAS 39	107.4
IFRS 9 transition adjustments	27.2
Change in write-off definition	(80.4)
At 1 October 2018 under IFRS 9	54.2

The reduction due to write off definitions is principally attributable to part redeemed loan balances which remained live on the administration systems of the Group and were therefore treated as live for accounting purposes. Under IFRS 9 these balances may be defined as written off, and the Group's IFRS 9 write off policy considers them to be so, as this provides users with a more useful measure of provision cover.

The increase in impairment on transition will be allowed as a deduction for the purposes of UK Corporation Tax under the Change in Accounting Practices Regulations. This is spread over the ten years following transition for loan assets and is allowable in the 2019 tax computations for finance leases. A deferred tax asset of £5.0m has been recognised on transition.

Cash balances, 'Trade receivables', and the sundry financial asset balances are classified as financial assets accounts for at amortised cost and are therefore subject to the impairment provisions of IFRS 9. However, these assets are principally UK sovereign exposures (including exposures to the Bank of England) and exposures to highly rated banks. The ECLs on these counterparties are considered to be minimal. The value, tenor and potential for default of the other exposures is such that any potential IFRS 9 provision is insignificant.

Derivative financial assets are carried at fair value, which includes the consideration of credit risk, as they were under IAS 39.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

31. CHANGES IN ACCOUNTING STANDARDS (CONTINUED)

IFRS 9 – Hedge accounting

The hedge accounting requirements of IFRS 9 do not specifically address portfolio fair value hedges of interest rate risk ('macro hedges') which IAS 39 deals with directly. A separate financial reporting standard is to be developed in this area. IFRS 9 allows the option to continue to apply the existing hedge accounting requirements of IAS 39 until this is implemented.

As the Group's hedging arrangements are either macro hedges, which are not specifically addressed by the new standard, or bespoke cash flow hedges, which would not be affected by the change of standard, the Group has decided to defer application of these rules until the full new hedge accounting regime is in place.

It thus continues to apply the hedge accounting requirements of IAS 39 and all hedging arrangements in place at 30 September 2018 continue to be recognised on 1 October 2018 after IFRS 9 transition.

IFRS 15 – Impact

IFRS 15 governs the accounting for those of the Group's income streams which are not within the scope of either IFRS 9 or IAS 17 - 'Leases'. These comprise principally third-party servicing income, maintenance income on vehicle leasing, third party commission income and account fee income. The accounting for most of these flows is unchanged as the amounts are charged on an event-by-event basis.

There is a small balance sheet impact in the Group accounts from the accounting for maintenance agreements, decreasing reserves at 30 September 2018 by £0.2m. In view of the low level of impact comparative amounts have not been restated for this change.

Summary

The overall impacts of the changes above on consolidated equity at 30 September 2018 are set out below.

		£m	£m
Equity at 30 September 2018			1,095.9
IFRS 9			
Impairment	(note 11)	(27.2)	
Deferred tax thereon		5.0	
		(22.2)	
IFRS 15			
Maintenance income		(0.2)	
Total adjustments			(22.4)
Equity at 1 October 2018			1,073.5

All these amendments impacted retained earnings. None of these changes have any impact on the Group's cash flow reporting.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

32. CRITICAL ACCOUNTING JUDGEMENTS AND ESTIMATES

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 2018 other than those related to IFRS 9, as described below.

(a) Significant Increase in Credit Risk ('SICR')

Under IFRS 9, the directors are required to assess where a credit obligation has suffered a Significant Increase in Credit Risk ('SICR'). The directors' assessment is based primarily on changes in the calculated probability of default, but also includes consideration of other qualitative indicators and the adoption of the backstop assumption in the Standard that all cases which are more than 30 days overdue have a SICR, for account types where days overdue is an appropriate measure.

If additional accounts were determined to have an SICR, these balances would attract additional impairment provision and the overall provision charge would be higher.

More information on the definition of SICR adopted is given in note 11.

(b) Definition of default

In applying the impairment provisions of IFRS 9 and the directors have used models to derive the probabilities of default. In order to derive and apply such models, it is required to define 'default' for this purpose. The Group's definition of default is aligned to its internal operational procedures. IFRS 9 provides a rebuttable presumption of default when an account is 90 days overdue and this was used as the starting point for this exercise. Other factors include account management activities such as appointment of a receiver or enforcement procedures.

A combination of qualitative and quantitative measures was considered in developing the definition of default.

If a different definition of default had been adopted the expected loss amounts derived might differ from those shown in the accounts.

More information on the Group's definition of default adopted is given in note 11.

(c) Classification of financial assets

The classification of financial assets under IFRS 9 is based on two factors:

- The company's 'business model' – how the it intends to general cash and profit from the assets; and
- The nature of the contractual cash flows inherent in the assets

Financial assets are classified as held at amortised cost, at fair value through other comprehensive income, or at fair value through profit or loss.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

32. CRITICAL ACCOUNTING JUDGEMENTS AND ESTIMATES (CONTINUED)

For an asset to be held at amortised cost, the cash flows received from it must comprise solely payments of principal and interest ('SPPI'). In effect, this restricts this classification to 'normal' lending activities, excluding arrangements where the lender may have a contingent return or profit share from the activities funded. The Group has considered its products and concluded that, as standard lending products, they fall within the SPPI criteria.

This is because all of the Group's lending arrangements involve the advancing of amounts to customers, either as loans or finance lease products and the receipt of repayments of principal and charges, where those charges are calculated based on the amount loaned. There are no 'success fee' or other compensation arrangements not linked to the loan principal.

The use of amortised cost accounting is also restricted to assets which a company holds within a business model whose objective is to collect cash flows arising from them, rather than seek to profit by disposing of them (a 'Held to Collect' model). The Group's strategy is to hold loan assets until they are repaid or written off. Loan disposals are rare, and the Group does not manage its assets in order to generate profits on sale. On this basis, it has categorised its business model as Held to Collect.

Therefore, the Group has classified its customer loan assets as carried at amortised cost.

(d) Derecognition of financial assets and liabilities

On 26 June 2019, the Group disposed of its residual interest in the Paragon Mortgages (No. 12) PLC securitisation transaction. In order to determine whether the financial assets and liabilities of the SPV should be derecognised at that point, a management judgement is required. Following a review of the terms of the sale transaction, it was concluded that the Group was no longer significantly exposed to the risks and rewards in relation to the cash flows arising from the scheme, and hence the criteria for derecognition were met. More information on this transaction is given in note 5.

(e) Impairment losses on loans to customers

Impairment losses on loans are calculated based on statistical models, applied to the present status, performance and management strategy for the loans concerned which are used to determine each loan's PD and LGD.

Internal information used will include number of months arrears, qualitative information, such as possession by a first charge holder on a second charge mortgage or where a buy-to-let case is under the control of a receiver of rent, the receiver's present and likely future strategy for the property (e.g. keeping current tenants in place, refurbish and relet, immediate sale etc).

External information used includes customer specific data, such as credit bureau information as well as more general economic data.

Key internal assumptions in the models relate to estimates of future cash flows from customers' accounts, their timing and, for secured accounts, the expected proceeds from the realisation of the property or other charged assets. These cash flows will include payments received from the customer, and, for buy-to-let cases where a receiver of rent is appointed, rental receipts from tenants, after allowing for void periods and running costs. These key assumptions are based on observed data from historical patterns and are updated regularly based on new data as it becomes available.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

32. CRITICAL ACCOUNTING JUDGEMENTS AND ESTIMATES (CONTINUED)

In addition, the directors consider how appropriate past trends and patterns might be in the current economic situation and make any adjustments they believe are necessary to reflect current and expected conditions.

The accuracy of the impairment calculations would therefore be affected by unexpected changes to the economic situation, variances between the models used and the actual results, or assumptions which differ from the actual outcomes. In particular, if the impact of economic factors such as employment levels on customers is worse than is implicit in the model then the number of accounts requiring provision might be greater than suggested by the model, while falls in house prices, over and above any assumed by the model might increase the provision required in respect of accounts currently provided. Similarly, if the account management approach assumed in the modelling cannot be adopted the provision required may be different.

In order to provide forward looking economic inputs to the modelling of the ECL, the Group must derive a set of scenarios which are internally coherent. The Group addresses these requirements using four distinct economic scenarios chosen to represent the range of possible outcomes.

The variables are used for two purposes in the IFRS 9 calculations:

- They are applied as inputs in the models which generate PD values, where those found by statistical analysis to have the most predictive value are used
- They are used as part of the calculation where the variable has a direct impact on the expected loss calculation, such as the house price index

The economic variables will also inform assumptions about the Group's approach to account management given a particular scenario. These assumptions are set out in note 11.

33. ACQUISITIONS

On 3 July 2018 the group acquired the entire share capital of Titlestone Property Finance Limited together with a portfolio of loans held by companies related to it (together 'Titlestone'). IFRS disclosures in respect of this acquisition were presented on a provisional basis in note 15 to the group accounts for the year ended 30 September 2018.

During the year ended 30 September 2019, the circumstances, performance and security value of certain of the Titlestone loans were reviewed in more detail, providing further information on the value of those assets at the acquisition date. As a result of this exercise the initial values of those loans were reduced by £2.7m with a corresponding change in the related deferred tax balances of £0.5m. Consequently, the goodwill balance was increased by £2.2m (note 13).

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

34. FINANCIAL ASSETS AND FINANCIAL LIABILITIES

The Group's financial assets and financial liabilities are valued on one of two bases, defined by IFRS 9:

- Financial assets and liabilities carried at fair value through profit and loss ('FVTPL')
- Financial assets and liabilities carried at amortised cost

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 2019 or the year ended 30 September 2018 carried at fair value and valued using level 3 measurements, other than contingent consideration amounts.

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.

a) Assets and liabilities carried at fair value

The following table summarised the Group's financial assets and liabilities which are carried at fair value.

	Note	**2019**	**2018**
		£m	**£m**
Financial assets			
Derivative financial assets	12	592.4	855.7
Financial liabilities			
Derivative financial assets	12	80.5	4.7
Contingent consideration		23.7	25.7
		104.2	30.4

All of these financial assets and financial liabilities are required to be carried at fair value by IFRS 9, and the introduction of the new standard has had no impact on their classification, valuation basis or valuations.

34. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

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 and SONIA 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. However, variability in this input does not have a significant impact on the valuation, compared to other inputs.

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 12.

Contingent consideration

The value of the contingent consideration balances included in sundry liabilities 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 business generated by operational units acquired, business derived as a result of the vendor's contacts or other goodwill and any other new business flows which are or might be attributable to the acquisition agreement, 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.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

34. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

b) Assets and liabilities carried at amortised cost

The fair values for financial assets and financial liabilities held at amortised cost, determined in accordance with the methodologies set out below are summarised below.

	Note	2019 Carrying amount £m	2019 Fair value £m	2018 IFRS 9 Carrying Amount £m	2018 IAS 39 Carrying amount £m	2018 Fair value £m
The Group						
Financial assets						
Cash	9	1,225.4	1,225.4	1,310.6	1,310.6	1,310.6
Loans to customers	10	12,186.1	12,370.1	12,100.6	12,127.8	12,222.9
Sundry financial assets		90.3	90.3	15.3	15.3	15.3
		13,501.8	13,685.8	13,426.5	13,453.7	13,548.8
Financial liabilities						
Short term bank borrowings		1.0	1.0	1.1	1.1	1.1
Asset backed loan notes		4,419.4	4,419.4	5,554.7	5,554.7	5,554.7
Secured bank borrowings		787.5	787.5	935.6	935.6	935.6
Retail deposits		6,391.9	6,408.9	5,296.6	5,296.6	5,296.6
Corporate and retail bonds		446.1	474.9	445.4	445.4	445.4
Other financial liabilities		83.1	83.1	82.8	82.8	82.8
		12,129.0	12,174.8	12,316.2	12,316.2	12,288.3

The fair values of retail deposits and Corporate and retail bonds shown above will include amounts for the related accrued interest

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.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

Loans to customers

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.

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.

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.

E. Appendices to the preliminary announcement

Additional financial information supporting amounts shown in the Management Report (Section A), but not forming part of the statutory accounts.

APPENDICES TO THE PRELIMINARY ANNOUNCEMENT
For the year ended 30 September 2019

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.

The fair value adjustments arise principally as a result of market interest rate movements, outside the Groups control. They are profit neutral over time and are not included in operating profit for management reporting purposes. They are also disregarded by many external analysts.

Transactions relating to acquisition and disposals include the direct transaction costs of the 2018 acquisitions, the additional net funding costs of deposits built up over time to satisfy consideration on those acquisitions and the break costs of the Idem Capital facility, in addition to the gains recognised.

The transactions relating to the asset disposals and acquisitions 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.

This definition of 'underlying' 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.

	2019 £m	2018 £m	2018 £m
Profit on ordinary activities before tax	159.0		181.5
Less: Gain on disposal of financial assets	(9.7)		(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	15.1		(1.2)
Underlying profit	164.4		156.5

APPENDICES TO THE PRELIMINARY ANNOUNCEMENT
For the year ended 30 September 2019

A. UNDERLYING RESULTS (CONTINUED)

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

	2019 £m	2018 £m
Underlying profit	164.4	156.5
Tax at effective rate	(32.7)	(30.8)
Underlying earnings	131.7	125.7
Basic weighted average number of shares (note 8)	257.6	260.8
Underlying earnings per share	51.1p	48.2p

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

	2019 £m	2018 £m
Underlying earnings	131.7	125.7
Amortisation of intangible assets	2.4	2.1
Adjusted underlying earnings	134.1	127.8
Average tangible equity (note 27(b))	920.7	915.8
Underlying RoTE	14.6%	14.0%

APPENDICES TO THE PRELIMINARY ANNOUNCEMENT
For the year ended 30 September 2019

B. INCOME STATEMENT RATIOS

The average net interest margin is calculated as follows:

Year ended 30 September 2019 (IFRS 9)

	Note	Mortgages	Commercial Lending	Idem Capital	Total
		£m	£m	£m	£m
Opening loans to customers	10	10,449.5	1,131.3	519.8	12,100.6
Closing loans to customers	10	10,344.0	1,452.2	389.9	12,186.1
Average loans to customers		10,396.8	1,291.8	454.8	12,143.4
Net interest		177.8	65.0	54.3	278.4
NIM		1.71%	5.03%	11.94%	2.29%
Impairment provision	11	1.0	7.2	(0.2)	8.0
Cost of risk		0.01%	0.56%	(0.04)%	0.07%

Year ended 30 September 2018 (IAS 39)

	Note	Mortgages	Commercial Lending	Idem Capital	Total
		£m	£m	£m	£m
Opening loans to customers	10	9,953.9	558.8	611.4	11,124.1
Closing loans to customers	10	10,473.5	1,133.2	521.1	12,127.8
Average loans to customers		10,213.7	846.0	566.3	11,626.0
Net interest		157.6	32.2	87.8	254.6
NIM		1.54%	3.81%	15.50%	2.19%
Impairment provision	11	5.5	2.0	(0.1)	7.4
Cost of risk		0.05%	0.24%	(0.02)%	0.06%

APPENDICES TO THE PRELIMINARY ANNOUNCEMENT
For the year ended 30 September 2019

B. INCOME STATEMENT RATIOS (CONTINUED)

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

	2019 £m	2018 £m
Net interest (as above)	278.4	254.6
One off items related to interest		
Acquisition funding costs	-	0.7
Facility break costs	-	1.2
Underlying net interest	278.4	256.5
Average loans to customers (as above)	12,143.4	11,626.0
Underlying net interest margin	2.29%	2.21%

C. COST:INCOME RATIO

Cost:income ratio is derived as follows:

	Note	2019 £m	2018 £m
Cost – operating expenses		125.2	114.2
Total operating income		307.3	301.9
Cost / Income		40.7%	37.8%

Underlying cost:income ratio is derived as follows:

	2019 £m	2018 £m
Cost – as above	125.2	114.2
Acquisition costs expensed	-	(1.5)
Other one-off costs	-	(0.8)
Adjusted cost	125.2	111.9
Income – as above	307.3	301.9
Gain on disposal of financial asset	(9.7)	(28.0)
Acquisition net funding costs	-	0.7
Facility break costs	-	1.2
Adjusted income	297.6	275.8
Underlying cost:income ratio	42.1%	40.6%

APPENDICES TO THE PRELIMINARY ANNOUNCEMENT
For the year ended 30 September 2019

D. NET ASSET VALUE

	Note	2019	2018
Total equity (£m)		1,108.4	1,095.9
Outstanding issued shares (m)	18	261.6	281.6
Treasury shares (m)	20	(5.2)	(20.8)
Shares held by ESOP schemes (m)	20	(3.9)	(2.9)
		252.5	257.9
Net asset value per £1 ordinary share		£4.39	£4.25
Tangible equity (£m)	27	920.7	926.6
Tangible net asset value per £1 ordinary share		£3.64	£3.59

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