

**Paragon Banking Group PLC**

**Preliminary announcement**

For the year ended 30 September 2020

RNS Announcement  
Paragon Banking Group PLC  
3 December 2020

## RESILIENT PERFORMANCE WITH GROWING MOMENTUM

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 2020

Nigel Terrington, Chief Executive of Paragon said:

*"Covid-19 has impacted every individual and business across the UK. However, we entered this year from a position of strength, with strong capital and liquidity, an exemplary loan book and an increasingly diversified business. Our lending performance has been robust and we have seen a recovery and growing momentum in new lending activities. Our retail deposit division has had a transformational year, broadening its product range and distribution with balances increasing by 22.9%, at a lower cost, providing us with a reliable, scalable and cost-effective source of funding.*

*"I am extremely proud of the way our people responded to the Covid-19 pandemic and how operationally resilient the business proved to be. We reacted quickly and with agility, enabling the Group to support our customers and other stakeholders, whilst protecting our employees.*

*"2021 will continue to present challenges for the people and businesses of the UK. Our financial and operational strength mean we are well placed to respond to these challenges and to react to the opportunities that will inevitably emerge."*

### Financial Highlights

- Underlying profit reduced to £120.0 million (2019: £164.4 million), driven by IFRS 9 Expected Credit Loss charges of £48.3 million, reflecting the impact of Covid-19 (2019: £8.0 million)
- Statutory profit before tax reduced to £118.4 million (2019: £159.0 million)
- Full year dividend of 14.4p in line with policy reflecting the resilient performance and strong capital position supporting the growing momentum in the business
- Capital ratios remain strong after accruing for the dividend; CET1 ratio at 14.3% (30 September 2019: 13.7%)
- Net interest margin reduced slightly to 2.24% (2019: 2.29%), reflecting the reduction in base rates during the year, largely recovered by year end given liability repricing

## Operational highlights

- Full operational functionality preserved throughout Covid-19; within four days of the national lockdown over 90% of employees were working from home
- Robust performance in the year with growing new lending
  - Buy-to-let advances reduced to £1,119.0 million (2019: £1,315.1 million), principally due to the closure of the housing market during the lockdown in the Spring
  - Buy-to-let new business pipeline £868.1 million, up from £789.8 million at the half-year and £911.7 million at September 2019 with further growth after the period end
  - Development finance lending advances grew to £385.3 million (2019: £362.9 million) with a strong pipeline of facilities heading in to 2020/21
- Retail deposits continued to grow, up 22.9% to £7,856.6 million (2019: £6,391.9 million), providing the Group with a reliable, scalable and cost-effective source of funding
- Participated in the Government's CBIL and BBL schemes, supporting existing and new customers where appropriate
- Accessed £910.0 million under the SME Term Funding Scheme ('TFSME') by 30 September 2020
- Strong payment holiday support provided to customers covering 21% of the portfolio. Now reduced to c1% of the book
- Buy-to-let 3-month plus arrears decreased to 0.15% (2019: 0.18%)
- Phase 1 of IRB process successfully completed; phase 2 has commenced

### **For further information, please contact:**

**Paragon Banking Group PLC**  
Nigel Terrington, Chief Executive  
Richard Woodman, Chief Financial Officer

0121 712 2607

**Headland Consultancy**  
Lucy Legh/ Del Jones

0789 407 7816 (LL)  
0778 857 7637 (DJ)

The Group will be holding a call for sell-side analysts on 3 December 2020 at 9:30am, a recording of which will be available on the Group's website at [www.paragonbankinggroup.co.uk/investors](http://www.paragonbankinggroup.co.uk/investors) from 2:30pm that day. The presentation material will be available on the website from 7:00am on the same day.

## CAUTIONARY STATEMENT

Sections of this Preliminary Announcement, including but not limited to the Management Report, may contain forward-looking statements with respect to certain of the plans and current goals and expectations relating to the future financial condition, business performance and results of the Group. These statements can be identified by the fact that they do not relate strictly to historical or current facts. They use words such as 'anticipate', 'estimate', 'expect', 'intend', 'will', 'project', 'plan', 'believe', 'target' and other words and terms of similar meaning in connection with any discussion of future operating or financial performance. These have been made by the directors in good faith using information available up to the date on which they approved this announcement and the Group undertakes no obligation to update these forward-looking statements other than in accordance with its legal or regulatory obligations (including under the Market Abuse Regulation, UK Listing Rules and the Disclosure Guidance and Transparency Rules of the Financial Conduct Authority).

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 that could cause actual results or events to differ materially from those expressed or implied by the forward-looking statements. 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. As a result, you are cautioned not to place reliance on such forward-looking statements as a prediction of actual results or otherwise.

These factors include, but are not limited to: material impacts related to foreign exchange fluctuations; macro-economic activity; the impact of outbreaks, epidemics or pandemics, such as the Covid-19 pandemic and ongoing challenges and uncertainties posed by the Covid-19 pandemic for businesses and governments around the world; potential changes in future dividend policy; changes in government policy and regulation (including the monetary, interest rate and other policies of central banks and other regulatory authorities in the principal markets in which the Group operates) and the consequences thereof (including, without limitation, actions taken as a result of the Covid-19 outbreak); actions by the Group's competitors; the UK's exit from the EU which may result in a prolonged period of uncertainty, unstable economic conditions and market volatility, including currency fluctuations; general changes in government policy that may significantly influence investor decisions; and other risks inherent to the industries in which the Group operates.

Nothing in this Preliminary Announcement should be construed as a profit forecast.

## Introduction

2020 has been an eventful, challenging and unprecedented year. It started with the run-in to the Brexit Withdrawal Agreement and the general election. The strength of the economy in the first few months of the year was brought to an abrupt halt with the emergence of the Covid-19 pandemic and lockdown. The consequences have been far-reaching for the economy, society and the political landscape and it will change forever how we work, how we live, how we buy and sell goods and services, and how we interact.

Paragon's business model has been built upon strong financial and operational resilience, through-the-cycle sustainability and crucially, adaptability. All these elements have been tested this year. Whilst the year had started well at an operating level, with strong new business volumes and good momentum, the rapid onset of the crisis meant that our priorities had to be dramatically changed. The new focus was on protecting our people, supporting our customers, protecting our suppliers, preserving our capital and protecting the longer-term franchise of the business.

Whilst our business model has been tested across much of 2020, I am pleased to say it has stood up to these tests. Paragon's focus will remain on reinforcing the fundamentals of our business, whilst looking for the opportunities that this new world order will invariably create.

## Response to Covid-19

The business reacted swiftly to the onset of Covid-19. Within four days of the national lockdown, over 90% of our employees were working from home. Our technology has been resilient, and we maintained all our product and service offerings throughout, including during both lockdowns.

Customer support was central to our activities across all business lines. Temporary payment reliefs were provided to mortgage, consumer and SME lending customers impacted by Covid-19, the vast majority of whom have returned to full payment as the year progressed, with 97% of the customers granted payment reliefs up to date at 30 September 2020. We also participated in the UK Government's business lending schemes.

Paragon has always maintained a strong focus on prudential strength. Capital ratios have been robust throughout and by the year end, CET1 stood at 14.3%, up from 13.7% a year earlier, after allowing for a full year dividend at policy levels. Liquidity levels have been strong, benefitting from increasing diversification of our funding sources and a prudent approach to maintaining high cash levels.

Paragon's prudent lending approach has also resulted in exemplary portfolio strength and measures were taken to protect against the economic consequences of the pandemic with a tighter lending risk appetite. The Group's portfolio is credit defensive, with 99% of the book secured and only 4% of the mortgage portfolio having a loan-to-value ratio greater than 80%.

## Trading performance

New lending activities were disrupted during lockdown, particularly in mortgage lending where the housing market was effectively closed. Most of the impact was felt in the second half of the year, with new lending down approximately 20% on the first half. However, with improved levels of customer retention the loan book expanded by 3.7% year-on-year, and lending volumes remained robust despite the challenges presented by Covid-19.

In mortgage lending, a strong first half was tempered by the impact of lockdown, when the housing market was effectively closed for a two-month period. Landlord demand rebounded quickly in the summer months once the housing market reopened, with pent-up acquisition opportunities and the introduction of the Stamp Duty holiday contributing to a replenished pipeline.

Development finance benefitted from approximately 80% of sites remaining open through the lockdown and the long-term nature of the product, with phased lending commitments. However, SME lending felt a greater impact as customers sought to defer investment decisions or chose instead to draw under one of the UK Government's funding initiatives.

This disruption to lending has now largely played through the business, notwithstanding the effects of a second wave and a further lockdown. At the same time, we are tracking the emergence of the expected credit losses which we have already provided for. The pipelines across the key business lines have rebuilt to pre-Covid-19 levels and, in some cases, are close to record levels. This momentum bodes well for the coming year.

In March the Bank of England reduced base rates to just 10bp. For the Group this resulted in the repricing of assets ahead of liabilities generating a short-term impact to Net Interest Margin ('NIM') in the second half. This had substantially unwound by the year end and we expect the structural upward trajectory in margins witnessed in recent years to resume going forward.

### Financial performance

The Group reported an operating profit of £120.0 million for the full year, 30% below 2019, largely driven by the IFRS 9 impairment charge which rose by over 500% year-on-year to £48.3 million, and was taken in anticipation of the expected impacts of Covid-19. Given the extensive government support to the UK economy, which has now been extended for a further period, much of this impairment charge is unlikely to crystallise in the form of customer defaults and write offs in the near term. Nevertheless, our approach has been conservative, applying post-model adjustments to modelled expected loss outputs. These were based on our close understanding of the customer base and reflected the Group's economic forecasts, anticipating the potential impact on our loan portfolio of the inevitable real economic consequences of the pandemic. Notwithstanding this impact on profitability, the Group still delivered an underlying return on tangible equity of 9.8% (9.7% on a statutory basis).

The huge uncertainty in the early stages of the pandemic meant that the Board took the decision at the time of the half year results not to pay a dividend. The Group's resilient performance, strong capital ratios and our assessment of the book under stress gives us sufficient confidence to declare a full year dividend of 14.4 pence per share, in line with the policy of maintaining dividend cover of 2.5 times.

### Business model developments

Our operating capability was thoroughly tested this year and has proven its resilience and adaptability. The efficient switch to home working enabled many of our customers to receive high levels of support across the depths of the lockdown period through the provision of forbearance and participation in government-sponsored initiatives. The experiences of 2020 will have a far-reaching impact on banking generally and on how customer engagement is undertaken in the future.

Despite the challenging environment, we delivered a number of customer and introducer-facing systems across the year. Whilst there have been some delays to the roll-out of the change road map this year it is likely we will see an acceleration of the new technology plans as digitalisation and greater workforce location flexibility emerge.

Paragon is a data-focussed business. This background, together with strong credit-focussed governance structures, has supported our application for IRB accreditation. IRB would allow internal credit models, specific to the Group, to be used to determine capital requirements. The greater use of such models within the Group's decision-making and capital analysis will further enhance our risk management over time. The IRB application process can be a lengthy one and for Paragon it has begun with its buy-to-let mortgage portfolio, with a subsequent roll-out to the Group's other lending portfolios scheduled over the next few years.

The Group's savings platform has seen material growth during the year, at much improved pricing with stock rates falling from 1.81% at 30 September 2019 to 1.34% at 30 September 2020. Strong direct inflows have been supplemented by closer ties with third-party platforms providing further diversification to our funding strategy. We expect to build on this strategy by increasing the number of third-party relationships and further extensions of our product range.

Alongside retail savings we have continued to broaden our wholesale funding facilities, having accessed securitisation markets, expanded warehouse capacity and increased central bank funding through access to the Bank of England's TFSME scheme.

Diversification is as important for our liabilities as it is in our assets. Warehouse and securitisation funding now represents 27.4% of total liabilities compared to 95.6% in 2014.

## People

The performance of our people has been exceptional during this challenging year. Supported by our technology team, the move to home working was delivered efficiently and quickly, with minimal business interruption.

Each of our operating businesses remained open for new business and to support customers throughout the year. The material increase in customer contact to put appropriate arrangements in place was delivered effectively and swiftly, demonstrating the adaptability of our people and processes.

A key priority of our strategic response to Covid-19 was the protection of our long-term franchise – I firmly believe the incredible performance of our various teams has enhanced this position across 2020.

The flexibility of our employee base also facilitated a rotation of certain roles from front-end underwriting to a more customer service focussed position. There has been greater flexibility applied to working patterns and a material focus on enhanced communications, morale and wellbeing. When surveyed, 94% of our employees believed the Group had been considerate of their wellbeing when making decisions affecting the workforce and 84% of our people were either satisfied or very satisfied with the support available for them.

Paragon has not used the Coronavirus Job Interruption (furlough) scheme, nor has it made any redundancies since the onset of Covid-19.

## Sustainability

2020 was a fundamentally important year in the recognition of the significance of some of the non-financial aspects of our business. We have always ensured that a wide range of stakeholders' interests are considered and, where appropriate, factored into strategy and policy. We are now explaining more fully about what we do across a range of stakeholder communications.

Paragon recognises that sustainable development can only be delivered through an increased awareness of such impacts across the business, embedded in its culture and values. The Board is fully engaged with this project and during the year made a clear statement of its commitment by promoting climate change to a principal risk within the governance framework, ensuring that environmental sustainability is placed at the core of our business model.

## Outlook

We have delivered on the objectives we set at the start of the pandemic to protect our people, support our customers and business partners, preserve capital and protect the longer-term franchise of the business. As a consequence, we are a stronger business today than before the crisis.

Our business model has proven its resilience both financially and operationally. Capital ratios and liquidity are strong, the balance sheet is credit defensive and the franchises have been enhanced during this difficult period.

Covid-19 has cast a long and dark shadow on the people and businesses of the UK, but we are well placed to manage the uncertainty that will run into 2021 and beyond. We remain committed to supporting our customers, helping them navigate through this period and achieve their ambitions, and believe we are in a strong position to capitalise on the opportunities which will inevitably emerge as the UK recovers from this pandemic.



# MANAGEMENT REPORT

## MANAGEMENT REPORT

**1 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 in the year		Net loan balances at the year end	
	2020 £m	2019 £m	2020 £m	2019 £m
Mortgage Lending	1,259.7	1,568.6	10,819.5	10,344.1
Commercial Lending	790.8	968.0	1,514.8	1,452.1
Idem Capital	-	-	297.1	389.9
	<u>2,050.5</u>	<u>2,536.6</u>	<u>12,631.4</u>	<u>12,186.1</u>

The Group's loan book increased by 3.7% in the year, despite the restrictions in lending activity caused by the Covid-19 crisis which depressed new business volumes across the business in the second half of the financial year.

**1.1 Mortgage Lending**

The Group's Mortgage Lending 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, the Group targets niche markets where its focus on detailed case-by-case underwriting and its robust and informed approach to property risk differentiate it from mass market and other specialist lenders. Its core products are buy-to-let residential property mortgages, targeted at specialist landlords (those who have four or more properties and / or operate through corporate structures).

*Housing and mortgage market*

During March 2020 the UK housing market began to be impacted by the Covid-19 crisis, with the increased levels of economic uncertainty impacting on house purchase decisions. Government responses on lockdown and social distancing also placed practical limitations on the operation of the housing market. RICS reported in its April 2020 Residential Market Survey that levels of activity in the housing market were the weakest since the inception of the survey in 1999.

To help mitigate the impact of the national lockdown on homeowners and landlords, the UK Government introduced mortgage relief schemes, covering both owner-occupied and buy-to-let mortgages of residential property which lenders in the sector then had to put in place. These enabled customers to take payment holidays without this impacting on their credit history or score. These holidays were initially for three months, but subsequently extended to six months if required.

## MANAGEMENT REPORT

**1 LENDING REVIEW (Continued)**

In November 2020, after the end of the year, the payment holiday regime was extended further to address the new wave of Covid-19 restrictions. Many of the Group's landlord customers will have been able to provide rent relief to their tenants as a result of these arrangements.

Activity in the mortgage market recovered in the final quarter of the financial year, following the end of the UK lockdown, which allowed physical valuations of properties to resume and house moves to take place.

For most of the first half of the financial year the prospects for the UK housing market had appeared relatively positive, with economic uncertainty reduced by the UK general election in December 2019. This led to increasing transaction levels and upward pressure on house prices following a period of stagnation in the market. Market conditions for mortgage customers had remained benign, with low interest rates, arrears and possession levels.

This pattern is clearly shown in the Bank of England's data on mortgage approvals. The total approvals for the year ended 30 September 2020 of £242.3 billion reduced by 7.8% (2019: £262.9 billion), with most of the reduction attributable to the quarter ended June 2020 when mortgage approvals, at £34.8 billion, were half of the £69.5 billion recorded in the corresponding quarter of 2019.

House prices began to increase after the election, with the Nationwide Building Society reporting an average increase of 2.0% in the first six months of the financial year. The expected downward pressure on house prices following the onset of Covid-19 did not emerge. Rather than withdraw from the market, homeowners looked to improve their housing position, resulting in a structural shift in demand buoyed by the stamp duty holiday introduced by the UK Government. As a result, house prices increased by 5.0% over the financial year, benefitting the Group's security values. As the impact of the pandemic continues to emerge, significant uncertainty on the near and medium-term outlook will remain.

*The Private Rented Sector ('PRS') and the buy-to-let mortgage market*

Specialist landlords form the largest part of the Group's target market. These are landlords with four or more rental properties who generally run their portfolio as a business and have a high level of personal day-to-day involvement. This approach has meant these specialist landlords have been better placed to address the challenges than other classes of mortgage customer.

The Group is amongst a small number of specialist lenders addressing this sector, which is underserved by many of the larger lenders. Non-bank lenders had a significant position in this market before the Covid-19 outbreak, but their funding issues have led to a restriction of the supply of credit from this source, providing opportunities for the Group.

Buy-to-let lending reflected the performance of the larger mortgage finance sector, with new advances of £38.2 billion in the year ended 30 September 2020 reported by UK Finance ('UKF'), compared to £41.8 billion in the same period in the previous year, a reduction of 8.6%, principally attributable to the performance in the June quarter. Refinancing of existing borrowings continued to represent the bulk of this activity, with 72.8% of new advances by value representing remortgages (2019: 71.3%).

## MANAGEMENT REPORT

**1 LENDING REVIEW (Continued)**

Whilst Covid-19 restrictions meant that on-site property valuations could not be conducted during April and May 2020, restricting new business activity, the Group developed an enhanced desktop valuation process and introduced products with stricter than normal loan-to-value limits. These changes allowed lending to continue through the lockdown period, particularly in the larger remortgage market, ahead of the phased reintroduction of physical valuations in late May.

In common with other lenders in the market, the Group tightened policy on properties which it could accept as security, especially in the student lettings and complex property space. Market limitations on propositions have remained in place, to a greater or lesser extent, post lockdown, with the level of supply into the buy-to-let market such that lenders can be selective.

The lettings market remained stable through the early part of the period, with RICS reporting continuing supply issues and increasing tenant demand towards the end of the year, leading to an expectation of rent increases. The Covid-19 impact saw a short-term downward pressure on supply, demand and rents, but in its September survey RICS expected a generally upward trend for rents and there is some evidence that restricted volumes in the residential mortgage market have kept potential first time buyers in the rented sector.

**Lending activity**

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

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
<i>Originated assets</i>		
Specialist buy-to-let	1,119.0	1,315.1
Non-specialist buy-to-let	86.4	165.4
	<hr/>	<hr/>
Total buy-to-let	1,205.4	1,480.5
Owner-occupied	0.3	11.9
Second charge	54.0	72.0
	<hr/>	<hr/>
	1,259.7	1,564.4
Acquired assets	-	4.2
	<hr/>	<hr/>
	1,259.7	1,568.6
	<hr/>	<hr/>

Total mortgage originations in the Group reduced by 19.7% in the year. The major factor driving the reduction was the Covid-19 lockdown, and its impact on market activity over the summer months.

*Buy-to-let*

Specialist buy-to-let lending activity fell 14.9% when compared to 2019, principally as a result of the restricted market in the summer months, whereas non-specialist, or simple, buy-to-let lending fell by 52.2% as the Group tightened its focus on the specialist market. The new business pipeline, the loans passing through the underwriting process, was £868.1 million at the year end (2019: £911.7 million), showing business returning to more normal levels heading into the new financial year.

## MANAGEMENT REPORT

**1 LENDING REVIEW (Continued)**

The Group sources the majority of its new buy-to-let lending through specialist intermediaries and it continues to invest to ensure the service offered to them is excellent. All the Group's significant intermediaries were able to stay in operation through the Covid-19 crisis. During the year the Group's regular surveys of its intermediaries showed 91% were satisfied with the ease of obtaining a response from the Group (2019: 84%), delivering a net promoter score at offer stage of +56 (2019: +60).

This result was achieved against the background of Covid-19, highlighting the value placed by the intermediary community on the Group's offering and on their relationship with the business. This relationship was enhanced by the Group's response to the Covid-19 crisis, with a survey of intermediaries finding that around 70% believed that its response was better than that of other lenders. Anecdotal evidence suggests that response times for brokers have generally been better than for other lenders in the market due to the proportion of the Group's employees who were able to remain active through the crisis.

The business is aware of the potential for climate change to impact on the mortgage business and seeks to mitigate risk through careful consideration of the properties on which it will lend. Since 2018 all properties accepted as security must have a minimum Energy Performance Certificate rating of E at the time of offer. The Group had EPC records for 85% of its mortgage book at 30 September 2020 with 98.1% of these covered by certificates of grade E and higher (on a scale of A to G). Such action by lenders will also lead to improvements in the housing stock in the PRS.

The Group also monitors the physical risks from climate change on its property exposure. As part of the underwriting process a property's flood risk is considered and less than 2.2% of our properties were situated within a medium or high flood risk zone (2019: 2.5%).

The business is also working with the Green Finance Institute to develop products which would encourage energy and carbon efficiency for the future.

*Other 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.

Lending in the Group's second charge mortgage operation was in line with plan in the first half year, however it was scaled back in the second half in response to Covid-19. Within the second charge mortgage market the Group targets only higher credit quality customers, rather than the lower-rated borrowers generally associated with this sector. This limits potential lending in this field but should provide more resilience in adverse economic conditions, as proved to be the case in the pandemic.

The Group continues to limit its exposure to first charge residential lending to owner-occupiers, given the pressure on market yields and a limited demand for products where its specialist approach adds value. The opportunities for the Group in this area principally relate to lending to the existing professional landlord customer base.

## MANAGEMENT REPORT

**1 LENDING REVIEW (Continued)****Performance**

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

	<b>30 September 2020 £m</b>	<b>30 September 2019 £m</b>
<i>Post-2010 assets</i>		
First charge buy-to-let	6,202.5	5,427.7
First charge owner-occupied	51.2	68.3
Second charge	182.6	171.6
	<hr/>	<hr/>
	6,436.3	5,667.6
<i>Legacy assets</i>		
First charge buy-to-let	4,381.3	4,674.2
First charge owner-occupied	1.9	2.3
	<hr/>	<hr/>
	10,819.5	10,344.1
	<hr/> <hr/>	<hr/> <hr/>

At 30 September 2020, the balance on the Group's total net mortgage balance was 4.6% higher than at the start of the financial year, despite the impact of Covid-19 on advances and provisions. The balance on the post-2010 buy-to-let portfolio grew by 14.3% and it now represents 57.3% of the total (2019: 52.5%).

The annualised redemption rate on buy-to-let mortgage assets, at 6.6% (2019: 8.6%), has continued to reduce, driven partly by the slowing of the market due to Covid-19, partly as a result of continuing initiatives to encourage existing customers to remain with the Group and partly as a result of the increasing average length of fixed rate periods over recent years.

Arrears on the buy-to-let book decreased in the year to 0.15% (2019: 0.18%), although some arrears will inevitably have been suppressed by payment holidays. Arrears on post-2010 lending were at 0.03% (2019: 0.03%). These arrears remain very low compared to the national buy-to-let market, with UKF reporting arrears of 0.52% across the buy-to-let sector at 30 September 2020 (2019: 0.42%).

While just over 20% of the Group's buy-to-let customers took payment holidays when offered, less than 5% remained on payment holiday at the year end, with further reductions being seen in October and November. Customer surveys indicated the motivation for taking these holidays was, in many cases, precautionary, to ensure they were well positioned to deal with potential future tenant payment issues. The majority of respondents were also confident in their ability to resume payments after the end of the payment holiday period.

This strong performance reflects the Group's focus 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.

The Group is also confident that its robust approach to valuation and the loan-to-value coverage in its buy-to-let book, at 65.8% (2019: 67.4%) provides it with significant security in the face of the present economic stress. The levels of interest cover and stressed affordability in the portfolio suggest that its customers are also well placed to manage Covid-19 impacts on their businesses in the longer term.

## MANAGEMENT REPORT

**1 LENDING REVIEW (Continued)**

Second charge arrears increased to 0.62% from 0.38% in the year, reflecting the increased seasoning and size of the portfolio. There were no arrears on post-2010 residential lending.

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. The Group's receiver of rent team worked with tenants through the Covid-19 lockdown to manage the rent position in a responsible manner. At the year end 623 properties were managed by a receiver on the customer's behalf, a reduction of 8.8% since 2019 (2019: 683 properties). Almost all these cases currently relate to pre-2010 lending, with cases being resolved on a long-term basis to ensure the best outcome for the Group, landlord and tenants.

**Outlook**

While the impact of Covid-19 means that the short-term macro-economic outlook for the Group and its landlord customers is difficult, the Group remains optimistic about its longer-term prospects. The vast majority of customers remain committed to the PRS and their positive experiences of the Group through this period will have enhanced business relationships.

The funding of the PRS is vital to the housing infrastructure of the nation and that will ensure that the demand for the Group's products and services remains into the future.

**1.2 Commercial Lending**

The Group's Commercial Lending division brings together various streams of predominantly asset-backed lending to, or through, commercial organisations and has been a major focus of growth over recent years.

The proposition is delivered through four key business lines:

- SME lending, providing leasing for business assets and unsecured cash flow lending for professional services firms, amongst other products
- Development finance, funding smaller, mostly residential, property development projects
- Structured lending, providing finance for niche non-bank lenders
- Motor finance, focussed on specialist parts of the sector

In each of its markets the division's competitors are small banks and non-bank 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 relies heavily on specialist teams to address the separate business lines, either sourced externally or developed internally.

The Group's strategy in this wider market is to target niches (either product types or customer groups) where its skill sets can be best applied, and its capital effectively deployed to optimise the relationship between growth, risk and return.

## MANAGEMENT REPORT

**1 LENDING REVIEW (Continued)**

Given the nature of the assets financed, in the second half of the year Covid-19 resulted in a material number of customers requesting some form of payment relief and new advances being sharply reduced. However, the SME sector has been the focus of government support programmes and the Group was authorised to provide loans under the CBILS and BBLIS initiatives, making advances under these programmes from June onwards.

As part of its strategy for the division the Group continues to enhance its operational functionality in this area, developing technological solutions both to enhance customer service and to assist in the procurement processes, enabling potential customers, or the brokers they use, to access appropriate finance.

The common themes of these diverse business lines are a deep understanding of their respective markets and customer needs, together with expertise in the valuation of any security, 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.

Work is ongoing to review the division's exposure to climate change risk. In development finance, the focus has been on determining the environmental impact of projects and the energy efficiency of the properties being constructed, whereas in motor finance the assessment has been on the fuel types and emissions of financed vehicles. Within SME lending, work is in progress to classify the sectors in which each of our clients operate with respect to their respective climate change sensitivities, while the potential for green financing solutions is being investigated.

**Lending activity**

During the first half of the year new business levels were strong across all business lines in the division. The Group's focus on widening the customer base and improving yields delivered both increased loan books and strong credit performance.

The onset of Covid-19 in March 2020 had a significant impact on volumes in the second half year. The impact on customers' businesses, and the levels of uncertainty for those not directly impacted, reduced the appetite for new finance, while the practical issues of sourcing and delivering new assets in a lockdown situation also had an impact on the leasing business.



## MANAGEMENT REPORT

**1 LENDING REVIEW (Continued)**

The Commercial Lending segment saw an 18.3% reduction in new advances compared to the previous year. While development finance continued to grow, though less strongly than planned (by 6.2%), activity in other areas was more materially reduced. The new lending activity in the segment during the year is set out below.

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
Development finance	385.3	362.9
SME lending	288.0	406.5
Structured lending	7.6	49.7
Motor finance	109.9	148.9
	<u>790.8</u>	<u>968.0</u>

The impact of this new business has been to increase the Group's overall Commercial Lending exposure by 4.3% in the year to £1,514.8 million (2019: £1,452.1 million).

*SME lending*

The SME lending business performed well through the first five months of the financial year, with the Group's customers regaining some level of confidence after the political uncertainties of 2019 and becoming more willing to enter into capital commitments. Advance levels in this period were strengthening and yields were being maintained.

The Covid-19 outbreak reduced new business activity from March, both as a result of customer unwillingness to enter into new commitments and, in the leasing business, as a result of the practical difficulties of sourcing and delivering large pieces of equipment, some internationally, in a global lockdown. Customers' access to other, cheaper funding sources through government sponsored relief schemes also reduced the scope for new business.

As a result of these impacts, new asset finance leasing volumes reduced by 42.5% compared to the comparative period in 2019, to £166.1 million (2019: £288.7 million). Investment in operating leases has also continued with £12.9 million of assets acquired in the period (2019: £11.6 million). Short-term lending to professional services firms reduced significantly, by 32.9% to £79.1 million (2019: £117.8 million) as Covid-19 related tax deferrals from March meant that customers did not require to draw down in order to satisfy their liabilities. As a result, across all products, SME lending decreased by 29.2% to £288.0 million (2019: £406.5 million).

The Covid-19 crisis saw around 46% of the SME lending business's customers applying for some form of payment relief. Relief in this market is normally given as an interest only period, where the customer continues to make payments. The financial issue for many of the customers, particularly in sectors such as construction, was the inability to generate income from the financed assets during the lockdown period, creating a cash shortfall.

In line with the approach taken on the mortgage book, extended payment holidays were offered to SME Lending customers, but these were taken up by a substantially smaller number than the initial three month reliefs and at the year end only 2.1% of accounts remained on a payment holiday.

## MANAGEMENT REPORT

**1 LENDING REVIEW (Continued)**

The long-term impact of Covid-19 on customers is difficult to predict at this stage, particularly given that many may have received short term relief in the form of CBILS or BBLs loans from their relationship banks, although feedback from the enhanced customer contact programme is encouraging.

The Group received authorisation to participate in the government-sponsored British Business Bank CBILS and BBLs schemes, providing funding to SMEs under a government guarantee. The Group has used this facility primarily to support its existing customers, completing £25.9 million of loans in the year, and anticipates making further advances, both to new and existing customers into the new financial year. The Group is working to support industry initiatives to establish a common collections framework for CBILS and BBLs, providing certainty to customers and hopes this can be established in the near future.

The Group has continued to focus on improving its operational procedures in this area, to deliver better customer service and enhance margins, focussing on people and processes and on improving the handling and use of data in the business to provide better targeting and analysis and to enhance customer experience. These developments continued to progress through the Covid-19 period, although they were delayed by the demands of the systems and process upgrades required for payment reliefs, CBILS and BBLs. The Group expects these investments to impact positively on efficiency and agility going forwards.

Lending activity into the new financial year will be dependent on the uncertain impact of the ongoing Covid-19 situation, with volumes likely to remain depressed in the short term. The priority of the business will be to support its customer base through the crisis while working to enhance the proposition for the future.

*Development finance*

Activity levels in the Group's target market were healthy in the first half of the financial year, with increased enquiry levels and higher levels of new commitments, and prospects looking promising up to the end of February. At that point the onset of the Covid-19 pandemic impacted the market, with levels of lending in March being more subdued. However, demand in the second half of the year rebounded, to some extent, following the easing of the lockdown and this is reflected in longer-term sentiment amongst the Group's customers which is less negative than might be expected.

New projects continued to commence throughout the second half of the year, while completed developments resulted in repayment of facilities. The Group remained active in the market throughout the year and this continuity of service was appreciated by our customers over the period.

The Group's target customer is a small to medium-sized developer of UK residential property. The typical types of projects funded have an average development value of approximately £7 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 Home Counties, with 67.0% of balances at 30 September 2020 located in London and the South East, the Group's strategic objective is to lend more widely across the UK and this focus continued through the year. Central London property hot spots have been generally avoided.

## MANAGEMENT REPORT

**1 LENDING REVIEW (Continued)**

The Group engages monitoring surveyors to review progress and costs on a regular basis through the build phase of each project, and these activities have generally continued through the Covid-19 period. The maximum level of closed sites during the crisis was 22%, but these were generally quickly reopened. 73% of sites remained active throughout the lockdown period. Many projects have been subject to some level of delay, principally due to access, labour or supply issues, but overall, the level of resilience in the customer base has been impressive.

While uncertainties around Covid-19 remain, prospects for the new financial year appear promising. Undrawn amounts on live facilities at 30 September 2020 of £380.9 million are expected to flow through to advances during the coming year, while the post-offer pipeline of £171.5 million is likely to be drawn down over a longer period, though the timing may be affected by ongoing Covid-19 restrictions. The Group is investing in the business, increasing resources to allow a greater variety of propositions and routes to market to be explored.

The underlying basis of the development finance proposition remains attractive, with positive market sentiment heading into the new financial year. The need for new housing will remain into the future and smaller developers have only a limited number of funding sources, which have reduced further through the Covid-19 crisis, with some non-bank lenders previously active in the sector suffering from limited lending capacity. The Group believes the business is well placed to support its developer customers during and after the pandemic.

*Structured lending*

The structured lending exposure has grown in the period by 7.7%, mostly as a result of additional drawings on extant facilities in the first half year, although new facilities of £8.0 million came on stream during the year. These loans generally fund non-bank lenders, of various kinds, and as such facilities are carefully constructed to provide a buffer for the Group in the event of default in the ultimate customer population, with first loss cover of at least 20% in all cases. The impact of Covid-19 on each of the exposures varies with the nature of the underlying assets and the Group's experienced account managers have carefully monitored each of the facilities, maintaining a high level of contact with the counterparties.

*Motor finance*

The Group's strategy for motor finance is to target its offerings on those specialist propositions not typically addressed by mass-market lenders. After a positive first six months of the year, where completions increased while maintaining yield levels, business was sharply reduced in the second half due to the substantially reduced levels of activity seen in the automotive market throughout the Covid-19 crisis.

## MANAGEMENT REPORT

**1 LENDING REVIEW (Continued)****Performance**

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

	<b>30 September 2020 £m</b>	<b>30 September 2019 £m</b>
Asset leasing	478.0	492.2
Professions finance	22.3	46.2
CBILS and BBLS	25.2	-
Invoice finance	13.5	18.5
Unsecured business lending	15.0	19.3
	<hr/>	<hr/>
Total SME lending	554.0	576.2
Development finance	609.0	506.5
Structured lending	94.9	88.1
Motor finance	256.9	281.3
	<hr/>	<hr/>
	<b>1,514.8</b>	<b>1,452.1</b>

Credit quality in the development finance book has been good, and the overall performance of the projects has been in line with expectation allowing for the impact of Covid-19 on the timing of some projects. These accounts are monitored on a case-by-case basis by the Credit Risk function. At 30 September 2020 very few cases had been classified by the monitoring process as being likely to result in a loss, with a number of the problem cases acquired with the business resolved in the year.

While no Covid-19 specific credit concerns have been identified on individual development finance accounts, the Group recognises the potential impact of increased economic uncertainty, including the impact of the end of Stamp Duty relief on the property market and execution risk on its portfolio. The average loan to gross development value for the portfolio at the year end, a measure of security cover, was 63.1% (2019: 64.8%), which gives the Group a substantial buffer if any project encounters problems.

Credit performance on the division's finance leasing portfolios remains stable, with arrears in asset leasing at 1.75% and motor finance at 1.76% (2019: 0.43% and 1.27% respectively). However, these measures may be distorted by the effect of payment holidays.

Take up of payment reliefs in SME lending was substantial, with 3,526 accounts given relief, representing over half of the book, although only 326 of these required an extension. 2,899 (16.2%) of the Group's motor finance accounts were granted a payment holiday, with only 419 (2.3%) requiring an extension.

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 loan facilities.

## MANAGEMENT REPORT

**1 LENDING REVIEW (Continued)****Outlook**

In the short term the focus for growth in Commercial Lending will be in development finance, where the fundamentals of product, demand and service remain strong despite Covid-19. In the other business lines the priority will be on the careful management of the books and supporting customers through the ongoing crisis. The underlying long-term prospects for the division remain positive and the Group continues to invest in developing its activities for the future.

**1.3 Idem Capital**

The Idem Capital segment contains the Group's acquired loan portfolios, together with its pre-2010 legacy consumer accounts. These include mostly second charge and unsecured consumer loans.

The division's strategic focus is on specialist loan portfolios which can augment the organic origination activities of the Group. In these portfolios, it can enhance value through leveraging the Group's originations and collections expertise, together with its access to a variety of retail and wholesale funding. It recognises that this model is essentially opportunistic and that the flow of such opportunities to the market may be sporadic. It carefully considers the capital requirements for any potential acquisition, particularly where asset types offered require relatively large amounts of capital to be held. It also considers the potential for conduct risk issues to arise in portfolios which may contain more vulnerable customers. Many of Idem Capital's customers have been under financial stress in the past and its processes aim to generate fair outcomes for all customers, recognising any vulnerabilities. In the present Covid-19 situation, that objective has an even greater focus.

Overall Idem Capital's success rests on understanding assets, strong analytics, advanced servicing capabilities and the efficient use of funding. All these attributes are vital in its management of the impact of Covid-19 on its customer base.

**New business**

While the UK loan portfolio purchase market remained active in the period up to the Covid-19 outbreak, and the Group participated in the majority of significant tender processes, there were few opportunities which were particularly appealing, either because of pricing, the nature of the assets or the capital which might have been required. Opportunities were even more limited in the post-Covid-19 environment, although some level of activity did remain in the market.

The Group only pursues transactions 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.

During the period, no portfolio acquisitions were completed (2019: none) although, as noted above, the division undertook a limited number of reviews of opportunities that were ultimately not progressed.

The main focus of the business in the year was the careful management of its existing books and ensuring that appropriate processes and systems are in place to address the Covid-19 outbreak with customers, many of whom were already identified as vulnerable.

## MANAGEMENT REPORT

**1 LENDING REVIEW (Continued)****Performance**

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

	<b>30 September 2020 £m</b>	<b>30 September 2019 £m</b>
Second charge mortgage loans	171.9	217.6
Unsecured consumer loans	109.7	134.7
Motor finance	15.5	37.6
	<u>297.1</u>	<u>389.9</u>

The reduction in balances is a result of collections from the brought forward loan portfolios, with receipts remaining relatively strong, despite the impact of Covid-19. The accounting balance was also reduced by £3.7m at the half year to allow for potential reductions in future cashflows due to Covid-19. 120 month Estimated Remaining Collections ('ERC') on acquired consumer assets fell to £313.7 million at 30 September 2020 (2019: £366.4 million) for the same reasons.

Collections from customers have, however, held up well in the year, despite the negative economic impacts of Covid-19, with instalment receipts remaining stable despite a temporary downturn in March. 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 18.8% (2019: 17.2%). These arrears levels remain higher than the average for the sector, but this reflects the seasoning of the balances, while the upward trend reflects the redemption of performing accounts. This book contains a significant number of accounts which are currently making full monthly payments but had missed payments at some point in the past, inflating the arrears rate. Average arrears for secured lending of 8.4% at 30 September 2020 were reported by the Finance and Leasing Association ('FLA') (2019: 8.7%).

Approximately 15.5% of the divisions secured accounts were granted initial payment holidays with 6.5% being granted extensions.

None of the live Idem Capital loan portfolios were regarded as materially underperforming at the year end, with strong overall cash generation, considering the impact of Covid-19. The Group monitors actual cash receipts from acquired portfolios against those forecast in the evaluation which informed the purchase price. Up to 30 September 2020 such collections were 109.8% of those forecast to that point (2019: 109.8%). The impact of Covid-19 on the long-term cash forecasts has not been significant.

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 Idem Capital loan book continues to provide strong cash flows and the Group's priority is to effectively manage this collection process while investigating potential portfolio investments which match its risk and reward requirements.

## MANAGEMENT REPORT

**2 FUNDING REVIEW**

The Group's funding strategy, built on diversification and sustainability, was both enhanced and tested in the period. New initiatives widened the footprint of the retail deposit operation, new forms of liquidity funding were introduced, and additional central bank funding schemes accessed.

This variety of funding options ensures that pricing and availability issues in any individual funding market can be mitigated, while, at the same time, maintaining the flexibility to fund strategic developments. In particular, it protects the Group from the effects of incidents such as the Covid-19 crisis. This saw capital market pricing seriously disrupted while emergency funding from the UK authorities was channelled principally through central bank lending to the UK banking sector.

Throughout the period the Group raised the majority of its new funding through the retail deposit market, where volumes proved robust throughout the Covid-19 crisis, as consumers' appetite for saving increased, either through economic anxiety or through reduced opportunities to spend. The Group's retail deposit balance grew by 22.9% in the year to £7,856.6 million (2019: £6,391.9 million), representing 55.8% of balance sheet funding.

The Group's funding at 30 September 2020 is summarised as follows:

	<b>2020</b>	<b>2019</b>	<b>2018</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>
Retail deposit balances	7,856.6	6,391.9	5,296.6
Securitised and warehouse funding	3,928.3	5,206.9	6,490.3
Central bank facilities	1,854.4	994.4	1,024.4
Tier 2 and retail bonds	446.6	446.1	445.4
	<u>14,085.9</u>	<u>13,039.3</u>	<u>13,256.7</u>
Total on balance sheet funding			
Off balance sheet central bank facilities	-	109.0	108.7
Other off balance sheet liquidity facilities	150.0	-	-
	<u>14,235.9</u>	<u>13,148.3</u>	<u>13,365.4</u>

The overall UK economic outlook has remained uncertain over the whole year, with the political instability of autumn 2019 followed in turn by the December general election and the Covid-19 crisis, while uncertainty over the final terms of any Brexit settlement continued through the year. All these factors affected market sentiment, generating considerable volatility.

In response, the Group maintained a conservative stance on liquidity throughout the year. £1,701.1 million of cash was available for liquidity and other purposes at the end of the period (2019: £872.1 million). The Group's contingent liquidity policy will be kept under review as the ultimate outcome of the Covid-19 crisis becomes clearer and longer-term trends become more evident.

In the short to medium term, the Group's principal source of funding will remain retail deposits, which have performed well throughout the Covid-19 crisis to date. These will be supplemented by participation in TFSME, the Bank of England scheme to support lending into the UK economy, especially to SMEs. New public securitisations in the near term are unlikely, with offerings in the short term likely to be designed to create securities to support other borrowings.

## MANAGEMENT REPORT

**2 FUNDING REVIEW (Continued)**

LIBOR, which had been the principal sterling reference rate used by the Group, is due to be withdrawn by the end of 2021, with regulators confirming their commitment to this deadline, despite the Covid-19 crisis. All Group debt issuance since 2019 has been priced with reference to SONIA, the Sterling Overnight Index Average and, during the year, SONIA became the Group's principal reference rate for hedging operations.

However, much of the Group's outstanding debt issuance is priced by reference to LIBOR and other IBOR rates and the Group is actively participating in industry initiatives to determine the optimal treatment of such securities on the withdrawal of these rates. The Group also has a significant LIBOR-linked asset base, mostly relating to legacy mortgage assets, where it is participating in a Bank of England 'Tough Legacy Task Force' addressing the impact of transition on such products. This aims to ensure fair and consistent outcomes for customers with such exposures.

**2.1 Retail funding**

Retail deposits provide the Group with a reliable, cost-effective and scalable source of funding, and continued to remain so in the face of market disruption resulting from Covid-19. The Group offers customers a range of deposit options, offering competitive rates and value for money. This, combined with a strong customer service ethic and the protection provided to depositors by the Financial Services Compensation Scheme ('FSCS'), supports the Group in meeting its funding and margin requirements.

The volume of retail deposits has continued to grow during the period reaching £7,856.6 million at the year end, 22.9% higher than a year earlier (2019: £6,391.9 million). This has been achieved with a reduced funding cost, reflecting the improvements made to the Group's capacity and capability.

The Group's share of the overall UK savings market remains minimal, with household savings balances reported by the Bank of England increasing by 5.5% in the year to £1,287.9 billion (2019: £1,220.4 billion), although these deposits remain overwhelmingly with clearing banks and building societies.

At 30 September 2020 the proportion of easy access deposits, which are repayable on demand, was 30.0% of the total deposit base, a little higher than its level at the beginning of the year (2019: 27.8%), and represented £2,359.6 million of the balance (2019: £1,778.0 million). This percentage is considered to be low compared to the rest of the banking sector and can be expected to rise going forward.



## MANAGEMENT REPORT

**2 FUNDING REVIEW (Continued)**

Savings accounts at the financial year end are analysed below.

	Average interest rate		Proportion of deposits	
	2020 %	2019 %	2020 %	2019 %
Fixed rate deposits	1.69%	2.02%	63.3%	65.0%
Variable rate deposits	0.72%	1.43%	36.7%	35.0%
All balances	<u>1.34%</u>	<u>1.81%</u>	<u>100.0%</u>	<u>100.0%</u>

The average initial term of fixed rate deposits was 27 months (2018: 28 months). Market savings rates in the year have fallen substantially, with the Bank of England quoting average interest rates at 30 September 2020 for new 2-year fixed rate deposits at 0.48% (2019: 1.41%) and for instant access balances at 0.07% (2019: 0.42%). Some market disruption was created in the second half year by the short-term pricing strategy adopted by NS&I, but the strength of the market meant that the Group was able to source its funding requirements throughout the period.

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. The Group also offers postal products, which tend to appeal to a different demographic to the online offering.

Growth in the deposit balance was enhanced by the launch of a flexible ISA product, which proved successful in the spring 2020 ISA season. Other enhancements to the product range are also being developed.

Offerings through third-party channels, including investment platforms and savings marketplaces operated by digital banks for their customers, provide access to further demographics and enhance the Group's ability to manage deposit inflows. The Group currently has four such relationships and is investing in people and systems to further develop this part of the business.

In customer feedback 88% 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 (2019: 89%). The net promoter score in the same survey was +61 (2019: +65).

When customers with maturing savings balances in the year were surveyed, 90% stated that they would 'probably' or 'definitely' consider taking out a replacement product with the Group (2019: 91%) with a net promoter score at maturity of +50, similar to the +53 recorded for the 2019 financial year.

Customers were also surveyed on the savings business's response to the Covid-19 crisis. 65% of the respondents felt that the Group's clarity of communications with customers had been good, while 99% of respondents said its response to the crisis was at least as good as other providers, including 17% who considered it to be better.

Given the benefits to customer and deposit retention of maintaining high service standards, these results give the Group great confidence in its market position. This is supported by continued success in industry awards. During the year, Paragon Bank won the 'Best Monthly Interest Provider' award in the 2020 MoneyNet awards, the third year in a row it had received this accolade, and was named 'Best Multi-Channel Savings Provider' at the 2020 Savings Champion Awards.

## MANAGEMENT REPORT

**2 FUNDING REVIEW (Continued)**

The Group's outsourced deposit administration platform continues to perform well, and its service levels have not been significantly impacted by Covid-19 during the year. It provides a cost-effective, stable and scalable solution in the medium to long term, and the Group has invested in its systems to manage the relationship.

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 operation will continue to expand the scope of its products, address wider demographics and explore new channels to market. The Group's broad product offering and the FSCS guarantee are likely to reduce the potential for any Covid-19 related economic downturn to impact liquidity and the Group's profiling of its target customers suggests they may be more resilient than average in such circumstances.

**2.2 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. The Group's 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 Covid-19 crisis.

Following the UK general election in December 2019 the performance of the capital markets strengthened during the early part of 2020, with increasing transaction volumes and improving margins for issuers. Demand in the markets remained high through the latter part of the year, however, the impact of Covid-19 and the availability of alternative funding sources made the markets unattractive for new public issuance.

Five mature securitisation transactions were refinanced during the year. These included three funding pre-2010 mortgages and two recent transactions which had reached their expected maturity dates and were paid down in accordance with market expectations. Notice was also given that two further legacy securitisations would be paid down after the year end. This will leave only two legacy transactions outstanding on the Group's balance sheet.

On 30 April 2020 the Group completed a fully retained securitisation transaction, Paragon Mortgages (No. 27) PLC, resulting in the issue of £735.8 million of rated notes to group companies. After the year end a further such transaction, Paragon Mortgages (No. 28) PLC issued £703.1 million of notes to group companies on 9 November 2020. These notes will be used as collateral in other funding transactions including central bank schemes.

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. The Group's £200.0 million facility with Bank of America Merrill Lynch was renewed in October 2019 and again in September 2020, when the commitment was increased to £400.0 million and the interest rate increased to LIBOR plus 1.05%.

## MANAGEMENT REPORT

**2 FUNDING REVIEW (Continued)**

During the period the Group also entered into a long /short repo transaction with a major UK bank. This provides £150.0 million of additional liquidity, based on retained securitisation notes, but does not appear on the Group's balance sheet, due to its contractual terms. This is the first such transaction the Group has undertaken, representing a further enhancement to its funding flexibility.

**2.3 Central bank facilities**

During the year the Group has increased its use of central bank funding as the Bank of England channelled funds into the UK economy through the banking sector in order to support SMEs through the Covid-19 crisis.

The Group has been approved to participate in the SME Term Funding scheme ('TFSME') and had drawn £910.0 million by 30 September 2020. This scheme provides access to funding appropriate for the Group's operations with a four year term with interest payable at the bank base rate, using either mortgage assets or mortgage securities as collateral. This makes these borrowings readily accessible and cost effective for the Group.

Drawings under the Term Funding Scheme ('TFS') remain in place and provide £944.4 million of the Group's funding (2019: £944.4 million). These begin to fall due for repayment during the next financial year, with repayments allowed for in the Group's capital planning.

The Group also utilised the Indexed Long-Term Repo scheme ('ILTR') for six-month borrowings, although no borrowings remained outstanding at the year end (2019: £50.0 million), and the Contingent Term Repo Facility ('CTRF') during the year. The Group's off balance sheet exposure under the Funding for Lending Scheme ('FLS') was settled in the year (2019: £109.0 million).

The Group has also pre-positioned mortgage loans and certain other assets with the Bank of England to act as collateral for future drawings on central bank funding lines, including the TFSME, if and when required, providing access to liquidity or funding of up to £684.0 million.

The Group will continue to access these facilities in future as part of its funding strategy, in accordance with the objectives of these schemes, where such borrowings are appropriate and cost effective.

**2.4 Funding outlook**

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.

Further information on all the above borrowings is given in notes 14 and 15.

**MANAGEMENT REPORT****3 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 and protect the business and its customers in future years. The maintenance of strong regulatory capital and liquidity positions to safeguard its depositors is also a principal strategic objective, supported by detailed capital planning and stress testing procedures.

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 2020 AGM, which will be proposed for renewal at the forthcoming meeting.

**3.1 Dividends and distribution policy**

The Group's stated distribution policy over recent years has been to distribute 40% of consolidated earnings to shareholders in ordinary circumstances, achieving a dividend cover ratio of approximately 2.5 times.

In normal years this would be achieved by the payment of an interim dividend following the announcement of the half year results with a final dividend after the year end making up the balance. However, at the time of the half year announcement the decision was taken, given the extreme levels of economic uncertainty due to Covid-19, to defer any discussion of dividend levels until after the end of the financial year and consequently no interim dividend was declared (2019: 7.0 pence).

Following the year end the Board considered the appropriateness of declaring a dividend for the year on the basis of the annual results and capital resources; customer and economic experience through the first six months of the Covid-19 crisis; updated business, capital and liquidity forecasts and stress tests; and the most recent economic forecasts. It also considered the most recent regulatory comments and views expressed by shareholder groups.

In determining the level of dividend for the year, the Board has considered the dividend policy, 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 24 February 2021, a dividend for the year of 14.4 pence for 2020 (2019: final dividend of 14.2p per share, total dividend of 21.2p per share). This dividend would be in line with the stated policy, giving a dividend cover of 2.50 times (2019: 2.33 times), with the reduction in amount from the previous year corresponding largely to the reduction in group earnings.

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

The Board also affirmed the existing dividend policy going forward, subject to an assessment of prevailing conditions at the time, but noted that, due to paying the full 2020 dividend as a final dividend, any interim dividend declared for 2021 would not necessarily bear the normal relation to the preceding final distribution.

## MANAGEMENT REPORT

## 3 CAPITAL REVIEW (Continued)

## 3.2 Regulatory capital

The Group is subject to supervision by the Prudential Regulatory Authority ('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, currently implemented through the EU Capital Requirements Regulation and Directive regime ('CRD IV'). This capital, which includes elements determined based on the Group's total risk exposure together with fixed elements, is held in order to safeguard depositors in the event of severe losses being incurred by the Group.

As a matter of strategy, the Group maintains strong capital and leverage ratios, its principal capital measures being set out below. It was granted transitional relief on the adoption of IFRS 9, with the impact on capital of additional impairments being phased in over a five-year period, with only 15.0% of the effect being recognised in this, the second year (2019: 5.0%). However, firms are also required to disclose capital measures as if the relief has not been given (referred to as the 'fully loaded' basis).

During the year, as part of a package of measures to mitigate the economic impacts of Covid-19, regulators increased the scope of this IFRS 9 relief to additionally defer impairment provisions made in the current year. This has widened the gap between the basic and fully loaded bases.

	Basic		Fully loaded	
	2020 £m	2019 £m	2020 £m	2019 £m
CET1 capital	991.2	922.0	948.9	900.8
Total Regulatory Capital ('TRC')	1,141.2	1,072.0	1,098.9	1,050.8
Pillar 1 + 2A capital requirement	749.6	742.9	745.3	741.8

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.

The Group's trading performance, including the deferral of bonuses, has led to the increase in capital shown above, with the basic measure, discounting IFRS 9 impairment charges, growing faster than the fully loaded measure. However, the amount of headroom over the Pillar 1 + 2A requirement, even on the fully loaded basis which allows for IFRS 9 provisioning, is significant.

Available 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. While the CCoB remained at 2.5%, its long-term rate, throughout the year, the CCyB was cut from 1.0% to zero during the period as a regulatory response to the pandemic. However, it was also announced that the long-term normal rate of the CCyB in the UK would be 2.0%. CET1 capital required to cover these buffers therefore reduced to £173.7 million at the year end on the regulatory basis (2019: £235.3 million). Further buffers may be set by the PRA on a firm-by-firm basis but may not be disclosed.

The Total Capital Requirement for the Group (Pillar 1 and Pillar 2A) must be met with at least 56% Common Equity Tier 1 (CET1) capital, and can include no more than 44% Additional Tier 1 ('AT1') capital and no more than 25% Tier 2 capital. Other capital requirements, including the CRD IV buffers, must be satisfied with CET1 capital.

## MANAGEMENT REPORT

**3 CAPITAL REVIEW (Continued)**

The Group's capital ratios are set out below.

	Basic		Fully loaded	
	2020	2019	2020	2019
CET1 ratio	14.3%	13.7%	13.7%	13.4%
Total capital ratio	16.4%	15.9%	15.9%	15.7%
UK leverage ratio	7.1%	6.7%	6.8%	6.6%

Capital ratios have strengthened on the fully loaded basis, even allowing for the payment of the proposed dividend, and are considerably stronger on the basic regulatory basis due to the reliefs described above.

As a result of the Covid-19 situation, the Basel Committee on Banking Supervision has deferred the implementation date of its revisions to the Basel III framework which were to take effect on 1 January 2022 to 1 January 2023, subject to those revisions being enacted in the relevant jurisdiction (expected to be CRD VI / CRR III in the EU framework). This means that changes which would have potentially increased the Group's Total Risk Exposure ('TRE') calculated under the standardised approach will be delayed.

The first stage of the Group's application for the accreditation of its Internal Ratings Based ('IRB') approach to credit risk for capital adequacy purposes was submitted to the PRA in March 2020. This phase of the application covers the Group's buy-to-let mortgage assets and considerable work has taken place to reach this stage. Models have been built and tested, governance frameworks enhanced, and IRB outputs are now being regularly considered internally. Work on this project has continued to progress throughout the second half of the year.

**3.3 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 the Liquidity Coverage Ratio ('LCR') and Net Stable Funding Ratio ('NSFR').

The monthly average LCR for the year was 173.7% compared to 143.7% during 2019, reflecting the steps taken to enhance liquidity in response to the Covid-19 situation. The year end NSFR stood at 114.7%, in line with the 115.0% reported at 30 September 2019.

## MANAGEMENT REPORT

**3 CAPITAL REVIEW (Continued)****3.4 Capital outlook**

The maintenance of strong capital and liquidity positions has been a central part of the Group's strategic thinking over many years, leaving it well placed to deal with stresses. Actions taken during the year, including the passing of the interim dividend and the deferral of senior management bonuses in shares, have maintained the strength of that position.

While the short-term regulatory capital reliefs put in place by regulators in response to Covid-19 are welcome, the Group considers itself to be well capitalised, even on a fully loaded basis.

This position is built upon strong businesses, careful management and a flexible funding base. Regular reviews of capital requirements by the Board form part of the planning and strategic development process, considering the level and form of capital demanded by current business, regulatory and economic conditions and future developments as well as the Group's strategic objectives.

This is designed to deliver a future capital position which is prudent and sustainable, even under stress, protecting the viability of the Group's business, for the benefit of all its stakeholders.

## MANAGEMENT REPORT

## 4 FINANCIAL RESULTS

The impacts from Covid-19 and the associated policy response have been included in the reported outcomes for 2020. These impacts include slower customer demand in the second half, a material reduction in interest rates which had an initially adverse effect on net interest margins and higher expected levels of loan impairments. Under IFRS 9, impairments are charged on an expected loss basis.

## 4.1 Consolidated results

Underlying operating profit for 2020 was 27.0% below 2019's level at £120.0 million (2019: £164.4 million (Appendix A)). On a statutory basis profit was reduced by 25.5% to £118.4 million (2019: £159.0 million). The single largest contributor to this reduction came from the charge for loan impairments, which was 503.8% higher than in 2019.

## CONSOLIDATED RESULTS

For the year ended 30 September 2020

	2020	2019
	£m	£m
Interest receivable	491.7	505.7
Interest payable and similar charges	(213.6)	(227.3)
<b>Net interest income</b>	<b>278.1</b>	<b>278.4</b>
Net leasing income	3.0	3.8
Gain on derecognition of financial assets	-	9.7
Other income	14.0	15.4
<b>Total operating income</b>	<b>295.1</b>	<b>307.3</b>
Operating expenses	(126.8)	(125.2)
Provisions for losses	(48.3)	(8.0)
	<b>120.0</b>	<b>174.1</b>
Fair value net (losses) / gains	(1.6)	(15.1)
<b>Operating profit being profit on ordinary activities before taxation</b>	<b>118.4</b>	<b>159.0</b>
Tax charge on profit on ordinary activities	(27.1)	(31.6)
<b>Profit on ordinary activities after taxation</b>	<b>91.3</b>	<b>127.4</b>
	<b>2020</b>	<b>2019</b>
Dividend – rate per share for the year	14.4p	21.2p
Basic earnings per share	36.0p	49.4p
Diluted earnings per share	35.6p	48.2p



## MANAGEMENT REPORT

## 4 FINANCIAL RESULTS REVIEW (Continued)

## Income

Net interest income was broadly unchanged when compared to 2019 at £278.1 million (2019: £278.4 million). Within this figure, average loan balances rose by 2.2% and the Group's net interest margin ('NIM') fell by 5 basis points to 224 basis points.

The reduction in base rates to just 10 basis points generated a short term reduction in the Group's NIM, with the reduction applying to both the investment rate earned on the Group's cash investments and also to variable rate loans, where the full reduction in rates was passed on to customers. Funding deposit costs have also reduced in the second half, but initially at a slower pace. After reporting 229 basis points of NIM at the first six months of the year, margins reduced for much of the second half but had recovered most of the lost ground by the year end.

With slower levels of new business growth in 2020, the effect of the amortisation of the Idem Capital portfolio had a greater effect on the mix of yields in the loan book and hence on reported net interest margins. The Idem-specific net interest margin fell to 7.60% for 2020 (2019: 11.94%), reflecting a combination of continued reductions in the loan book, changes in the mix of products and lower future cash flow expectations. The largest element of this cash flow re-estimate was a result of a detailed review on the basis of the Covid-19 economic outlook, where £3.7 million was written off, reversing income taken in previous years.

Net interest income for the Group excluding Idem increased from 1.92% in 2019 to 2.09% in 2020. This reflects structural change in the loan book, with new buy-to-let and commercial loans carrying higher margins than the legacy buy-to-let portfolio. The scale of change in this ratio (+17 basis points) was lower than the +39 basis points reported for 2019 as a result of the base rate changes reported above.

The progression of the Group's NIM, including and excluding the Idem Capital division, over the past five years is set out below.

	<b>Total</b>	<b>Excluding</b>
	<b>Basis points</b>	<b>Idem Capital</b>
<b><i>Year ended 30 September</i></b>		<b>Basis points</b>
2020	224	209
2019	229	192
2018	219	153
2017	213	141
2016	215	139

Other operating income was £17.0 million for the six months, compared with £19.2 million reported in 2019. This reduction reflected lower account fee income, which is attributable to the changing profile of the portfolio, and reduced levels of broking income in the year.

## MANAGEMENT REPORT

## 4 FINANCIAL RESULTS REVIEW (Continued)

**Costs**

Operating expenses were 1.3% above their 2019 level at £126.8 million (2019: £125.2 million). The Group had been anticipating a higher rate of increase than this, but Covid-19 served to delay the implementation of certain projects, with these costs now expected to be incurred during 2021 and 2022.

The cost base for the year does, however, reflect the Group's continued investment in IT infrastructure and operational resilience, an approach which has helped support its response to the Covid-19 pandemic. An updated broker portal for the Mortgage Lending division and new treasury systems came on stream during the early part of the year and developments continued, even during the lock-down period, with enhancements to the SME lending customer experience a particular focus.

While staff numbers remained stable and all employees remained on full pay throughout the Covid-19 crisis, savings arose from lower senior management cash bonuses and share-based remuneration charges. The accounting effect of the deferral in shares of 100% of the executive bonuses and large proportions of other senior management bonuses is to remove these costs from the 2020 cost base, instead spreading them over future periods.

The Group outsources its savings deposit administration, the costs of which relate to the size and activity levels of the savings portfolio rather than being linked to general cost inflation. As the Group refocuses its funding model to have a greater retail deposit weighting, operating costs will therefore tend to grow at rates above the general inflation rate. Savings related overheads grew by £1.6 million in the year.

The progress of the Group's cost income ratio over the last five year is set out below.

	<b>Underlying</b>	<b>Statutory</b>
	<b>%</b>	<b>%</b>
<b><i>Year ended 30 September</i></b>		
2020	43.0	43.0
2019	42.1	40.7
2018	40.6	37.8
2017	40.5	40.5
2016	37.9	37.9

**Impairment provisions**

Impairment charges totalled £48.3 million for 2020 compared to £8.0 million during 2019. The major factors driving this increase was the impact of Covid-19 on expected customer behaviour and the impact of lower projected asset values in the event of default. Up to the point of the impact of Covid-19 on the UK in March, the Group's provision data was largely positive, with charges remaining in line with expectations. However, from the half year onwards the Group factored the potential impact of Covid-19 into its consideration of expected credit losses. While IFRS 9 is intended to provide for expected future losses, the unprecedented and unexpected nature of the Covid-19 crisis resulted in a sharp increase in provisions to reflect the fundamental change in economic outlook.

## MANAGEMENT REPORT

**4 FINANCIAL RESULTS REVIEW (Continued)**

In addition to applying a more severe suite of economic projections to the Group's IFRS 9 impairment models, the year-end analysis also takes explicit account of payment holidays granted to customers during the year, together with adjusting for the lagging effect government policy has had, and potentially continues to have, on observable impairment. Careful consideration was also given to the extent to which the Group's base models, derived on the basis of historic data, can accurately predict behaviour in these unprecedented circumstances.

The impairment calculations generate £62.0 million of the £81.8 million total balance sheet provision, with the balancing £19.8 million being post model adjustments ('PMAs') based on management's judgement of the effects of lagging and payment reliefs.

*Payment holidays*

Over £2.6 billion of customer balances were granted Covid-19 payment reliefs at some point during the year, with some of these holidays extended beyond the year end.

The table below shows how this position developed throughout 2020, including October 2020's results, which gives the most up-to-date view on the flows.

Month End	Relief in force		Relief expired		Redeemed	Total
	Initial	Extension	Initial	Extension		
	£m	£m	£m	£m	£m	£m
March	658.2	-	0.2	-	0.3	658.7
April	2,306.9	-	2.4	-	0.6	2,309.9
May	2,414.7	7.3	130.3	0.0	1.4	2,553.7
June	1,767.6	190.6	642.9	1.3	3.3	2,605.7
July	245.7	619.4	1,752.6	9.6	9.2	2,636.5
August	94.4	688.0	1,825.3	23.2	21.8	2,652.7
September	46.1	506.0	1,843.7	230.2	33.3	2,659.3
October	24.1	111.5	1,844.8	638.7	49.1	2,668.2

The position at 31 October 2020 is summarised in the table below, which analyses the values of accounts by payment relief status and which also highlights, for each of those groups, the relative change between the October 2020 arrears position and the 29 February 2020, pre-Covid-19 position. Cases where the payment holiday has ended, but no payment is yet due are shown separately.

	Currently business as usual			Between relief and BAU	Current relief	
	No relief	Single relief only	Extended relief		Extended	Original
	£ billion	£ billion	£ billion	£ billion	£ billion	£ billion
<b>Balance</b>	<b>10.20</b>	<b>1.84</b>	<b>0.62</b>	<b>0.03</b>	<b>0.11</b>	<b>0.03</b>
<i>Proportion</i>	<i>79.5%</i>	<i>14.4%</i>	<i>4.8%</i>	<i>0.2%</i>	<i>0.9%</i>	<i>0.2%</i>
% with arrears deterioration	0.9%	1.5%	6.8%	10.0%	2.8%	1.7%
% with arrears improvement	3.0%	1.1%	7.8%	1.5%	3.5%	2.8%

*Payment holiday status (2 November 2020)*

## MANAGEMENT REPORT

**4 FINANCIAL RESULTS REVIEW (Continued)**

Whilst almost 95% (by value) of accounts which had been granted relief have since returned to a fully paying status, there has been materially more arrears volatility amongst those loans where extensions were granted, both worsening and improving. This generally increased level of volatility for the portfolio has resulted in management increasing the probability of default for this population above the levels suggested by the underlying models, but this increase is only considered significant in respect of accounts that have taken a payment holiday extension. Such accounts have been transferred from Stage 1 to Stage 2 for impairment purposes.

**Multiple economic scenario summary and outputs**

The Group creates four macro-economic scenarios to underpin its IFRS 9 impairment modelling, and business forecasting. These comprise a base case position, an upside, a downside and a severe case. Covid-19 has had a material impact on the most recent iteration of these forecasts when compared to the Group's 2019 economic outlook for the same periods. The year-on-year differences in a selection of the variables defining these scenarios are set out below, on a weighted average basis.

*Scenarios used at 30 September 2019*

	Weighted scenario outcome at					
	2019	2020	2021	2022	2023	2024
GDP (indexed to Sep 2019)	100	101.0	102.8	106.4	108.3	110.3
House prices (indexed to Sep 2019)	100	100.9	103.0	106.8	111.4	116.2
Unemployment rate (absolute value)	3.8%	4.5%	4.6%	4.5%	4.4%	4.2%

*Scenarios used at 30 September 2020*

	Weighted scenario outcome at					
	2019	2020	2021	2022	2023	2024
GDP (indexed to Sep 2019)	100	94.5	99.5	102.3	104.6	108.3
House prices (indexed to Sep 2019)	100	105	97.6	96.0	102.0	106.1
Unemployment rate (absolute value)	3.8%	4.8%	7.0%	5.8%	5.1%	4.4%

*Change*

	Weighted scenario change				
	2020	2021	2022	2023	2024
GDP (indexed to Sep 2019)	(6.5)	(3.3)	(4.1)	(3.7)	(4.0)
House Prices (indexed to Sep 2019)	4.1	(5.4)	(10.8)	(12.9)	(14.2)
Unemployment rate (absolute value)	+0.3%	+2.4%	+1.3%	+1.0%	+0.9%

## MANAGEMENT REPORT

**4 FINANCIAL RESULTS REVIEW (Continued)**

The forecast economic assumptions within each scenario, and the weightings applied are set out in more detail in note 11.

These economic assumptions are principal inputs to the Group's IFRS 9 models. The probability of default profiles arising from the models have, in turn, been re-phased to reflect the impacts of policy reactions to Covid-19, essentially incorporating a lag in the profile. Intervention by the UK Government has suppressed enforcement action by lenders, while recorded arrears performance and market credit data is currently not fully representative of underlying credit quality due to the payment relief rules.

The lag applied by the Group ensures that the consequences of the GDP reduction experienced since the half year are still adequately reflected in the model output, where, thus far, the impairments that would normally be expected to arise from such changes are yet to emerge.

***Impairment cover ratios and trends***

The combination of harsher economic forecasts and the approach to assessing payment reliefs have led to materially higher provisions and cover ratios.

	<b>30 September 2019 £m</b>	<b>31 March 2020 £m</b>	<b>30 September 2020 £m</b>
Calculated provision	41.9	42.7	62.0
Overlay	-	24.0	-
PMAs (for payment relief and lagged effects)	-	-	19.8
<b>Total</b>	<b>41.9</b>	<b>66.7</b>	<b>81.8</b>
<b>Cover ratio</b>	<b>0.34%</b>	<b>0.53%</b>	<b>0.64%</b>

**Fair value movements**

The material reductions in both spot and forward rates during 2020 have resulted in a fair value charge of £1.6 million for the year arising from the Group's hedging activities. This compares to a charge of £15.1 million during 2019. The fair value movements reflect non-cash items and revert to zero over the lives of the instruments involved.

**Tax**

The effective tax rate applied to the Group's profits in 2020 has increased from 19.9% in 2019 to 22.9% during 2020. While the standard tax rate applying to the Group remained at 19.0%, the proportion of Group profits arising in Paragon Bank and consequently attracting the banking surcharge, increased. This caused the surcharge amount to increase by £1.9m, equivalent to an increase of 190 basis points on the tax rate.

## MANAGEMENT REPORT

**4 FINANCIAL RESULTS REVIEW (Continued)**

The reduction in UK corporation tax rates to 17.0% which had been previously legislated for, and hence accounted for, was reversed in the year, with the impact of this on the Group's deferred tax balances affecting the year's charge.

The Group remained up-to-date with all payments of national and local taxes throughout the Covid-19 period.

**Results**

As noted above, there were no one-off gains or losses included in the 2020 result, whereas 2019 benefitted from a £9.7 million gain on the disposal of the Group's residual interest in one of its legacy securitisations. Profit before tax for the year was 25.5% lower than 2019's outturn at £118.4 million (2019: £159.0 million).

Basic earnings per share for 2020 were 36.0 pence (2019: 49.4 pence) and the diluted measure was 35.6 pence per share (2019: 48.2 pence), reflecting the fall in profit.

This result increased equity to £1,156.0 million (2019: £1,108.6 million), representing a tangible net asset value of £3.90 per share (2019: £3.71 per share) and a net asset value on the statutory basis of £4.57 per share (2019: £4.39 per share) (appendix D).

## MANAGEMENT REPORT

## 4 FINANCIAL RESULTS REVIEW (Continued)

## 4.2 Assets and liabilities

## SUMMARY BALANCE SHEET

30 September 2020

	2020 £m	2019 £m	2018 £m
<b>Investment in customer loans</b>			
Mortgage Lending	10,819.5	10,344.1	10,449.5
Commercial Lending	1,514.8	1,452.1	1,131.3
Idem Capital	297.1	389.9	519.8
	<u>12,631.4</u>	<u>12,186.1</u>	<u>12,100.6</u>
Derivative financial assets	463.3	592.4	855.7
Cash	1,925.0	1,225.4	1,310.6
Intangible assets	170.1	171.1	169.3
Other assets	315.7	220.5	51.7
	<u>15,505.5</u>	<u>14,395.5</u>	<u>14,487.9</u>
<b>Total assets</b>			
Equity	1,156.0	1,108.6	1,073.5
Retail deposits	7,856.6	6,391.9	5,296.6
Other borrowings	6,229.7	6,648.4	7,961.2
Derivative financial assets	132.4	80.5	4.7
Pension deficit	20.4	34.5	19.5
Other liabilities	110.4	131.6	132.4
	<u>15,505.5</u>	<u>14,395.5</u>	<u>14,487.9</u>
<b>Total equity and liabilities</b>			

The Group's loan portfolio grew by 3.7% during 2020, with growth in each of its Mortgage Lending and Commercial Lending divisions and continued amortisation of balances in Idem Capital. More detail on these movements is given in section 1. This increase, together with the Group's liquidity and capital policy, determines its funding requirements and hence the level of its liabilities.

### Funding structure and cash resources

The Group's funding increased by 8.0% during the year in response to the growth of the business and a cautious outlook on funding and liquidity. The proportion represented by retail deposits increased to 55.8% in accordance with the Group's long-term funding strategy (2019: 49.0%). The cautious approach to liquidity and capital resulted in the increased cash balance, which increased by £699.6 million in the period. Movements in funding balances are discussed in more detail in section 2.

### Derivatives

Movements in derivative financial assets principally relate to the retirement of certain of the Group's currency denominated floating rate notes and their related hedging instruments in the period. These swaps decreased by £137.4 million over the year. These movements do not impact the Group's results.

## MANAGEMENT REPORT

**4 FINANCIAL RESULTS REVIEW (Continued)**

Derivative assets and liabilities used for interest rate hedging increased by £6.6m and £51.5 million respectively, as a result of interest rate movements. These were largely offset by a £45.5 million increase in the hedging adjustment on loans to customers, included in sundry assets above, and a £4.5 million increase in the adjustment on retail deposits, included in sundry liabilities.

**Pension obligations**

The IAS 19 valuation of the Group's defined benefit pension scheme deficit reduced by £14.1 million in the period, less than the £20.0 million additional cash contribution made by the Group in the year. Market implied gilt yields, which are used to value future liabilities, reduced by less in the year than bond yields, which are used to estimate the discount rates applied to them, and hence the discounted value of the liability increased. The deficit at 30 September 2020 stood at £20.4 million (2019: £34.5 million).

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 30 September 2020 was estimated at £9.7 million, a reduction of £19.5 million in the period (2019: £29.2 million), representing a 93.9% funding level (2019: 80.0%).

**Other assets and liabilities**

Sundry assets have increased since 30 September 2019 by £95.2 million. This increase was driven principally by movements in swap rates which generated the £45.5 million movement in fair value hedging referred to above and required a £31.3 million increase in CSA collateral deposits as a result of the increased value of derivative liabilities. Other movements included the inclusion of a tax current debtor of £5.7 million, with payments on account in the year being greater than the calculated tax payable; an increase of £3.7 million in mandatory CRD deposits at the Bank of England, which are calculated based on the size of the Group's deposit base; and the recognition of £7.0 million of right-of-use assets on the adoption of IFRS 16 (note 29).

Within sundry liabilities, which reduced by £21.2 million, the absence of a current tax liability (2019: £15.2 million), as referred to above, and a reduction in accrued investment interest receivable as a result of reduced interest rates, are offset by the lease liability recognised on transition to IFRS 16.



## MANAGEMENT REPORT

**4 FINANCIAL RESULTS REVIEW (Continued)****4.3 Segmental results**

The underlying operating profits of the three segments described in the Lending Review in section 1 are detailed fully in note 2 and are summarised below.

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
<b>Segmental profit</b>		
Mortgage Lending	154.3	167.9
Commercial Lending	45.9	43.8
Idem Capital	19.6	48.0
	<u>219.8</u>	<u>259.7</u>
Gains on disposals	-	9.7
Unallocated central costs and other one-off items	(99.8)	(95.3)
	<u>120.0</u>	<u>174.1</u>

The Group's central administration and funding costs, principally the costs of service areas, establishment costs and bond interest have not been allocated.

**Mortgage Lending**

The Mortgage Lending division has maintained a strong position in its market throughout the year, increasing its average net loan balance by 1.8%, despite the impact of Covid-19 through the second half of the year. Average NIM improved by 9 basis points over the year as a result of business initiatives and the replacements of legacy assets with higher yielding accounts. This generated a 6.9% increase in net interest. However, the impact of the virus on loss expectations generated impairment charges for the year of £25.8 million (2019: £1.0 million), increasing the cost of risk to 0.24% (2019: 0.01%).

The impact of this increased provision saw segmental profit decrease by 8.1% to £154.3 million, from the corresponding period in the previous year (2019: £167.9 million).

**Commercial Lending**

Segmental profit in Commercial Lending was £45.9 million in the period (2019: £43.8 million), an increase of 4.8% even after allowing for the impact of Covid-19 on provisions. This resulted from the 14.8% growth in average loan balances, year-on-year, principally attributable to the strength of growth in the development finance business.

Coupled with a strategic focus on yield which saw NIM in the segment increased by 50 basis points in the year, this growth generated a rise of 21.1% in total operating income in the segment. With the cost base broadly similar to the previous period, the increase in operating income was offset by the £14.5 million increase in provision arising from the worsening economic outlook reflected in the Group's IFRS 9 impairment scenarios.

## MANAGEMENT REPORT

**4 FINANCIAL RESULTS REVIEW (Continued)****Idem Capital**

The result for the Idem Capital division continues to be driven by the rate of portfolio run-off, with no new deals completed in the year. The average loan balance reduced by 24.5% in the year while average NIM continued to reduce with high-yielding assets paying down more rapidly than lower yielding secured balances.

Unsecured consumer assets in the division are valued based on future expected cash flows. The reforecast of these balances in the light of Covid-19 generated a write-down of expected interest of £3.7 million, which has also impacted NIM in the segment. However, actual performance in the last six months of the year has been encouraging.

This, together with the Covid-19 provisioning on the secured assets, impacted on segment profit, which fell to £19.6 million (2019: £48.0 million).

## MANAGEMENT REPORT

**5 OPERATIONS REVIEW**

The major factor impacting the Group's operational capabilities in the year was the Covid-19 pandemic, which affected all business areas. The achievement of the Group's objectives is heavily reliant on its people, business partners, suppliers, systems and governance structures, with a single framework covering all locations and operations. This framework has been successfully reconfigured in response to Covid-19.

The development of the Group's operations has continued despite the virus. Both before the outbreak of Covid-19 and during the pandemic, the Group has continued to invest in its infrastructure, particularly in customer and broker-facing systems. The Group's planned change programme progressed throughout the year with minimal impact from the pandemic, delivering new technology and operational enhancements which will generate efficiencies and improve customer experiences.

**5.1 Covid-19 response**

The Group's operational response to Covid-19 has focussed on enabling its businesses to continue operating as normally as possible whilst supporting its customers and protecting employees and other stakeholders. Operating in a key economic sector, it recognised the need for service levels to be preserved as far as possible and the difficulties in achieving that. The Group is proud of what has been achieved and is confident that it has in place the operational infrastructure to deliver the levels of customer service and employee safety required both during and after the pandemic.

The Group's operational functions faced three major challenges as a result of the Covid-19 situation:

- to develop processes and IT systems to deliver appropriate financial reliefs to customers, in line with the structures set out by the UK Government
- to enable working from home to be widely available amongst the workforce while preserving the Group's culture and retaining a strong compliance and cyber-security framework
- to develop the systems and procedures to offer the CBILS and BBLs products introduced across the financial services industry to support its customers

The UK Government announced the initial package of Covid-19 reliefs that it expected lenders to grant on 17 March 2020 and the Group was able to develop and put in place the necessary processes and systems before the first large batch of payments fell due on 31 March, 14 days later. This involved a significant amount of work by operational and IT staff to ensure that not only were the appropriate reliefs given, but also that they were given in a way that would not adversely impact customers' credit records. Systems have continued to develop as reliefs have been extended and amended through the second half of the year.

Prior to the announcement of the UK lockdown the Group was already planning for that eventuality, with groups of employees trialling working from home while on-site social distancing was enhanced. Following the announcement, a programme was quickly put in place to convert as many people as possible to working from home, including customer service and contact centre employees. This involved both the transfer of significant amounts of IT equipment to employees' homes and also changes to the Group's networks and systems. These changes were required to enable remote working, while still retaining appropriate controls over data and system security as well as the levels of monitoring required by regulators, particularly in a contact centre environment.

## MANAGEMENT REPORT

**5 OPERATIONS REVIEW (Continued)**

The operation saw the conversion of around 1,000 previously office-based employees to home working. This involved the provision of desktop computers, screens and related IT equipment at 425 homes, an additional 50 users being provided with laptop computers, and additional equipment being provided to many other employees already equipped for home working.

By 31 March 2020, the Group had enabled 90% of employees to work from home on a sustained basis whilst maintaining service levels for all its customers. Almost all the Group's offices have been temporarily closed with employees identified as critical being retained in a handful of premises, mostly in roles which require the employees' physical presence, such as those maintaining council waste disposal vehicles funded by the Commercial Lending division. Other than these workshop personnel, almost all remaining on-site employees are based in the head office in Solihull.

At the year end most employees were still working from home and while plans had been made to bring some people back to the Group's offices, those plans were put on hold following the worsening of the Covid-19 situation in the autumn, with a large scale return to office working not expected before March 2021 at the earliest. The Group has not placed any employee on a furlough scheme, nor made any employee redundant following the Covid-19 outbreak, and has no current intention of doing so.

This approach has allowed the Group to provide operational capacity to support its customers, who may themselves be suffering from the effects of the Covid-19 crisis. Data relating to both the period of transition and the period since, with customer-facing employees mostly working from home, demonstrated no significant increase in complaint levels.

The protection of the health and wellbeing of the Group's employees has been a principal objective of its Covid-19 response. Increased hygiene products and more frequent cleaning routines were introduced across the Group's offices from February. Throughout March a coordinated approach was implemented to identify and protect the Group's most vulnerable employees, as defined by the UK Government, and these people were immediately sent home and subsequently, as described above, provided with the necessary IT infrastructure to work from home effectively. Social distancing, in line with UK government guidance was implemented across all open offices during March and this remains in place.

Ensuring regular engagement with employees working from home during the crisis has been an area of focus. Regular briefings by the CEO and senior team, delivered online, have spearheaded a coordinated and regular programme of communications for all employees, as well as specific communications for line managers. Additional learning opportunities have been provided to managers and employees addressing physical and emotional wellbeing with a focus on working from home effectively and managing teams remotely. Further support is provided by the Group's team of emotional wellbeing volunteers, set up in 2018, who have been identified and trained with the assistance of the charity Mind.

In addition, quarterly engagement pulse surveys have monitored employees' overall physical and mental wellbeing, enabling the Group to respond quickly to any emerging needs. Fortnightly meetings with the Group's elected People Forum representatives, attended by senior management, as well as two members of the Board on one occasion during the pandemic, have provided a further source of feedback to ensure employees have been considered throughout the Group's response to the pandemic.

## MANAGEMENT REPORT

**5 OPERATIONS REVIEW (Continued)**

All activity is in line with the advice of the UK Government. In addition, an ongoing programme of development activity has taken place through the second half of this year. This is delivered through both learning and virtual group sessions and covers such topics as: effective use of Office 365 applications, including Microsoft Teams; the importance of communication; how to motivate and engage people; and delivering effective performance management whilst working remotely.

Overall, the Group is satisfied with its operational performance during the first six months of the Covid-19 crisis, which has justified its investment in contingency planning and operational resilience over recent years. It is proud of the response to the crisis by its people throughout the operation, without whom this could not have been achieved.

**5.2 Management and people**

The Group employs just under 1,400 people, with the majority of employees being based at its Solihull head office. The Group is proud of its strong culture; our employees and leadership live by our values and we believe that this is one of our differentiators that makes us a great place to work.

During the period the Group commissioned an independent review of its culture from PwC which concluded that “there is a strong working relationship across the leadership team and consistent alignment on the firm’s values and desired behaviours as it pertains to good customer outcomes”.

**Governance and management**

The Group’s business continuity governance processes were invoked once it became clear that the Covid-19 pandemic was likely to impact the UK. In addition to the governance provided by senior management, the Board increased its oversight with an additional series of director updates, issued by the Chair of the Board and the CEO, specifically discussing the impact of Covid-19 on the Group and its market. Ad hoc meetings of the Board and committees have also taken place. Board and committee meetings have been held remotely since March 2020. The impact of the pandemic on the Group’s stakeholders, including its customers and employees, and the Group’s response to it have been thoroughly communicated to the Board and discussed at board meetings.

Since 1 October 2019 the Company has been subject to the 2018 UK Corporate Governance Code (the ‘Code’). This includes significant changes from the 2016 edition of the Code and work was undertaken during the year ended 30 September 2019 to ensure compliance with the Code. The Company has complied with the principles of the Code during the year.

In January 2020 the Group and the Board offered their thanks and best wishes on his retirement to John Heron who was the Group’s longest serving employee and Managing Director - Mortgages. John had been an executive director since 2003 and was instrumental in establishing and building both the Group’s buy-to-let mortgage offering and the buy-to-let sector as a distinct part of the UK mortgage market.

## MANAGEMENT REPORT

**5 OPERATIONS REVIEW (Continued)**

Peter Hartill reached nine years' service on the Board in February 2020, and it had previously been announced that he intended to step down from the Board at that point. However, the Board announced in December 2019 that it considered Peter's independence, skills and experience allowed him to continue to make a very effective contribution as a non-executive director, Senior Independent Director and Audit Committee Chair and that it had therefore asked him to postpone his resignation. This was in order to ensure that the Board would not have to compromise on either the quality of candidate or a suitable transition period in finding a replacement for him.

In March 2020 Alison Morris was appointed to the Board and succeeded Peter as Chair of the Audit Committee, chairing her first meeting in September 2020. Alison is a chartered accountant and recently retired as a partner in PwC's Financial Services Assurance Practice. She joined PwC in 1982 and spent her entire career with the organisation in a range of internal and external audit roles across the Asset and Wealth Management practice and Banking and Capital Markets business unit.

A thorough handover from Peter to Alison took place over the summer and Peter stepped down from the Board on 30 September 2020. Peter retires from the Board with the thanks of the Chair and the Board for his commitment to the Group and his professionalism and dedication in the role of Audit Committee Chair and, latterly, Senior Independent Director.

Hugo Tudor replaced Peter as Senior Independent Director on 23 July 2020 and continues to chair the Remuneration Committee.

Following the year end, the Group announced the appointment of Peter Hill as a non-executive director, following a robust search and selection process. Peter was CEO of Leeds Building Society from 2011 until his retirement in 2019 and is currently a non-executive director of Pure Retirement Limited and chairman of its risk committee. He is also Chair of Mortgage Brain and brings with him a wealth of experience in financial services and a proven track record in risk oversight, gained during his executive and non-executive career.

Peter will become Chair of the Risk and Compliance Committee with effect from 31 December 2020 to allow for a managed and orderly transition from the current committee chair, Finlay Williamson, who has announced his intention to step down from the Board on 31 December 2020.

Finlay was appointed to the Board in 2017 and is Chair of the Risk and Compliance Committee and a member of the Audit Committee. Finlay will also be stepping down at the same time from the Board of Paragon Bank PLC, to which he was appointed in 2015. He leaves with the Board's thanks for the contribution he has made to embedding the Group's Risk Management Framework. He has brought humour, great experience and energy to his role and his input will be missed.

Following these changes, women will comprise 37.5% of the Board.

## MANAGEMENT REPORT

**5 OPERATIONS REVIEW (Continued)****People and development**

The Group continues to focus on maintaining an efficient and effective workforce, increasing employee numbers by 1.4% over the year. It maintains its accreditation from the UK Living Wage Foundation and minimum pay continues to meet the levels set by the Foundation.

Retention of employees continues to remain high, with the attrition rate of 10.4% continuing to track below the national average of 21.7%. These high levels of retention are further bolstered by 24.7% of employees achieving over 5 years' service, 13.3% achieving over 20 years with the Group and 4.5% achieving over 30 years' service.

Retaining this level of skill and knowledge within the Group has helped to navigate the challenges that remote working has presented during the Covid-19 pandemic and enabled operational challenges to be met, with employees redeployed to meet operational needs. The Group believes that these levels of retention are driven by a culture of continuing to provide employees with opportunities for personal development and career progression; 25% of the Group's vacancies during the year were filled internally.

The Group has continued to recruit and develop the best talent over the year; adapting how this is achieved through the Covid-19 pandemic. Most of the Group's employees were moved to work from home in the space of a week; new hires were virtually onboarded; and the provision of day-to-day training moved online. The Group has seen its employees pull together and demonstrate their resilience over the course of the year, with some employees temporarily moving into new roles to ensure operational needs are met and customer service standards maintained.

This year it has been more important than ever to continue to promote wellbeing and the Group's Wellbeing Network has organised numerous initiatives to support our people's mental and physical health.

The Group's senior leadership development programme has continued during the year. This is aimed at developing those identified as successors for the executive management team and their direct reports. During this year four members of this programme have secured promotions within the Group. Additionally, the Group continued its participation in the Women Ahead 30% Club cross-company mentoring scheme.

The Group has also continued to take on new apprentices during the period with 46 apprentices currently in place across various business functions. The Group's intern opportunities also continued to be successful, with interns undertaking placements in Finance and Treasury during the year and recruitment taking place over the summer despite the pandemic.

The Group rolled out its 'Leadership Blueprint' in October 2019. This personal development initiative is designed to build the capability of line managers and drive consistency in the way the Group manages its people. It focuses on developing the behaviours of line managers and leaders and measuring the impact that these improvements have on business outcomes.

The Group also focussed on the provision of professional qualifications training during the period, with an additional 37 employees commencing their Certificate in Mortgage Advice and Practice during the period, and other employees being supported in qualifications relevant to their specialism.

## MANAGEMENT REPORT

**5 OPERATIONS REVIEW (Continued)**

During the year the Group also complied with the FCA requirement for the Senior Managers and Certification Regime ('SMCR') to be extended to all regulated legal entities. People performing Senior Management Functions (SMFs') for its solo regulated businesses (Paragon Finance PLC, Mortgage Trust Services PLC, The Business Mortgage Company Services Limited, Premier Asset Finance Limited, Paragon Technology Finance Limited and Paragon Commercial Finance Limited) have been identified and approved by the FCA.

Alison Morris, non-executive director, became the Group's Whistleblowing Champion this year and all members of the Whistleblowing Committee received training from Protect on how to develop robust whistleblowing arrangements and achieve a culture where employees feel able to raise concerns.

### Equality and diversity

The Group continued to make progress with its Equality, Diversity and Inclusion strategy during the year. In January 2020 the Group enhanced its maternity provision, to 18 weeks leave at full pay from 6 weeks at 90%, to support the retention and career progression of female employees. The Group has continued its participation in the 'Women Ahead 30% Club' cross-company mentoring scheme, providing ten trained mentors to support female mentees from other companies, whilst nominating ten female mentees from the Group's workforce to receive external mentoring support at the same time. This is an annual programme and feedback from both mentors and mentees has been very positive. It is the Group's second year of involvement.

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 2020; unfortunately, the proportion of female senior managers fell to 33.9% during the period (2019 35.9%). This reduction is primarily due to reporting line changes within the senior management population and plans are in place to ensure that the Group can achieve its 35% target by the January 2022 deadline.

At the time of setting its Women in Finance target, the Group set additional targets which it is making excellent progress towards. In particular:

- 50.1% of employees receiving management development/leadership training are female (compared to 42.7% in 2019)
- 24.3% of the workforce are on flexible working contracts (compared to 35.8% in 2019)
- 82% of flexible working available is on a part-time basis (compared to 65.9% in 2019)

The Group continues to monitor external development and is confident that the practices and plans that are in place are aligned to best practice and reflect the recommendations made by the Hampton Alexander review.



## MANAGEMENT REPORT

**5 OPERATIONS REVIEW (Continued)**

The Group calculated its gender pay gap at April 2020. This calculation shows that median female pay in the Group was 36.9% less than the median male pay (2019: 31%). This is broadly in line with the results reported by other financial services companies and the 35.9% gap for the sector reported by the Office of National Statistics in their Annual Survey of Hours and Earnings ('ASHE') published in October 2020. 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 Group has begun to increase its focus on other diversity strands during the period; rolling out new recruitment technology to reduce the likelihood of unconscious bias in the early stages of candidate selection.

The Group is also in the process of rolling out an Equality, Diversity and Inclusion Network, an employee resource group which consists of people who are passionate about supporting the Group's target of becoming more inclusive for all employees. Richard Rowntree, Managing Director-Mortgages, is the executive sponsor for the network and progress will be reported to the Nomination Committee.

**5.3 Environment and social****Climate change**

During April 2019 the PRA published a Policy Statement noting that climate change, and society's response to it, present financial risks which are relevant to its objectives. Furthermore, the PRA released a 'Dear CEO' letter in July 2020 emphasising their expectations for firms to have fully embedded their approaches to managing climate related financial risks by the end of 2021.

The Group is developing an enhanced approach to identifying and managing the potential impacts of climate change in its business in order to meet these requirements.

In order to provide the appropriate governance, the Board has been engaged in the process for developing and accepting climate change as a principal risk. The Group has established a project and working group reporting to the Executive Risk Committee which is chaired by the CEO. The working group contains personnel from across the business to manage the broad scope of climate change. The working group's remit includes but is not limited to:

- Ensuring the financial risk from climate change are managed effectively following its allocation as a principal risk
- Keeping up-to-date with emerging best practice across the financial services industry
- Developing a clear understanding of how our current products impact the UK's progression to net zero by 2050
- Embedding climate change risk within established risk types such as operational risk and credit risk to ensure a consistent approach is taken across the business

## MANAGEMENT REPORT

**5 OPERATIONS REVIEW (Continued)**

The Group is also cooperating with several industry initiatives on climate change, including projects led by the Green Finance Institute to investigate how financing solutions can support increasing energy efficiency in the UK property sector.

Operationally the Group has taken the decision to move away from diesel vehicles in its company fleet in favour of electric or hybrid vehicles which will reduce greenhouse gas emissions as new cars join the fleet. The Group has also relaunched its cycle-to-work scheme.

**Charitable activity**

As part of its response to Covid-19, and its ongoing commitment to the communities in which it operates, the Group has donated £100,000 to charities supporting people impacted by the pandemic. These included organisations supporting NHS staff, homeless people and elderly people. It has also recognised the difficulties faced by the employee charity committee in fundraising, with so many of the Group's people working off-site, and pledged to double the amount raised by staff in the 'Move for Macmillan' challenge. This initiative both supported this year's company charity and promoted exercise and wellbeing amongst people working from home.

**5.4 Risk**

The effective management of risk remains 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 focus of the Group's risk management has inevitably been heavily focussed on managing the impacts of Covid-19. The Group has responded effectively to the changes in risk profile arising from the impact of the pandemic.

The Group's risk management framework has provided a robust mechanism to ensure that new risks are promptly identified, assessed, managed and appropriately overseen from a risk governance perspective. As the pandemic unfolded a dedicated Risk Working Group ('RWG') reporting to the Crisis Management Team, was established to oversee all significant process and lending changes resulting from Covid-19, providing independent challenge and oversight, and ensured that all risk aspects were fully considered.

In particular, the RWG and the independent risk function have provided assurance over the following:

- New risks arising from the provision of CBILS and BBLs lending including process changes and underwriting decisions
- Changes to technology and infrastructure required to facilitate mass home working especially in the many customer-facing roles where this practice was new
- Revised credit policies and decisioning to reflect the challenges in applying existing lending criteria

## MANAGEMENT REPORT

**5 OPERATIONS REVIEW (Continued)**

- Implementation of payment holidays in accordance with regulatory initiatives together with other payment reliefs across all product lines
- Planning for a Covid-19 safe return to office-based working and the implications for the longer-term workplace strategy

In addition to the challenges of Covid-19, the Group has continued to evolve and embed its risk management framework and in particular has focussed on:

- Anticipating the level of change in product design, funding and operations which will be required in preparation for the withdrawal of LIBOR in 2021
- Embedding operational resilience capabilities which have also been critical in handling the Covid-19 situation. This has included refinement of critical business services and tolerances and ensuring these considerations are embedded as part of day-to-day operations
- Addressing the impact of climate change on managing financial risks
- Developing advanced models and the overarching model risk framework to enhance credit risk management and support the Group's IRB application process
- Evolution and embedding of the Group's approach to managing the risks and oversight of its outsourced relationships and important suppliers
- Enhancing stress testing procedures to ensure the robustness of capital and liquidity positions
- Ensuring effective cyber-security controls and a robust data protection approach

The Group continues to review its exposure to emerging developments in the Brexit process once the transition period ends on 31 December 2020 given the remaining potential for no deal being agreed for the terms of exit. While the Group does not have operations outside the UK it has continued to review the capital, liquidity and operational implications of the stresses which might be caused by the process. The Board has monitored the position throughout the year and the Group considers itself well placed to address the challenges. However, the position remains uncertain and will continue to be subject to detailed monitoring given the imminent deadline.

The principal challenges in the risk environment faced by the Group during the year and moving forward into 2021 include:

- Management of those risks arising from changes introduced in response to Covid-19. As payment reliefs end and the wider economic impacts of the crisis are felt, there will be a need to ensure appropriate treatment of ongoing arrears and the ongoing position of affected customers. Key to this will be ensuring that the treatment of customers is fair and conduct principles remain at the forefront of all interactions
- Management of the transition from LIBOR to alternative benchmark rates given the commitment by the regulators to the transfer being fully completed by 31 December 2021

## MANAGEMENT REPORT

**5 OPERATIONS REVIEW (Continued)**

- Whilst Covid-19 has underlined the need to ensure the Group is fully resilient, the unprecedented crisis has identified a number of industry-wide issues which will need to be built into the resilience frameworks going forward. Further clarification on the broader industry approach is expected with the publication of a consultation paper in late 2020. The Group is committed to strengthening its operational resilience as a core priority in 2021

**5.5 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.

Since March 2020, the impact of Covid-19 has largely driven regulatory priorities and the Group continues to respond effectively to these ongoing challenges. Overall, the Covid-19 response has included reviewing the Group's arrangements to address an evolving situation, whilst maintaining clear focus on customers, staff and the marketplace. Across all product areas the Group continues to provide support and service to its customers.

In response to the economic shock from Covid-19, regulators have sought to alleviate some of the pressures on the banking sector. These regulatory responses include:

- 'Quick Fix' amendments to the CRR discussed in the capital section 3 alleviating the short-term impact of Covid-19 on regulatory capital. These have been reviewed, and where relevant, incorporated into capital and corporate planning
- Guidance from accounting and financial services regulators on the application of IFRS 9 in the Covid-19 environment, including the treatment of payment reliefs and the need to pay regard to the impact of government support measures. These are discussed in section 4.
- Guidance on payment deferrals by the FCA for mortgages, unsecured consumer credit and motor finance to enable customers suffering Covid-19 related financial difficulties to be supported without impact on their credit files. The Group has applied the guidance in full and has worked with customers to ensure they are supported throughout the deferral period, and affordable repayment arrangements are put in place following any such relief

In addition to requirements introduced in response to Covid-19, the following developments currently in progress are particularly relevant to the Group:

- Both the PRA and FCA have been active in ensuring an orderly transition from LIBOR to alternative benchmark measures, both in terms of the impact on financial markets and the impact on customers. A project has been established to oversee the Group's LIBOR transition plan to ensure the regulatory deadlines and requirements are met

## MANAGEMENT REPORT

**5 OPERATIONS REVIEW (Continued)**

- Due to Covid-19 the consultation period for proposed PRA and FCA operational resilience requirements was extended to 1 October 2020, with final rules expected to be published in early 2021. The FCA has also requested that firms comply with the EBA Guidelines on ICT and security risk, particularly focusing on business continuity. The business has reviewed the guidelines and confirmed its proportionate adherence to the requirements. A gap analysis of the Operational Resilience Consultation Paper has been completed, and a plan to ensure compliance within appropriate timeframes is in place
- The FCA published updated guidance on vulnerable customers this year, and HM Treasury has continued work on its proposed Breathing Space scheme. The Group has amended processes and updated procedures to reflect these changes, and to take account of temporary guidance for those experiencing financial difficulties linked to Covid-19
- The FCA has further developed its messaging on culture during 2019/20, broadening its focus from 'Tone at the Top', to a wider view of culture across firms. The FCA has cautioned firms against measuring culture too narrowly. Culture remains a key area for the Board, senior management and throughout the business
- The PRA published a Policy Statement in July 2020 confirming its expectations of firms when managing the key prudential risks associated with asset encumbrance, specifically in the contexts of managing liquidity and funding risks, recovery planning and resolution. The Group has reviewed the Policy Statement and considers itself to be in a good position to meet these expectations and related PRA rules
- The PRA has confirmed that it expects firms to have fully embedded their approaches to managing climate-related financial risks by the end of 2021. To help firms understand the risks and opportunities that arise from climate change, and to provide support on how to integrate these risks into strategy and decision-making processes, the Climate Financial Risk Forum Guide was published in June 2020. The Group continues to develop its strategy in respect of climate change, in line with this guidance, to ensure it is well-positioned to address these emerging challenges
- The PRA is undertaking a consultation on proposed amendments to the Capital Requirements Directive ('CRD V'). CRD V builds on the existing CRD IV, introducing further measures covering capital, remuneration and governance. It also introduces a number of EU-specific measures designed to further harmonise micro and macroprudential supervision and to introduce greater proportionality in prudential requirements. Whilst the Group awaits the outcome of this consultation, it believes it will be well-placed to meet the final requirements

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 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 end of the Brexit transition period on 31 December 2020. HM Treasury has extended the temporary transitional powers for the regulators until 31 March 2022. Regulatory obligations for firms will generally remain the same for that period.

## MANAGEMENT REPORT

**5 OPERATIONS REVIEW (Continued)**

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.

## PRINCIPAL RISKS

We have identified a number of principal risks, arising from both the environment in which we operate and our business model, which could impact our ability to achieve our strategic priorities.

### Capital

Insufficient capital to operate effectively and meet minimum requirements

### Liquidity and funding

Insufficient financial resources to enable us to meet our obligations as they fall due

### Market

Changes in the net value of, or net income arising from, our assets and liabilities from adverse movements in market prices

### Credit

Financial loss arising from a borrower or counterparty failing to meet their financial obligations

### Model

Making incorrect decisions based on the output of internal models

### Pension obligation

Our commitments under our defined benefit pension scheme are insufficient to meet our liabilities

### Reputational

Failing to meet the expectations and standards of our stakeholders

### Strategic

Changes to business model or environmental factors may lead to an inappropriate or obsolete strategy or strategic plan

### Climate change

Financial risks arising through climate change impacting the Group and our strategy

### Conduct

Poor behaviours or decision making leading to failure to achieve fair outcomes for customers

### Operational

Resulting from Inadequate or failed internal procedures, people, systems or external events

## DIRECTORS' RESPONSIBILITIES

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 2020, 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 that 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](http://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.

### MARIUS VAN NIEKERK

Company Secretary

3 December 2020

### Board of Directors

F J Clutterbuck  
N S Terrington  
R J Woodman

H R Tudor  
B A Ridpath  
F F Williamson

G H Yorston  
A C M Morris  
P A Hill

# PRELIMINARY FINANCIAL INFORMATION

**CONSOLIDATED STATEMENT OF PROFIT OR LOSS**  
**For the year ended 30 September 2020**

	Note	2020 £m	2020 £m	2019 £m	2019 £m
Interest receivable	3		491.7		505.7
Interest payable and similar charges	4		(213.6)		(227.3)
<b>Net interest income</b>			<u>278.1</u>		<u>278.4</u>
Other leasing income		19.2		18.3	
Related costs		(16.2)		(14.5)	
Net leasing income		<u>3.0</u>		<u>3.8</u>	
Gain on derecognition of financial assets		-		9.7	
Other income	5	14.0		15.4	
Other operating income			<u>17.0</u>		<u>28.9</u>
<b>Total operating income</b>			<u>295.1</u>		<u>307.3</u>
Operating expenses			(126.8)		(125.2)
Provisions for losses	11		(48.3)		(8.0)
<b>Operating profit before fair value items</b>			<u>120.0</u>		<u>174.1</u>
Fair value net (losses)	6		(1.6)		(15.1)
<b>Operating profit being profit on ordinary activities before taxation</b>			<u>118.4</u>		<u>159.0</u>
Tax charge on profit on ordinary activities	7		(27.1)		(31.6)
<b>Profit on ordinary activities after taxation for the financial year</b>			<u><u>91.3</u></u>		<u><u>127.4</u></u>
			<b>2020</b>		<b>2019</b>
<b>Earnings per share</b>	<b>Note</b>				
- basic	8		36.0p		49.4p
- diluted	8		35.6p		48.2p

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

**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME**  
**For the year ended 30 September 2020**

	Note	2020 £m	2020 £m	2019 £m	2019 £m
Profit for the year			91.3		127.4
<b>Other comprehensive income</b>					
<i>Items that will not be reclassified subsequently to profit or loss</i>					
Actuarial (loss) on pension scheme	17	(7.4)		(16.5)	
Tax thereon		2.1		2.4	
			(5.3)		(14.1)
<i>Items that may be reclassified subsequently to profit or loss</i>					
Cash flow hedge gains taken to equity	12	(0.6)		0.5	
Tax thereon		0.1		(0.1)	
Reclassification on derecognition		-		(0.9)	
Tax thereon		-		0.2	
			(0.5)		(0.3)
Other comprehensive income for the year net of tax			(5.8)		(14.4)
<b>Total comprehensive income for the year</b>			85.5		113.0

**CONSOLIDATED BALANCE SHEET**  
**For the year ended 30 September 2020**

	Note	2020 IFRS 9 £m	2019 IFRS 9 £m	2018 IFRS 9 £m	2018 IAS 39 £m
<b>Assets</b>					
Cash – central banks	9	1,637.1	816.4	895.9	895.9
Cash – retail banks	9	287.9	409.0	414.7	414.7
Loans to customers	10	12,741.1	12,250.3	12,076.5	12,103.7
Derivative financial assets	12	463.3	592.4	855.7	855.7
Sundry assets		128.0	92.8	19.0	19.0
Current tax assets		5.7	-	-	-
Deferred tax assets		6.2	6.2	-	-
Property, plant and equipment		66.1	57.3	56.8	56.8
Intangible assets	13	170.1	171.1	169.3	169.3
<b>Total assets</b>		<b>15,505.5</b>	<b>14,395.5</b>	<b>14,487.9</b>	<b>14,515.1</b>
<b>Liabilities</b>					
Short term bank borrowings		0.4	1.0	1.1	1.1
Retail deposits	14	7,867.0	6,395.8	5,292.4	5,292.4
Derivative financial liabilities	12	132.4	80.5	4.7	4.7
Asset backed loan notes		3,270.5	4,419.4	5,554.7	5,554.7
Secured bank borrowings	15	657.8	787.5	935.6	935.6
Retail bond issuance		296.8	296.5	296.1	296.1
Corporate bond issuance		149.8	149.6	149.3	149.3
Central bank facilities		1,854.4	994.4	1,024.4	1,024.4
Sundry liabilities	16	100.0	112.7	114.4	114.4
Current tax liabilities		-	15.2	21.4	21.4
Deferred tax liabilities		-	-	0.8	5.6
Retirement benefit obligations	17	20.4	34.5	19.5	19.5
<b>Total liabilities</b>		<b>14,349.5</b>	<b>13,287.1</b>	<b>13,414.4</b>	<b>13,419.2</b>
Called up share capital	18	261.8	261.6	281.6	281.6
Reserves	19	932.0	887.3	895.9	918.3
Own shares	20	(37.8)	(40.5)	(104.0)	(104.0)
<b>Total equity</b>		<b>1,156.0</b>	<b>1,108.4</b>	<b>1,073.5</b>	<b>1,095.9</b>
<b>Total liabilities and equity</b>		<b>15,505.5</b>	<b>14,395.5</b>	<b>14,487.9</b>	<b>14,515.1</b>

Approved by the Board of Directors on 3 December 2020.

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 2020**

	Note	2020 £m	2019 £m
Net cash generated by operating activities	22	1,028.7	397.9
Net cash (utilised) / generated by investing activities	23	(2.8)	8.3
Net cash (utilised) by financing activities	24	(325.7)	(491.3)
		<u>          </u>	<u>          </u>
Net increase / (decrease) in cash and cash equivalents		700.2	(85.1)
Opening cash and cash equivalents		1,224.4	1,309.5
		<u>          </u>	<u>          </u>
<b>Closing cash and cash equivalents</b>		<b>1,924.6</b>	<b>1,224.4</b>
		<u>          </u>	<u>          </u>
Represented by balances within:			
Cash	9	1,925.0	1,225.4
Short term bank borrowings		(0.4)	(1.0)
		<u>          </u>	<u>          </u>
		<u>1,924.6</u>	<u>1,224.4</u>

**CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY**  
**For the year ended 30 September 2020**

*Year ended 30 September 2020*

	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
<b>Transactions arising from</b>								
Profit for the year	-	-	-	-	-	91.3	-	91.3
Other comprehensive income	-	-	-	-	(0.5)	(5.3)	-	(5.8)
Total comprehensive income	-	-	-	-	(0.5)	86.0	-	85.5
<b>Transactions with owners</b>								
Dividends paid (note 21)	-	-	-	-	-	(35.9)	-	(35.9)
Shares cancelled	-	-	-	-	-	-	-	-
Own shares purchased	-	-	-	-	-	-	(5.2)	(5.2)
Exercise of share awards	0.2	0.4	-	-	-	(7.7)	7.9	0.8
Charge for share based remuneration	-	-	-	-	-	2.7	-	2.7
Tax on share based remuneration	-	-	-	-	-	(0.3)	-	(0.3)
<b>Net movement in equity in the year</b>	0.2	0.4	-	-	(0.5)	44.8	2.7	47.6
<b>Opening equity</b>	261.6	68.3	50.3	(70.2)	3.0	835.9	(40.5)	1,108.4
<b>Closing equity</b>	261.8	68.7	50.3	(70.2)	2.5	880.7	(37.8)	1,156.0

## CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY (Continued)

For the year ended 30 September 2019

Year ended 30 September 2019

	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
<b>Transactions arising from</b>								
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
<b>Transactions with owners</b>								
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
<b>Net movement in equity in the year</b>	<b>(20.0)</b>	<b>2.5</b>	<b>21.6</b>	<b>-</b>	<b>(0.3)</b>	<b>(32.4)</b>	<b>63.5</b>	<b>34.9</b>
<b>Opening equity</b>								
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 29)	-	-	-	-	-	(22.4)	-	(22.4)
As restated	281.6	65.8	28.7	(70.2)	3.3	868.3	(104.0)	1,073.5
<b>Closing equity</b>	<b>261.6</b>	<b>68.3</b>	<b>50.3</b>	<b>(70.2)</b>	<b>3.0</b>	<b>835.9</b>	<b>(40.5)</b>	<b>1,108.4</b>



**NOTES TO THE FINANCIAL INFORMATION**  
**For the year ended 30 September 2020****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 2018, 30 September 2019 or 30 September 2020, 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 2018 and 30 September 2019 have been delivered to the Registrar of Companies and those for the year ended 30 September 2020 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.

Copies of the Annual Report and Accounts for the year ended 30 September 2020 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](http://www.paragonbankinggroup.co.uk).

These financial statements are presented in pounds sterling, which is the currency of the economic environment in which the Group operates.

The remaining notes to the accounts are organised into four sections:

- Analysis – providing further analysis and information on the amounts shown in the primary financial statements
- Employment costs – providing information on employee and key management remuneration arrangements including share schemes and pension arrangements
- Capital and Financial Risk – providing information on the Group's management of operational and regulatory capital and its principal financial risks
- Basis of preparation – providing details of the Group's accounting policies and of how they have been applied in the preparation of the financial statements

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

*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.*

**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:

- Mortgage Lending, 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.

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.

Other assets 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 2020**

**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 2020***

	<b>Mortgage Lending £m</b>	<b>Commercial Lending £m</b>	<b>Idem Capital £m</b>	<b>Unallocated Items £m</b>	<b>Total Segments £m</b>
Interest receivable	344.9	112.9	30.4	3.5	491.7
Interest payable	(154.9)	(30.8)	(4.3)	(23.6)	(213.6)
Net interest income	190.0	82.1	26.1	(20.1)	278.1
Other operating income	6.5	9.9	0.6	-	17.0
Total operating income	196.5	92.0	26.7	(20.1)	295.1
Direct costs	(16.4)	(24.4)	(6.3)	(79.7)	(126.8)
Provisions for losses	(25.8)	(21.7)	(0.8)	-	(48.3)
	154.3	45.9	19.6	(99.8)	120.0

***Year ended 30 September 2019***

	<b>Mortgage Lending £m</b>	<b>Commercial Lending £m</b>	<b>Idem Capital £m</b>	<b>Unallocated Items £m</b>	<b>Total Segments £m</b>
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

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

	<b>2020 £m</b>	<b>2019 £m</b>
Results shown above	120.0	174.1
Fair value items	(1.6)	(15.1)
Operating profit	118.4	159.0

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**2. SEGMENTAL INFORMATION (CONTINUED)**

The assets of the segments listed above are:

	<b>2020</b>	<b>2019</b>	<b>2018</b>
	<b>£m</b>	<b>£m</b>	<b>IFRS 9</b>
			<b>£m</b>
Mortgage Lending	11,488.2	11,279.9	11,598.2
Commercial Lending	1,554.3	1,488.4	1,166.7
Idem Capital	297.1	389.9	539.6
	<hr/>	<hr/>	<hr/>
Total segment assets	13,339.6	13,158.2	13,304.5
Unallocated assets	2,165.9	1,237.3	1,183.4
	<hr/>	<hr/>	<hr/>
Total assets	15,505.5	14,395.5	14,487.9
	<hr/>	<hr/>	<hr/>

An analysis of the Group's loan assets by type and segment is shown in note 10.

**3. INTEREST RECEIVABLE**

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
<i>Interest receivable in respect of</i>		
Loan accounts	440.4	449.3
Finance leases	44.3	44.5
Invoice finance income	2.4	3.1
	<hr/>	<hr/>
Interest on loans to customers	487.1	496.9
Other interest receivable	4.6	8.8
	<hr/>	<hr/>
Total interest on financial assets	491.7	505.7
	<hr/>	<hr/>

The above interest arises from:

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
Financial assets held at amortised cost	447.4	461.2
Finance leases	44.3	44.5
	<hr/>	<hr/>
	491.7	505.7
	<hr/>	<hr/>

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**4. INTEREST PAYABLE AND SIMILAR CHARGES**

	<b>Note</b>	<b>2020</b>	<b>2019</b>
		<b>£m</b>	<b>£m</b>
On retail deposits		129.7	114.2
On asset backed loan notes		42.2	63.4
On bank loans and overdrafts		5.4	9.6
On corporate bonds		10.9	10.9
On retail bonds		18.5	18.6
On central bank facilities		4.5	8.0
		<hr/>	<hr/>
Total interest on financial liabilities		211.2	224.7
On pension scheme deficit	17	0.4	0.5
Discounting on contingent consideration		0.4	0.5
Discounting on lease liabilities		0.2	-
Other finance costs		1.4	1.6
		<hr/>	<hr/>
		213.6	227.3
		<hr/>	<hr/>

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

**5. OTHER INCOME**

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
Loan account fee income	5.7	7.2
Broker commissions	1.7	2.2
Third party servicing	5.0	5.0
Other income	1.6	1.0
	<hr/>	<hr/>
	14.0	15.4
	<hr/>	<hr/>

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**6. FAIR VALUE NET (LOSSES) / GAINS**

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
Ineffectiveness of fair value hedges (note 12)		
Portfolio hedges of interest rate risk		
Deposit hedge	0.2	(0.2)
Loan hedge	0.1	(6.3)
	<u>0.3</u>	<u>(6.5)</u>
Ineffectiveness of cash flow hedges	-	-
Other hedging movements	(2.9)	(5.8)
Net (losses) / gains on other derivatives	1.0	(2.8)
	<u>(1.6)</u>	<u>(15.1)</u>

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 requirements of IAS 39. Some accounting volatility arises on these items due to accounting ineffectiveness on designated hedges, or because hedge accounting has not been adopted or is not achievable on certain items. The losses and gains are primarily due to timing differences in income recognition between the derivative instruments and the economically hedged assets and liabilities. Such differences will reverse over time and have no impact on the cash flows of the Group.

**7. TAX CHARGE ON PROFIT ON ORDINARY ACTIVITIES**

Income tax for the year ended 30 September 2020 is charged at an effective rate of 22.9% (2019: 19.9%), representing the best estimate of the annual effective rate of income tax expected for the full year, applied to the pre-tax income of the period.

The standard rate of corporation tax in the UK applicable to the Group in the period was 19.0% (2019: 19.0%), based on currently enacted legislation. During the year, legislation was substantively enacted, reversing the reduction in the tax rate to 17.0% which had been due to come into effect from April 2020. The effects of the increases in the expected rate for the year from 18.0% to 19.0%, and the expected rate in future years from 17.0% to 19.0% on deferred tax balances have been accounted for in the period.

The increase in the effective rate of tax is principally attributable to the increased proportion of the Group's profit earned in its banking subsidiary, Paragon Bank PLC, and therefore subject to the banking surcharge.

A change in the legislation governing the timing payments on account in respect of UK corporation tax applied to the Group for the first time in the current period. As a result, the 30 September 2020 balance sheet shows a debtor in respect of current tax.

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**8. EARNINGS PER SHARE**

Earnings per ordinary share is calculated as follows:

	<b>2020</b>	<b>2019</b>
Profit for the year (£m)	91.3	127.4
Basic weighted average number of ordinary shares ranking for dividend during the year (million)	253.6	257.6
Dilutive effect of the weighted average number of share options and incentive plans in issue during the year (million)	2.5	6.7
Diluted weighted average number of ordinary shares ranking for dividend during the year (million)	256.1	264.3
Earnings per ordinary share		
- basic	36.0p	49.4p
- diluted	35.6p	48.2p

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS****For the year ended 30 September 2020****9. CASH AND CASH EQUIVALENTS**

‘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. It is analysed as set out below.

	<b>2020</b>	<b>2019</b>	<b>2018</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>
Deposits with the Bank of England	1,637.1	816.4	895.9
Balances with central banks	1,637.1	816.4	895.9
Deposits with other banks	287.9	409.0	393.1
Money Market Fund investments	-	-	21.6
Balances with other banks	287.9	409.0	414.7
Cash and cash equivalents	1,925.0	1,225.4	1,310.6

Not all of the Group’s cash is immediately available for its general purposes, including liquidity management. Cash received in respect of loan assets funded through warehouse facilities and securitisations is not immediately available, due to the terms of those arrangements.

Cash held by the Trustee of the Group’s employee share ownership plan (‘ESOP’) may only be used to invest in the shares of the Company, pursuant to the aims of that plan.

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

	<b>2020</b>	<b>2019</b>	<b>2018</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>
Available cash	1,701.1	872.1	962.9
Securitisation cash	223.4	353.1	338.8
ESOP cash	0.5	0.2	8.9
	1,925.0	1,225.4	1,310.6

Cash and cash equivalents are classified as Stage 1 exposures (see note 11) for the purposes of impairment provisioning. The probabilities of default have been assessed to be so low as to require no significant impairment provision.



## NOTES TO THE FINANCIAL INFORMATION – ANALYSIS

For the year ended 30 September 2020

## 10. LOANS TO CUSTOMERS

	Note	2020 IFRS 9 £m	2019 IFRS 9 £m	2018 IFRS 9 £m	2018 IAS 39 £m
Loans to customers		12,631.4	12,186.1	12,100.6	12,127.8
Fair value adjustments from portfolio hedging	12	109.7	64.2	(24.1)	(24.1)
		<u>12,741.1</u>	<u>12,250.3</u>	<u>12,076.5</u>	<u>12,103.7</u>

## NOTES TO THE FINANCIAL INFORMATION – ANALYSIS

For the year ended 30 September 2020

## 10. LOANS TO CUSTOMERS (CONTINUED)

The Group's loans to customers at 30 September 2020, analysed between the segments described in note 2 are as follows:

	<b>Mortgage Lending £m</b>	<b>Commercial Lending £m</b>	<b>Idem Capital £m</b>	<b>Total £m</b>
<b><i>At 30 September 2020</i></b>				
First mortgages	10,636.9	-	-	10,636.9
Consumer loans	182.6	-	281.6	464.2
Motor finance	-	256.9	15.5	272.4
Asset finance	-	452.0	-	452.0
Development finance	-	609.0	-	609.0
Other commercial loans	-	196.9	-	196.9
<b>Loans to customers</b>	<b>10,819.5</b>	<b>1,514.8</b>	<b>297.1</b>	<b>12,631.4</b>
<b><i>At 30 September 2019</i></b>				
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
<b>Loans to customers</b>	<b>10,344.1</b>	<b>1,452.1</b>	<b>389.9</b>	<b>12,186.1</b>
<b><i>At 1 October 2018</i></b>				
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
<b>Loans to customers</b>	<b>10,449.5</b>	<b>1,131.3</b>	<b>519.8</b>	<b>12,100.6</b>

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**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 IFRS 16, 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
- Sensitivity analysis

**(a) 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. The provision may be based on either twelve month or lifetime ECL, dependent 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 2020**

**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.

In extreme or unprecedented economic conditions, such as the Covid-19 pandemic, it is likely that mechanical models will be less predictive of outcomes as the historical data used for modelling will be insufficiently representative of present conditions. In these circumstances, management carefully review all outputs to ensure provision is adequate.

At 30 September 2020 the effects of the material reductions in GDP since the onset of the Covid-19 crisis had not yet been evidenced in customer credit performance and defaults, due to the lagging effect of government policy interventions. Where customers were given payment reliefs arrears, adverse credit indicators were not recorded by the Group or other lenders, meaning that both internal credit metrics and external credit bureau data might not accurately reflect the customer's credit position leading to modelled PDs being underestimated.

While forecast economics assume the current economic situation, the future, generally upward, trends also tend to reduce PDs, in a way that may not be justifiable where an underlying credit issue on an account has not emerged, which may result in default as government support initiatives unwind.

In reviewing the subsequent payment patterns of accounts that have been granted Covid-19 reliefs, it is evident that there is higher payment volatility (both in terms of account improvement and deterioration) so whilst credit risk is increased, it is not significant in scale in all cases. The Group has reflected this position by applying PD floors to its payment holiday population in the main portfolios at Stage 1, and moved accounts with payment holiday extensions to Stage 2, again with floors reflecting extrapolations of recent cohort experience to reflect the more adverse economic conditions forecast within the Group's macroeconomic scenarios and to allow for the potential under-recognition of losses caused by these effects.

*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.

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS****For the year ended 30 September 2020****11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)**

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.

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 determining whether an account has an SICR in the Covid-19 environment the granting of Covid-19 reliefs, including payment holidays and similar arrangements, may mean that an SICR may exist without this being reflected in either arrears performance or credit bureau data. The Group has accepted the advice of UK regulatory bodies that the grant of Covid-19 relief does not, of itself, indicate an SICR, but has carefully considered internal credit and customer data to determine whether there might be any accounts with SICR not otherwise identified by the process.

For customers with extended payment reliefs in place, the account has been placed in Stage 2, regardless of other indicators, as a result of the analysis described above. This aligns the Group's approach to regulatory guidance which suggested that while initial payment reliefs should not automatically be taken as an indication of an SICR, an extension to such a relief was more likely to be so.

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.

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.

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS****For the year ended 30 September 2020****11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)***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.

Loans are retained in Stage 3 for three months after the point where they cease to exhibit the characteristics of default. After this point, they may move to Stage 2 or Stage 1 depending on whether an SICR trigger remains.

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.

**(b) Impairments by stage**

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 an 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 lifetime 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 2020**

**11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)**

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

	<b>Stage 1</b>	<b>Stage 2 *</b>	<b>Stage 3 *</b>	<b>POCI</b>	<b>Total</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
<b>30 September 2020</b>					
<b>Gross loan book</b>					
Mortgage Lending	9,822.6	903.2	127.0	15.0	10,867.8
Commercial Lending	1,384.2	132.3	20.2	6.7	1,543.4
Idem Capital	122.9	9.9	28.9	140.3	302.0
<b>Total</b>	<b>11,329.7</b>	<b>1,045.4</b>	<b>176.1</b>	<b>162.0</b>	<b>12,713.2</b>
<b>Impairment provision</b>					
Mortgage Lending	(5.0)	(12.6)	(30.7)	-	(48.3)
Commercial Lending	(17.0)	(3.0)	(8.2)	(0.4)	(28.6)
Idem Capital	(0.2)	(0.2)	(4.5)	-	(4.9)
<b>Total</b>	<b>(22.2)</b>	<b>(15.8)</b>	<b>(43.4)</b>	<b>(0.4)</b>	<b>(81.8)</b>
<b>Net loan book</b>					
Mortgage Lending	9,817.6	890.6	96.3	15.0	10,819.5
Commercial Lending	1,367.2	129.3	12.0	6.3	1,514.8
Idem Capital	122.7	9.7	24.4	140.3	297.1
<b>Total</b>	<b>11,307.5</b>	<b>1,029.6</b>	<b>132.7</b>	<b>161.6</b>	<b>12,631.4</b>
<b>Coverage ratio</b>					
Mortgage Lending	0.05%	1.40%	24.17%	-	0.44%
Commercial Lending	1.23%	2.27%	40.59%	5.97%	1.85%
Idem Capital	0.16%	2.02%	15.57%	-	1.62%
<b>Total</b>	<b>0.20%</b>	<b>1.51%</b>	<b>24.65%</b>	<b>0.25%</b>	<b>0.64%</b>

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)**

	Stage 1 £m	Stage 2 * £m	Stage 3 * £m	POCI £m	Total £m
<b>30 September 2019</b>					
<b>Gross loan book</b>					
Mortgage Lending	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
<b>Total</b>	<b>11,382.6</b>	<b>458.5</b>	<b>167.9</b>	<b>219.0</b>	<b>12,228.0</b>
<b>Impairment provision</b>					
Mortgage Lending	(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)
<b>Total</b>	<b>(6.0)</b>	<b>(3.7)</b>	<b>(32.2)</b>	<b>-</b>	<b>(41.9)</b>
<b>Net loan book</b>					
Mortgage Lending	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
<b>Total</b>	<b>11,376.6</b>	<b>454.8</b>	<b>135.7</b>	<b>219.0</b>	<b>12,186.1</b>
<b>Coverage ratio</b>					
Mortgage Lending	-	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%
<b>Total</b>	<b>0.05%</b>	<b>0.81%</b>	<b>19.18%</b>	<b>-</b>	<b>0.34%</b>

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



**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS****For the year ended 30 September 2020****11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)**

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. Additional provision arising on these assets post-acquisition is shown as 'Impairment Provision' above.

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 within the Mortgage Lending and Idem Capital segments 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 2020

## 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.

Levels of Stage 2 assets have been increased significantly as a result of the Covid-19 outbreak. This is seen in an increased level of assets where an SICR has been identified in the absence of arrears on the account, particularly through the evaluation of the potential significance of extended payment holidays. In Mortgage Lending and Idem Capital the level of Stage 2 arrears accounts has fallen, due to regulatory interventions preventing arrears being recorded.

Coverage levels have increased in both Mortgage Lending and Commercial Lending, as a consequence of the harsher economic assumptions applied in 2020 and the PD floors applied to accounts with payment holiday extensions. Reduced expectations of security values have also increased provision requirements. Impacts on the highly seasoned Idem Capital books have been less and the levels of such assets in Stage 2 remain relatively small.

	<b>&lt; 1 month arrears</b>	<b>&gt; 1 &lt;= 3 months arrears</b>	<b>Total</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>
<b>30 September 2020</b>			
<b>Gross loan book</b>			
Mortgage Lending	879.9	23.3	903.2
Commercial Lending	113.2	19.1	132.3
Idem Capital	4.8	5.1	9.9
<b>Total</b>	<b>997.9</b>	<b>47.5</b>	<b>1,045.4</b>
<b>Impairment provision</b>			
Mortgage Lending	(12.0)	(0.6)	(12.6)
Commercial Lending	(2.5)	(0.5)	(3.0)
Idem Capital	(0.1)	(0.1)	(0.2)
<b>Total</b>	<b>(14.6)</b>	<b>(1.2)</b>	<b>(15.8)</b>
<b>Net loan book</b>			
Mortgage Lending	867.9	22.7	890.6
Commercial Lending	110.7	18.6	129.3
Idem Capital	4.7	5.0	9.7
<b>Total</b>	<b>983.3</b>	<b>46.3</b>	<b>1,029.6</b>
<b>Coverage ratio</b>			
Mortgage Lending	1.36%	2.58%	1.40%
Commercial Lending	2.21%	2.62%	2.27%
Idem Capital	2.08%	1.96%	2.02%
<b>Total</b>	<b>1.46%</b>	<b>2.53%</b>	<b>1.51%</b>

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)**

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

*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.

Accounts which no longer meet default criteria but which are being retained in Stage 3 for a probationary period are included with the > 3 month arrears accounts below.

## NOTES TO THE FINANCIAL INFORMATION – ANALYSIS

For the year ended 30 September 2020

## 11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

The impact of Covid-19 on the Group's Stage 3 loans can be seen mostly in the level of > 3 month arrears accounts shown below, both in terms of increased numbers and in higher provision coverage. The impact is proportionally less in Idem Capital where there is a significant balance of second charge loans which are long-term arrears balances, the customer making regular payments, but not reducing arrears. Government and regulatory policy intervention have reduced the likelihood of new enforcement actions, particularly on consumer portfolios.

In Mortgage Lending the overall level of Stage 3 balances has continued to reduce, despite Covid-19 as the managed work-out of legacy receiver of rent cases continued in the period. Coverage for Stage 3 RoR managed and realisations cases has increased over the year as a result of a less positive outlook for property sale values. 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.

	> 3 month arrears £m	RoR managed £m	Realisations £m	Total £m
<b>30 September 2020</b>				
<b>Gross loan book</b>				
Mortgage Lending	19.4	86.7	20.9	127.0
Commercial Lending	11.4	-	8.8	20.2
Idem Capital	24.3	-	4.6	28.9
<b>Total</b>	<b>55.1</b>	<b>86.7</b>	<b>34.3</b>	<b>176.1</b>
<b>Impairment provision</b>				
Mortgage Lending	(1.7)	(20.8)	(8.2)	(30.7)
Commercial Lending	(4.2)	-	(4.0)	(8.2)
Idem Capital	(2.8)	-	(1.7)	(4.5)
<b>Total</b>	<b>(8.7)</b>	<b>(20.8)</b>	<b>(13.9)</b>	<b>(43.4)</b>
<b>Net loan book</b>				
Mortgage Lending	17.7	65.9	12.7	96.3
Commercial Lending	7.2	-	4.8	12.0
Idem Capital	21.5	-	2.9	24.4
<b>Total</b>	<b>46.4</b>	<b>65.9</b>	<b>20.4</b>	<b>132.7</b>
<b>Coverage ratio</b>				
Mortgage Lending	8.76%	23.99%	39.23%	24.17%
Commercial Lending	36.84%	-	45.45%	40.59%
Idem Capital	11.52%	-	36.96%	15.57%
<b>Total</b>	<b>15.79%</b>	<b>23.99%</b>	<b>40.52%</b>	<b>24.65%</b>

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)**

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

The security values available to reduce exposure at default in the calculation shown above for Stage 3 accounts are set out below. The estimated value of the security represents, for each account, the lesser of the valuation estimate and the exposure at default in the Central scenario. Security values are based on the most recent valuation of the relevant asset held by the Group, indexed or depreciated as appropriate.

	<b>2020</b> £m	<b>2019</b> £m
First mortgages	71.9	65.7
Second mortgages	17.3	14.0
Asset finance	6.7	2.2
Motor finance	1.5	1.0
	<b>97.4</b>	<b>82.9</b>

## NOTES TO THE FINANCIAL INFORMATION – ANALYSIS

For the year ended 30 September 2020

## 11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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.

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

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 2020		30 September 2019	
	No.	£m	No.	£m
<b>Managed accounts</b>				
<i>Appointment date</i>				
2010 and earlier	369	62.4	402	70.5
2011 to 2013	72	12.4	86	17.3
2014 to 2016	29	4.2	31	4.5
2016 and later	46	7.7	84	14.0
	<hr/>	<hr/>	<hr/>	<hr/>
<b>Total managed accounts</b>	516	86.7	603	106.3
Accounts in the process of realisation	104	19.7	80	11.9
	<hr/>	<hr/>	<hr/>	<hr/>
	620	106.4	683	118.2
	<hr/>	<hr/>	<hr/>	<hr/>

Receiver of rent accounts in the process of realisation at the period end are included under that heading in the Stage 3 tables above.

In addition to the cases analysed above, 3 POCI mortgage accounts also had a receiver of rent appointed (2019: 3), making a total of 623.

## NOTES TO THE FINANCIAL INFORMATION – ANALYSIS

For the year ended 30 September 2020

## 11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

**(c) Movements in impairment provision by stage**

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

	<b>Mortgage Lending £m</b>	<b>Commercial Lending £m</b>	<b>Idem Capital £m</b>	<b>Total £m</b>
At 30 September 2019	26.8	10.7	4.4	41.9
Provided in period (note 11(d))	25.8	22.7	1.3	49.8
Amounts written off	(4.3)	(4.8)	(0.8)	(9.9)
Assets derecognised	-	-	-	-
<b>At 30 September 2020</b>	<b>48.3</b>	<b>28.6</b>	<b>4.9</b>	<b>81.8</b>
At transition – 1 October 2018	36.1	6.6	11.5	54.2
Provided in period (note 11(d))	1.2	7.2	0.3	8.7
Amounts written off	(6.5)	(3.1)	(7.4)	(17.0)
Assets derecognised	(4.0)	-	-	(4.0)
<b>At 30 September 2019</b>	<b>26.8</b>	<b>10.7</b>	<b>4.4</b>	<b>41.9</b>

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.

The difference between the amount shown above and the profit and loss account charge for the period is amounts recovered on previously written off accounts of £1.5m (2019: £0.7m).

## NOTES TO THE FINANCIAL INFORMATION – ANALYSIS

For the year ended 30 September 2020

## 11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

A more detailed analysis of these movements by IFRS 9 stage on a consolidated basis for the year ended 30 September 2020 and 30 September 2019 is set out below.

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Loss allowance at 30 September 2019	6.0	3.7	32.2	-	41.9
New assets originated or purchased	10.2	-	-	-	10.2
Changes in loss allowance					
Transfer to Stage 1	0.9	(0.7)	(0.2)	-	-
Transfer to Stage 2	(1.2)	1.3	(0.1)	-	-
Transfer to Stage 3	(0.5)	(0.4)	0.9	-	-
Changes due to credit risk	6.8	11.9	20.5	0.4	39.6
Write offs	-	-	(9.9)	-	(9.9)
Assets derecognised	-	-	-	-	-
<b>Loss allowance at 30 September 2020</b>	<b>22.2</b>	<b>15.8</b>	<b>43.4</b>	<b>0.4</b>	<b>81.8</b>
Loss allowance at 1 October 2018	4.9	2.6	46.7	-	54.2
New assets originated or purchased	4.4	-	-	-	4.4
Changes in loss allowance					
Transfer to Stage 1	0.5	(0.5)	-	-	-
Transfer to Stage 2	(0.3)	0.4	(0.1)	-	-
Transfer to Stage 3	(0.5)	(0.4)	0.9	-	-
Changes due to credit risk	(2.9)	3.3	3.9	-	4.3
Write offs	-	-	(17.0)	-	(17.0)
Assets derecognised	(0.1)	(1.7)	(2.2)	-	(4.0)
<b>Loss allowance at 30 September 2019</b>	<b>6.0</b>	<b>3.7</b>	<b>32.2</b>	<b>-</b>	<b>41.9</b>

The principal factor generating the increase in the loss allowance in the period is the impact of the Covid-19 crisis, which has led to increased loss expectations across all of the Group's portfolios, primarily as a result of the forecast deterioration in key economic variables and their impact on the Group's customers. The broad availability of payment holidays has also been reflected, with floors applied for both payment holiday accounts and payment holiday extensions.

These increases in expected losses have also led to increased numbers of accounts having an SICR identified and therefore being transferred from Stage 1 to Stage 2. The transfers to Stage 2 in 2020 include £576.3m of balances with extended payment reliefs which were identified as having an SICR for this reason only.



**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**

**For the year ended 30 September 2020**

**11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)**

Overall the impact of the PD floors and the transfer of additional accounts to the life-time ECL provisioning required by Stage 2 has increased the total provision by £19.8m from the £62.0m which would have been indicated had the Group's standard SICR tests only been used.

In the year ended 30 September 2019, the principal factors generating the reduction in the loss allowance were 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.,

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)**

The movements in the Loans to Customers balances in respect of which these loss allowances have been made are set out below.

	<b>Stage 1 £m</b>	<b>Stage 2 £m</b>	<b>Stage 3 £m</b>	<b>POCI £m</b>	<b>Total £m</b>
Balances at 30 September 2019	11,382.6	458.5	167.9	219.0	12,228.0
New assets originated or purchased	2,071.4	-	-	-	2,071.4
Changes in staging					
Transfer to Stage 1	202.3	(200.1)	(2.2)	-	-
Transfer to Stage 2	(846.2)	849.2	(3.0)	-	-
Transfer to Stage 3	(42.6)	(20.5)	63.1	-	-
Redemptions and repayments	(1,488.3)	(54.1)	(42.0)	(78.1)	(1,622.5)
Goodwill adjustment (note 31)	-	-	-	-	-
Assets derecognised	-	-	-	-	-
Write offs	-	-	(9.9)	-	(9.9)
Other changes	50.5	12.4	2.2	21.1	86.2
<b>Balance at 30 September 2020</b>	<b>11,329.7</b>	<b>1,045.4</b>	<b>176.1</b>	<b>162.0</b>	<b>12,713.2</b>
Loss allowance	(22.2)	(15.8)	(43.4)	(0.4)	(81.8)
<b>Carrying value</b>	<b>11,307.5</b>	<b>1,029.6</b>	<b>132.7</b>	<b>161.6</b>	<b>12,631.4</b>
Balances at 1 October 2018	11,274.1	397.8	188.2	294.7	12,154.8
New assets originated or purchased	2,443.2	-	-	4.1	2,447.3
Changes in staging					
Transfer to Stage 1	100.8	(97.5)	(3.3)	-	-
Transfer to Stage 2	(240.0)	243.4	(3.4)	-	-
Transfer to Stage 3	(27.1)	(18.6)	45.7	-	-
Redemptions and repayments	(1,586.1)	(30.0)	(29.6)	(110.1)	(1,755.8)
Goodwill adjustment (note 31)	-	-	-	(2.7)	(2.7)
Assets derecognised	(636.8)	(39.4)	(14.1)	(14.7)	(705.0)
Write offs	-	-	(17.0)	-	(17.0)
Other changes	54.5	2.8	1.4	47.7	106.4
<b>Balance at 30 September 2019</b>	<b>11,382.6</b>	<b>458.5</b>	<b>167.9</b>	<b>219.0</b>	<b>12,228.0</b>
Loss allowance	(6.0)	(3.7)	(32.2)	-	(41.9)
<b>Carrying value</b>	<b>11,376.6</b>	<b>454.8</b>	<b>135.7</b>	<b>219.0</b>	<b>12,186.1</b>

Other changes includes interest and similar charges

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS****For the year ended 30 September 2020****11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)****(d) 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. 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.

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 informs its central scenario. These sources include forecasts produced by the Office of Budget Responsibility ('OBR') and the PRA as well as private sector economic research bodies.

The four economic scenarios comprise a base case, which will normally carry the highest scenario weighting, an upside case, a downside and a severe downside, the latter typically being benchmarked to be at least as severe as scenarios provided by the Bank of England for stress testing purposes. For the 2020 year end, each of the Group's scenarios represents a differing level of impact of the pandemic on the economy and different timings of recovery. They have been reviewed against emerging economic data and updated external forecasts reflecting the most recent information available, including the impact of the UK's second lockdown. The approach utilises data and forecasts from both economic advisers and from public sources, such as Bank of England statements and projections.

The fundamental rebasing of the Group's scenarios in the year, resulting from the impact of the Covid-19 pandemic, means that it is not useful to discuss detailed changes in the scenarios year-on-year.

The Group revised its weightings at the time of the half year accounts. Whilst the base case represents the highest individually weighted scenario at 40%, the combined downside and severe downside cases carry a combined 50% weighting, reflecting the scale of uncertainty and potentially adverse economic impact from Covid-19.

It should be noted that 'Severe Downside' in the Covid-19 scenarios is based on a potential outcome and is less severe than that used at 30 September 2019 which was based on the PRA 'once in 200-year' stress test. Therefore, the 2020 scenario carries a higher probability.

The weightings attached to each scenario are set out below

	<b>2020</b>	<b>2019</b>
Central Scenario	40%	40%
Upside Scenario	10%	20%
Downside Scenario	35%	35%
Severe Scenario	15%	5%
	100%	100%

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)**

The economic variables comprising each scenario, and their projected values in each of the first five years of the forecast period are set out below.

**30 September 2020**

*Gross Domestic Product ('GDP') (year-on-year change)*

	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
Central scenario	4.9%	5.7%	2.2%	1.5%	1.4%
Upside scenario	6.0%	5.4%	2.4%	1.5%	1.5%
Downside scenario	2.1%	9.3%	2.9%	1.3%	1.5%
Severe scenario	0.2%	9.5%	2.2%	1.4%	1.3%

*House Price Index ('HPI') (year-on-year change)*

	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
Central scenario	(0.8)%	0.3%	4.0%	4.0%	3.8%
Upside scenario	1.3%	1.3%	3.0%	3.3%	3.8%
Downside scenario	(3.5)%	(7.0)%	(0.1)%	2.8%	3.8%
Severe scenario	(11.8)%	(13.8)%	(5.3)%	1.5%	3.6%

*Bank Base Rate ('BBR') (rate)*

	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
Central scenario	0.1%	0.1%	0.4%	0.8%	0.8%
Upside scenario	0.1%	0.4%	0.7%	0.9%	1.0%
Downside scenario	0.1%	0.1%	0.1%	0.3%	0.8%
Severe scenario	0.0%	(0.2)%	0.1%	0.2%	0.6%

*Consumer Price Inflation ('CPI') (rate)*

	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
Central scenario	0.9%	1.7%	2.2%	2.1%	2.1%
Upside scenario	1.2%	2.1%	2.1%	2.2%	2.1%
Downside scenario	0.7%	1.3%	1.8%	2.1%	2.0%
Severe scenario	(0.1)%	0.7%	1.5%	2.0%	2.0%

*Unemployment (rate)*

	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
Central scenario	7.1%	5.3%	5.0%	5.0%	4.4%
Upside scenario	6.3%	4.8%	4.6%	4.5%	4.1%
Downside scenario	8.2%	6.5%	5.7%	5.0%	4.8%
Severe scenario	8.5%	7.8%	7.0%	6.3%	5.5%

## NOTES TO THE FINANCIAL INFORMATION – ANALYSIS

For the year ended 30 September 2020

## 11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

*Secured lending (annual change)*

	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
Central scenario	3.6%	3.7%	3.8%	3.9%	3.9%
Upside scenario	4.7%	4.5%	4.2%	4.1%	4.0%
Downside scenario	1.8%	2.3%	3.2%	3.7%	3.8%
Severe scenario	(0.9)%	0.2%	2.3%	3.4%	3.7%

*Consumer credit (annual change)*

	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
Central scenario	6.0%	6.1%	6.1%	6.3%	6.3%
Upside scenario	8.7%	8.2%	7.3%	6.9%	6.7%
Downside scenario	1.8%	2.8%	4.3%	5.4%	5.7%
Severe scenario	(4.6)%	(2.3)%	1.6%	4.0%	4.8%

**30 September 2019***Gross Domestic Product ('GDP') (year-on-year change)*

	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>
Central scenario	1.3%	1.7%	1.8%	1.5%	1.9%
Upside scenario	2.2%	2.5%	2.0%	1.5%	2.1%
Downside scenario	(0.1)%	0.4%	1.6%	1.3%	1.5%
Severe scenario	(2.1)%	(1.6)%	1.2%	1.4%	1.0%

*House Price Index ('HPI') (year-on-year change)*

	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>
Central scenario	1.3%	2.9%	4.0%	4.2%	4.3%
Upside scenario	2.9%	7.4%	8.6%	4.6%	4.0%
Downside scenario	(1.3)%	(4.4)%	(3.4)%	3.6%	4.8%
Severe scenario	(5.2)%	(15.4)%	(14.4)%	2.7%	5.5%

*Bank Base Rate ('BBR') (rate)*

	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>
Central scenario	0.8%	0.8%	0.8%	0.8%	0.8%
Upside scenario	1.0%	1.5%	2.0%	2.4%	2.5%
Downside scenario	0.5%	0.5%	0.5%	0.5%	0.5%
Severe scenario	0.0%	0.0%	0.0%	0.0%	0.0%

*Consumer Price Inflation ('CPI') (rate)*

	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>
Central scenario	2.1%	2.1%	2.1%	2.1%	2.1%
Upside scenario	2.0%	1.5%	1.6%	2.0%	2.2%
Downside scenario	2.3%	3.1%	2.9%	2.1%	2.1%
Severe scenario	2.5%	4.6%	4.1%	2.2%	2.1%

## NOTES TO THE FINANCIAL INFORMATION – ANALYSIS

For the year ended 30 September 2020

## 11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

*Unemployment (rate)*

	2020	2021	2022	2023	2024
Central scenario	4.0%	4.0%	3.9%	3.9%	3.8%
Upside scenario	3.6%	3.5%	3.5%	3.5%	3.5%
Downside scenario	4.9%	6.1%	5.9%	5.6%	5.3%
Severe scenario	6.4%	9.2%	8.8%	8.2%	7.5%

*Secured lending (annual change)*

	2020	2021	2022	2023	2024
Central scenario	3.3%	3.6%	3.7%	3.8%	3.9%
Upside scenario	3.6%	4.7%	4.5%	4.2%	4.0%
Downside scenario	2.8%	1.8%	2.3%	3.2%	3.7%
Severe scenario	1.9%	(0.9)%	0.2%	2.3%	3.4%

*Consumer credit (annual change)*

	2020	2021	2022	2023	2024
Central scenario	6.0%	6.0%	6.1%	6.1%	6.3%
Upside scenario	6.9%	8.7%	8.2%	7.3%	6.9%
Downside scenario	4.8%	1.8%	2.8%	4.3%	5.4%
Severe scenario	2.9%	(4.6)%	(2.3)%	1.6%	4.0%

After the end of the initial five year period, the final rate or rate of change (as appropriate) is to continue into the future in each scenario.

To illustrate the levels of non-linearity in the various scenarios, the maximum and minimum quarterly levels for each variable over the five year period are set out below.

**30 September 2020**

	Central scenario		Upside scenario		Downside scenario		Severe scenario	
	Max %	Min %	Max %	Min %	Max %	Min %	Max %	Min %
<b>Economic driver</b>								
GDP	18.0	(7.6)	18.8	(5.9)	17.8	(15.1)	20.5	(17.9)
HPI	5.0	(4.0)	4.0	0.0	3.8	(10.0)	4.0	(20.0)
BBR	0.8	0.1	1.0	0.1	0.8	0.1	0.8	(0.4)
CPI	2.4	0.6	2.3	0.7	2.1	0.2	2.3	(0.3)
Unemployment	7.6	4.0	7.0	4.0	8.2	4.5	9.0	5.3
Secured lending	3.9	3.5	4.8	4.0	3.8	1.7	3.7	(1.2)
Consumer credit	6.3	6.0	8.8	6.7	5.7	1.5	4.8	(5.2)

## NOTES TO THE FINANCIAL INFORMATION – ANALYSIS

For the year ended 30 September 2020

## 11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

30 September 2019

	Central scenario		Upside scenario		Downside scenario		Severe scenario	
	Max %	Min %	Max %	Min %	Max %	Min %	Max %	Min %
<b>Economic driver</b>								
GDP	1.9	1.2	3.1	1.2	1.6	(1.0)	1.3	(4.7)
HPI	4.3	0.7	9.7	0.9	4.9	(4.7)	5.7	(17.8)
BBR	0.8	0.8	2.5	0.8	0.5	0.5	0.0	0.0
CPI	2.2	2.0	2.2	1.4	3.2	2.0	4.9	2.0
Unemployment	4.1	3.8	3.9	3.5	6.1	4.2	9.2	4.5
Secured lending	3.9	3.2	4.8	3.3	3.8	1.7	3.7	(1.2)
Consumer credit	6.3	6.0	8.8	6.2	6.0	1.5	5.9	(5.2)

The asymmetry in the models is demonstrated by comparing the calculated impairment provision with that which would have been produced using the Central scenario alone, 100% weighted.

	2020 £m	2019 £m
Calculated provision	81.8	41.9
100% weighted central scenario	67.4	37.7
Effect of multiple economic scenarios	14.4	4.2

To illustrate the potential impact of differing future economic scenarios on the total impairment, the provision which would be calculated if each of the economic scenarios were 100% weighted would be:

Scenarios	2020	
	Provision £m	Difference £m
Central	67.4	(14.4)
Upside	58.0	(23.8)
Downside	82.4	0.6
Severe downside	134.3	52.5

The weighted average of these 100% weighted provisions need not equal the weighted average ECL due to the impact of the differing PDs on staging. However due to the significant impact of post model stage adjustments, the effect on the PD SICR test of 100% weighting has not been taken into account above.

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**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 2020 or the preceding year.

	2020 Assets £m	2020 Liabilities £m	2019 Assets £m	2019 Liabilities £m
<b>Derivatives in hedge accounting relationships</b>				
<i>Fair value hedges</i>				
Interest rate swaps				
Fixed to floating	-	(130.0)	0.2	(78.3)
Floating to fixed	14.4	-	7.6	(0.2)
	<u>14.4</u>	<u>(130.0)</u>	<u>7.8</u>	<u>(78.5)</u>
<i>Cash flow hedges</i>				
Cross-currency basis swaps				
Dollar-sterling	213.2	-	274.6	-
Euro-sterling	232.1	-	308.1	-
	<u>445.3</u>	<u>-</u>	<u>582.7</u>	<u>-</u>
Total derivatives in hedge accounting relationships	459.7	(130.0)	590.5	(78.5)
<b>Other derivatives</b>				
Interest rate swaps	3.4	(2.4)	1.9	(2.0)
Currency futures	0.2	-	-	-
Total recognised derivative assets / (liabilities)	<u><u>463.3</u></u>	<u><u>(132.4)</u></u>	<u><u>592.4</u></u>	<u><u>(80.5)</u></u>

All hedging relationships and strategies at 30 September 2019 described in the 2019 Group Accounts 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.

These compensating differences gave rise to the exchange differences shown in note 22.



**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**13. INTANGIBLE ASSETS**

Intangible assets at net book value comprise:

	<b>2020</b>	<b>2019</b>	<b>2018</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>
Goodwill	164.4	164.4	162.2
Computer software	2.2	2.4	2.1
Other intangibles	3.5	4.3	5.0
Total assets	<u>170.1</u>	<u>171.1</u>	<u>169.3</u>

The balance for goodwill at 30 September 2020 shown above includes £113.0m in respect of the Asset Finance Cash Generating Unit ('CGU') and £49.8m in respect of the Development Finance CGU.

Movements in goodwill in the year ended 30 September 2019 relate to the finalisation of the acquisition accounting for Titlestone described in the accounts for that year.

**(a) SME lending**

The goodwill carried in the accounts relating to the SME lending (formerly Asset Finance) CGU was recognised on the acquisitions in the years ended 30 September 2016 and 30 September 2018.

An impairment review undertaken at 30 September 2020 indicated that no write down was required.

The recoverable amount of the asset finance CGU used in this impairment testing is determined on a value in use basis using pre-tax cash flow projections based on financial budgets approved by the Board covering a five-year period. These forecasts reflect the potential ongoing impact of Covid-19 on the business, with overall average growth increased to include the recovery from the Covid-19 low point.

The key assumptions underlying the value in use calculation for the asset finance CGU are:

- Level of business activity, based on management expectations. The forecast assumes a compound annual growth rate ('CAGR') for new business over the five-year period of 19.7%, compared with 12.0% used in the calculation at 30 September 2019. Cash flows beyond the five-year budget are extrapolated using a constant growth rate of 1.5% (2019: 1.9%) which does not exceed the long term average growth rates for the markets in which the business is active  
  
Management have concluded that the levels of activity assumed for the purpose of this forecast are reasonable, based on past experience and the current economic environment
- Discount rate, which is based on third party estimates of the implied industry cost of capital. The pre-tax discount rate applied to the cash flow projection is 15.0% (2019: 13.2%)

As an illustration of the sensitivity of this impairment test to movements in the key assumptions, the Group has calculated that a 10.0% reduction in profit levels coupled with a 100 basis point increase in the pre-tax discount rate would eliminate the headroom in the projection.

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS****For the year ended 30 September 2020****13. INTANGIBLE ASSETS (CONTINUED)**

In the testing carried out at 30 September 2019, a 24.0% reduction in profit levels coupled with a 370 basis point increase in the pre-tax discount rate would have that effect.

**(b) Development finance**

The goodwill carried in the accounts relating to the development finance CGU was first recognised on a business acquisition in the year ended 30 September 2018.

An impairment review undertaken at 30 September 2020 indicated that no write down was required.

The recoverable amount of the development finance CGU used in this impairment testing is determined on a value in use basis using pre-tax cash flow projections based on financial budgets approved by the Board covering a five-year period. These forecasts include the potential ongoing impact of Covid-19 on the business.

The key assumptions underlying the value in use calculation for the development finance cash generating unit are:

- Level of business activity, based on management expectations. The forecast assumes a CAGR for new commitments over the five-year period of 16.9%, compared with 18.3% used in the calculation at 30 September 2019. Cash flows beyond the five-year budget are extrapolated using a constant growth rate of 1.5% (2019: 1.9%) which does not exceed the long-term average growth rate for the UK economy

Management have concluded that the levels of activity assumed for the purpose of this forecast are reasonable, based on past experience and the current economic environment

- Discount rate, which is based on third party estimates of the implied industry cost of capital. The pre-tax discount rate applied to the cash flow projection is 14.2% (2019: 13.2%)

Management believes any reasonably possible change in the key assumptions above would not cause the recoverable amount of the development finance CGU to fall below the balance sheet carrying value. This was also the case in the testing carried out at 30 September 2019.

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**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 notice and easy access accounts. The method of interest calculation on these deposits is analysed as follows:

	<b>2020</b>	<b>2019</b>	<b>2018</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>
Fixed rate	4,975.9	4,154.4	3,643.1
Variable rates	2,880.7	2,237.5	1,653.5
	<u>7,856.6</u>	<u>6,391.9</u>	<u>5,296.6</u>

The weighted average interest rate on retail deposits at 30 September 2020, analysed by charging method, was:

	<b>2020</b>	<b>2019</b>	<b>2018</b>
	<b>%</b>	<b>%</b>	<b>%</b>
Fixed rate	1.69	2.02	1.94
Variable rates	0.72	1.43	1.36
All deposits	<u>1.34</u>	<u>1.81</u>	<u>1.76</u>

The contractual maturity of these deposits is analysed below.

	<b>2020</b>	<b>2019</b>	<b>2018</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>
<b>Amounts repayable</b>			
In less than three months	565.0	466.6	256.8
In more than three months, but not more than one year	2,725.6	2,088.4	2,024.7
In more than one year, but not more than two years	1,541.6	1,158.0	1,010.6
In more than two years, but not more than five years	664.8	900.9	655.3
<b>Total term deposits</b>	<u>5,497.0</u>	<u>4,613.9</u>	<u>3,947.4</u>
<b>Repayable on demand</b>	<u>2,359.6</u>	<u>1,778.0</u>	<u>1,349.2</u>
	<u>7,856.6</u>	<u>6,391.9</u>	<u>5,296.6</u>
Fair value adjustments for portfolio hedging (note 12)	10.4	3.9	(4.2)
	<u>7,867.0</u>	<u>6,395.8</u>	<u>5,292.4</u>

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS****For the year ended 30 September 2020****15. BORROWINGS**

On 20 March 2020, Fitch Ratings confirmed the Group's Long-Term Issuer Default Rating at BBB. It downgraded its senior unsecured debt rating to BBB- (from BBB) and the rating of the £150.0m Tier 2 Bond to BB+ (from BBB-) following the application of updated bank rating criteria.

All borrowings described in the Group Accounts for the year ended 30 September 2019 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.

It also drew down £140.0m under the Bank of England Contingent Term Repo Facility ('CTRF'). This is a facility for collateralised drawings introduced by the Bank of England in response to the Covid-19 situation.

The Group has also been authorised to participate in the SME Term Funding Scheme (TFSME) and made drawing of £910.0m in the year.

Of the Group's borrowings at 30 September 2019, the following mortgage backed floating rate notes were repaid

- Paragon Mortgages (No. 23) PLC in October 2019
- Paragon Mortgages (No. 9) PLC in February 2020
- Paragon Mortgages (No. 24) PLC in April 2019
- Paragon Mortgages (No. 10) PLC in September 2020
- First Flexible No. 6 PLC in September 2020

In September 2020 notice was given of the Group's intention to repay the remaining notes issued by Paragon Mortgages (No. 11) PLC and this took place on 15 October 2020, after the end of the period. In November 2020 notice was given of the Group's intention to repay the remaining notes issued by Paragon Mortgages (No. 15) PLC and this is expected to take place in December 2020. In each case, this followed the purchase of the entity's loan assets by other group companies.

On 24 October 2019, the Group's £200.0m warehouse funding facility, drawn by Paragon Seventh Funding on Bank of America Merrill Lynch, was renewed for a further 12 month commitment period on substantially the same terms as set out in the Group Accounts for the year ended 30 September 2019. It was further renewed and extended to £400.0m on 25 September 2020.

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

During the period, the Group entered into a back-to-back long / short repo transaction with a UK bank. This provides £150.0m of liquidity and encumbers £28.5m of Group assets, but does not appear on the Group's balance sheet.

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS****For the year ended 30 September 2020****16. SUNDRY LIABILITIES**

Sundry liabilities include £30.7m of amounts falling due after more than one year (2019: £38.8m).

Total sundry liabilities include £13.5m in respect of deferred consideration, of which £10.3m falls due after more than one year (2019: £23.7m), and £5.6m in respect of lease liabilities (2019: £nil), of which £4.1m falls due after more than one year (2019: £nil) (note 29).

**17. RETIREMENT BENEFIT OBLIGATIONS**

The defined benefit obligation at 30 September 2020 has been calculated on a year-to-date basis. Since the last IAS 19 actuarial valuation at 30 September 2019, 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 2020. In particular, over the period since the 30 September 2019 actuarial valuation, the discount rate has decreased by 110 basis points per annum, whereas expectations of long-term inflation have reduced by around 40 basis points.

In addition, the defined benefit obligation takes into account the results of the plan's statutory funding valuation as at 31 March 2019, which results in a reduction in forecast plan liabilities.

The net effect of these changes, together with the Group's contribution, which included a one-off contribution of £20.0m in the year, and the performance of the plan assets, has resulted in the value of the defined benefit obligation at 30 September 2020 reducing from that at 30 September 2019. The impact of allowing for the results of the 2019 valuation and the change in actuarial assumptions has been recognised as an actuarial gain in other comprehensive income.

The movements in the deficit on the defined benefit plan during the year ended 30 September 2020 are summarised below.

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
Opening pension deficit	34.5	19.5
Employer contributions	(24.5)	(4.6)
<i>Amounts posted to profit and loss</i>		
Service cost	2.0	1.6
Past service cost	-	0.3
Net funding cost (note 4)	0.4	0.5
Administrative expenses	0.6	0.7
<i>Amounts posted to other comprehensive income</i>		
Return on plan assets not included in interest	1.8	(6.6)
Experience (gain) on liabilities	(1.6)	-
Actuarial (gain) / loss from changes in financial assumptions	6.0	24.5
Actuarial (gain) from changes in demographic assumptions	1.2	(1.4)
<b>Closing pension deficit</b>	<b>20.4</b>	<b>34.5</b>

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS****For the year ended 30 September 2020****17. RETIREMENT BENEFIT OBLIGATIONS (CONTINUED)**

Past service cost during 2019 relates to the cost of GMP equalisation, discussed in note 41 to the Group Accounts for the year ended 30 September 2019.

Pursuant to the recovery plan agreed with the Trustee of the pension plan, the Group has effectively granted a first charge over its freehold head office building as security for its agreed contributions. No account of this charge is taken in the calculation of the above deficit.

**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:

	<b>2020</b>	<b>2019</b>
	<b>Number</b>	<b>Number</b>
<b>Ordinary shares</b>		
At 1 October 2019	261,573,351	281,596,936
Shares issued	204,621	1,606,849
Shares cancelled	-	(21,630,434)
	<hr/>	<hr/>
At 30 September 2020	<u>261,777,972</u>	<u>261,573,351</u>

During the year, the Company issued 204,621 shares (2019: 1,606,849) to satisfy options granted under Sharesave schemes for a consideration of £585,315 (2019: £4,075,843).

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

**19. RESERVES**

	<b>2020</b>	<b>2019</b>	<b>2018</b>	<b>2018</b>
	<b>IFRS 9</b>	<b>IFRS 9</b>	<b>IFRS 9</b>	<b>IAS 39</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
Share premium account	68.7	68.3	65.8	65.8
Capital redemption reserve	50.3	50.3	28.7	28.7
Merger reserve	(70.2)	(70.2)	(70.2)	(70.2)
Cash flow hedging reserve	2.5	3.0	3.3	3.3
Profit and loss account	880.7	835.9	868.3	890.7
	<hr/>	<hr/>	<hr/>	<hr/>
	<u>932.0</u>	<u>887.3</u>	<u>895.9</u>	<u>918.3</u>

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**20. OWN SHARES**

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
<b>Treasury shares</b>		
At 1 October 2019	23.0	91.8
Shares purchased	-	26.7
Shares cancelled	-	(95.5)
	<hr/>	<hr/>
At 30 September 2020	23.0	23.0
	<hr/>	<hr/>
<b>ESOP shares</b>		
At 1 October 2019	17.5	12.2
Shares purchased	5.2	7.6
Options exercised	(7.9)	(2.3)
	<hr/>	<hr/>
At 30 September 2020	14.8	17.5
	<hr/>	<hr/>
Balance at 30 September 2020	37.8	40.5
	<hr/>	<hr/>
Balance at 1 October 2019	40.5	104.0
	<hr/>	<hr/>

At 30 September 2020 the number of the Company's own shares held in treasury was 5,218,702 (2019: 5,218,702). These shares had a nominal value of £5,218,702 (2019: £5,218,702). 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 2020, the trust held 3,636,218 ordinary shares (2019: 3,912,516) with a nominal value of £3,636,218 (2019: £3,912,516 and a market value of £12,108,606 (2019: £18,873,977). Options, or other share-based awards, were outstanding against all of these shares at 30 September 2020 (2019: all). The dividends on all of these shares have been waived (2019: all).

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS****For the year ended 30 September 2020****21. EQUITY DIVIDEND**

Amounts recognised as distributions to equity shareholders in the period:

	<b>2020</b>	<b>2019</b>	<b>2020</b>	<b>2019</b>
	<b>Per share</b>	<b>Per share</b>	<b>£m</b>	<b>£m</b>
<i>Equity dividends on ordinary shares</i>				
Final dividend for the previous year	14.2p	13.9p	35.9	35.9
Interim dividend for the current year	-	7.0p	-	18.1
	<u>14.2p</u>	<u>20.9p</u>	<u>35.9</u>	<u>54.0</u>

Amounts paid and proposed in respect of the year:

	<b>2020</b>	<b>2019</b>	<b>2020</b>	<b>2019</b>
	<b>Per share</b>	<b>Per share</b>	<b>£m</b>	<b>£m</b>
Interim dividend for the current year	-	7.0p	-	18.1
Proposed final dividend for the current year	14.4p	14.2p	36.4	35.8
	<u>14.4p</u>	<u>21.2p</u>	<u>36.4</u>	<u>53.9</u>

The proposed final dividend for the year ended 30 September 2020 will be paid on 26 February 2021, subject to approval at the Annual General Meeting, with a record date of 29 January 2021. The dividend will be recognised in the accounts when it is paid.



**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**22. NET CASH FLOW FROM OPERATING ACTIVITIES**

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
<b>Profit before tax</b>	118.4	159.0
Non-cash items included in profit and other adjustments:		
Depreciation of operating property, plant and equipment	3.5	1.5
Profit on disposal of operating property, plant and equipment	-	-
Amortisation of intangible assets	2.0	2.4
Foreign exchange movement on borrowings	(136.8)	(124.8)
Other non-cash movements on borrowings	1.5	3.6
Impairment losses on loans to customers	48.3	8.0
Charge for share based remuneration	2.7	5.9
Gain on derecognition	-	(9.7)
Derecognition of cash flow hedge	-	(0.9)
Net (increase) / decrease in operating assets:		
Assets held for leasing	(3.2)	(0.9)
Loans to customers	(493.6)	(792.0)
Derivative financial instruments	129.1	169.7
Fair value of portfolio hedges	(45.5)	(88.3)
Other receivables	(35.6)	(73.8)
Net increase / (decrease) in operating liabilities:		
Retail deposits	1,464.7	1,095.3
Derivative financial instruments	51.9	75.8
Fair value of portfolio hedges	6.5	8.1
Other liabilities	(39.1)	(1.6)
Cash generated by operations	1,074.8	437.3
Income taxes (paid)	(46.1)	(39.4)
	<u>1,028.7</u>	<u>397.9</u>

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

**23. NET CASH FLOW FROM INVESTING ACTIVITIES**

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
Proceeds from sales of operating property, plant and equipment	0.1	-
Purchases of operating property, plant and equipment	(1.9)	(1.1)
Purchases of intangible assets	(1.0)	(2.0)
Residual disposal	-	11.4
<b>Net cash (utilised) / generated by investing activities</b>	<u>(2.8)</u>	<u>8.3</u>

**NOTES TO THE FINANCIAL INFORMATION – ANALYSIS**  
**For the year ended 30 September 2020**

**24. NET CASH FLOW FROM FINANCING ACTIVITIES**

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
Shares issued (note 18)	0.6	3.9
Dividends paid (note 21)	(35.9)	(54.0)
Issue of asset backed floating rate notes	-	362.5
Repayment of asset backed floating rate notes	(1,013.3)	(591.1)
Movement on central bank facilities	860.0	(30.0)
Movement on other bank facilities	(130.1)	(148.3)
Capital element of lease payments	(2.0)	-
Purchase of shares (note 20)	(5.2)	(34.3)
Sale of shares	0.2	-
	<hr/>	<hr/>
<b>Net cash (utilised) by financing activities</b>	<b>(325.7)</b>	<b>(491.3)</b>
	<hr/> <hr/>	<hr/> <hr/>

**25. RELATED PARTY TRANSACTIONS**

During the year, certain of the non-executive directors of the Group were beneficially interested in savings deposits made with Paragon Bank, on the same terms as were available to members of the public. Deposits of £301,000 were outstanding at the year end (2019: none), and the maximum amount outstanding during the year was £500,000 (2019: £250,000).

Mr A K Fletcher, a non-executive director of the Company until 31 December 2018, is a director of Paragon Pension Plan Trustees Limited, which acts as the corporate trustee of the Plan. In respect of this appointment he was paid £4,000 in the year ended 30 September 2019 by Paragon Finance PLC, the sponsoring company of the Plan up to the date of his resignation as a director of the Company.

The Plan is a related party of the Group. Transactions with the Plan are described in note 17.

The Group had no other transactions with related parties other than the key management compensation.

**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK**  
**For the year ended 30 September 2020**

*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.*

**26. 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's response to the Covid-19 situation has been planned and executed with the protection of its capital base and its long-term viability as key strategic priorities.

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 regulatory requirement to retain an appropriate level of capital in Paragon Bank PLC, there are no restrictions preventing profits elsewhere in the Group from being distributed to the parent.

**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK****For the year ended 30 September 2020****26. 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.

At the time of approving the half yearly report, the Board considered the exceptional level of uncertainty in the UK and global economy, together with the public statements of government and regulatory bodies and emerging market practice and concluded that, while the capital position and liquidity position of the Company remained strong, it would not be advisable to declare an interim dividend for the year.

The appropriate level of dividend for the full year was considered in light of economic and regulatory developments in the second half of the year. In particular the levels of provision in the Group's loan portfolios and the potential for further provision under stress were considered by the Board, along with the capital requirements of the Group both under the base case medium term forecast and under stress, discounting the effects of the current temporary reduction in regulatory buffers in response to Covid-19. On the basis of the analysis the Board concluded that a dividend payment for the year of around 40% of earnings, in line with policy could be made.

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

	<b>Note</b>	<b>2020</b>	<b>2019</b>
Earnings per share (p)	8	36.0	49.4
Proposed dividend per share in respect of the year (p)	21	14.4	21.2
Dividend cover (times)		<u>2.50</u>	<u>2.33</u>

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 most recent policy review, in November 2020, also confirmed the existing dividend policy would continue to apply for future periods, subject to the impact of any future events, and will consider the appropriateness and scale of any interim dividend in the context of the Group's results and the operating and economic environment at the time.

**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK**  
**For the year ended 30 September 2020**

**26. 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 2020 is derived as follows:

	Note	2020 £m	2019 £m
Profit for the year after tax		91.3	127.4
Amortisation of intangible assets	13	2.0	2.4
Adjusted profit		<u>93.3</u>	<u>129.8</u>
<b>Divided by</b>			
Opening equity		1,108.4	1,073.5
Opening intangible assets	13	(171.1)	(169.3)
Opening tangible equity		<u>937.3</u>	<u>904.2</u>
Closing equity		1,156.0	1,108.4
Closing intangible assets	13	(170.1)	(171.1)
Closing tangible equity		<u>985.9</u>	<u>937.3</u>
Average tangible equity		<u>961.6</u>	<u>920.7</u>
Return on Tangible Equity		<u>9.7%</u>	<u>14.1%</u>

*This table is not subject to audit*

**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK****For the year ended 30 September 2020****26. 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 in order to safeguard depositors from loss in the event of severe losses being incurred by the Group. This comprises variable elements based on its total risk exposure and also fixed elements. This requirement is set in accordance with the international Basel III rules, issued 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 Group has elected to take advantage of the IFRS 9 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 applying to transition adjustments will allow for a 95% add back to CET1 capital and Risk Weighted Assets ('RWA') 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.

As part of the regulatory response to Covid-19, Article 473a was revised to extend the transitional arrangements for Stage 1 and Stage 2 impairment provisions created in the financial year ended 30 September 2020 and the financial year ending 30 September 2021, while maintaining the transitional arrangements for impairment provisions created before the current period. In order to increase institutions lending capacity in the short term, the EU has determined that these additional provisions should be to be phased into capital over the financial years ending 30 September 2022 to 30 September 2024, rather than recognising the reduction in capital immediately.

These responses also allow, under paragraph 7a of the Article, the impact of transitional adjustments to be weighted at 100% in calculating RWA. The Group has taken advantage of this derogation and hence the IFRS 9 adjustment to RWA is equal to the adjustment to capital at 30 September 2020.

Where these reliefs are taken, firms are also required to disclose their capital positions calculated as if the relief were not available (the 'fully loaded' basis).

The tables below demonstrate that at 30 September 2020 the Group's regulatory capital of £1,141.2m (2019: £1,072.0m) exceeded the amounts required by the regulator, including £749.6m (2019: £742.9m) in respect of Pillar 1 and Pillar 2a capital (unaudited), which is comprised of fixed and variable elements.

The total regulatory capital at 30 September 2020 on the fully loaded bases of £1,098.9m was in excess of the Pillar 1 and 2a requirement of £745.3m (2019: £741.8m) on the same basis (amounts not subject to audit).

## NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2020

## 26. CAPITAL MANAGEMENT (CONTINUED)

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 2020) (2019: 2.5%) and a Counter-Cyclical Buffer ('CCyB'), currently 0.0% of risk weighted assets (2019: 1.0%). The reduction in the CCyB in the year was a response to the Covid-19 pandemic and the long-term rate in a standard risk environment is expected to be 2.0%. Firm specific buffers may also be required.

The Group's regulatory capital differs from its equity as certain adjustments are required by the regulator. A reconciliation of the Group's equity to its regulatory capital determined in accordance with CRD IV at 30 September 2020 is set out below.

	Note	Regulatory basis		Fully loaded basis	
		2020 £m	2019 £m	2020 £m	2019 £m
Total equity		1,156.0	1,108.4	1,156.0	1,108.4
<i>Deductions</i>					
Proposed final dividend		(36.4)	(35.8)	(36.4)	(35.8)
IFRS 9 transitional relief	*	42.3	21.2	-	-
Intangible assets	13	(170.1)	(171.1)	(170.1)	(171.1)
Prudent valuation adjustments	§	(0.6)	(0.7)	(0.6)	(0.7)
<b>Common Equity Tier 1 ('CET1') capital</b>		<u>991.2</u>	<u>922.0</u>	<u>948.9</u>	<u>900.8</u>
Other tier 1 capital		-	-	-	-
<b>Total Tier 1 capital</b>		<u>991.2</u>	<u>922.0</u>	<u>948.9</u>	<u>900.8</u>
Corporate bond		<u>150.0</u>	<u>150.0</u>	<u>150.0</u>	<u>150.0</u>
<b>Total Tier 2 capital</b>		<u>150.0</u>	<u>150.0</u>	<u>150.0</u>	<u>150.0</u>
<b>Total regulatory capital ('TRC')</b>		<u>1,141.2</u>	<u>1,072.0</u>	<u>1,098.9</u>	<u>1,050.8</u>

\* 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.

**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK**  
**For the year ended 30 September 2020**

**26. 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.

	Regulatory basis		Fully loaded basis	
	2020 £m	2019 £m	2020 £m	2019 £m
<i>Credit risk</i>				
Balance sheet assets	6,171.7	5,997.2	6,171.7	5,997.2
Off balance sheet	104.1	85.5	104.1	85.5
IFRS 9 transitional relief	42.3	10.5	-	-
	<u>6,318.1</u>	<u>6,093.2</u>	<u>6,275.8</u>	<u>6,082.7</u>
Total credit risk	6,318.1	6,093.2	6,275.8	6,082.7
Operational risk	544.3	516.6	544.3	516.6
Market risk	-	-	-	-
Other	85.7	114.0	85.7	114.0
	<u>6,948.1</u>	<u>6,723.8</u>	<u>6,905.8</u>	<u>6,713.3</u>
<b>Total risk exposure amount ('TRE')</b>	<b>6,948.1</b>	<b>6,723.8</b>	<b>6,905.8</b>	<b>6,713.3</b>
	<u><u>6,948.1</u></u>	<u><u>6,723.8</u></u>	<u><u>6,905.8</u></u>	<u><u>6,713.3</u></u>
<b>Solvency ratios</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>
CET1	14.3	13.7	13.7	13.4
TRC	16.4	15.9	15.9	15.7
	<u><u>16.4</u></u>	<u><u>15.9</u></u>	<u><u>15.9</u></u>	<u><u>15.7</u></u>

*This table is not subject to Audit*

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



**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK**  
**For the year ended 30 September 2020**

**26. 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	2020 £m	2019 £m
Total balance sheet assets		15,505.5	14,395.5
Less: Derivative assets	12	(463.3)	(592.4)
Central bank deposits	9	(1,637.1)	(816.4)
CRDs		(15.1)	(11.4)
Accrued interest on sovereign exposures		-	(0.2)
		<hr/>	<hr/>
On-balance sheet items		13,390.0	12,975.1
Less: Intangible assets	13	(170.1)	(171.1)
		<hr/>	<hr/>
<b>Total on balance sheet exposures</b>		<b>13,219.9</b>	<b>12,804.0</b>
		<hr/>	<hr/>
Derivative assets	12	463.3	592.4
Potential future exposure on derivatives		92.3	120.0
		<hr/>	<hr/>
<b>Total derivative exposures</b>		<b>555.6</b>	<b>712.4</b>
		<hr/>	<hr/>
Post offer pipeline at gross notional amount		949.1	903.4
Adjustment to convert to credit equivalent amounts		(773.8)	(739.2)
		<hr/>	<hr/>
<b>Off balance sheet items</b>		<b>175.3</b>	<b>164.2</b>
		<hr/>	<hr/>
Tier 1 capital		991.2	922.0
		<hr/>	<hr/>
Total leverage exposure before IFRS 9 relief		13,950.8	13,680.6
IFRS 9 relief		42.3	25.8
		<hr/>	<hr/>
Total leverage exposure		13,993.1	13,706.4
		<hr/>	<hr/>
<b>UK leverage ratio</b>		<b>7.1%</b>	<b>6.7%</b>
		<hr/> <hr/>	<hr/> <hr/>

*This table is not subject to audit*

The fully loaded leverage ratio is calculated as follows

	2020 £m	2019 £m
Fully loaded Tier 1 capital	948.9	900.8
Total leverage exposure before IFRS 9 relief	13,950.8	13,680.6
	<hr/>	<hr/>
Fully loaded UK leverage exposure	6.8%	6.6%
	<hr/> <hr/>	<hr/> <hr/>

*This table is not subject to audit*

**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK**

For the year ended 30 September 2020

**26. CAPITAL MANAGEMENT (CONTINUED)**

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.

**27. CREDIT RISK**

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

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

The Group's balance sheet loan assets at 30 September 2020 are analysed as follows:

	2020		2019	
	£m	%	£m	%
Buy-to-let mortgages	10,583.8	83.8%	10,101.9	82.9%
Owner-occupied mortgages	53.1	0.4%	70.6	0.6%
<b>Total first charge residential mortgages</b>	<b>10,636.9</b>	<b>84.2%</b>	<b>10,172.5</b>	<b>83.5%</b>
Second charge mortgage loans	354.5	2.8%	389.2	3.2%
<b>Loans secured on residential property</b>	<b>10,991.4</b>	<b>87.0%</b>	<b>10,561.7</b>	<b>86.7%</b>
Development finance	609.0	4.8%	506.5	4.1%
<b>Loans secured on property</b>	<b>11,600.4</b>	<b>91.8%</b>	<b>11,068.2</b>	<b>90.8%</b>
Asset finance loans	452.0	3.6%	472.9	3.9%
Motor finance loans	272.4	2.2%	318.9	2.6%
Aircraft mortgages	26.0	0.2%	19.3	0.2%
Structured lending	94.9	0.7%	88.1	0.7%
Invoice finance	13.5	0.1%	18.5	0.1%
<b>Total secured loans</b>	<b>12,459.2</b>	<b>98.6%</b>	<b>11,985.9</b>	<b>98.3%</b>
Professions finance	22.3	0.2%	46.2	0.4%
CBILS and BBLS	25.2	0.2%	-	-
Other unsecured commercial loans	15.0	0.1%	19.3	0.2%
Unsecured consumer loans	109.7	0.9%	134.7	1.1%
<b>Total loans to customers</b>	<b>12,631.4</b>	<b>100.0%</b>	<b>12,186.1</b>	<b>100.0%</b>

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.

**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK****For the year ended 30 September 2020****27. CREDIT RISK (CONTINUED)**

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.

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

Loans made under the Coronavirus Business Interruption Loan Scheme ('CBILS') and the Bounce Back Loan Scheme ('BBLs') have the benefit of a guarantee underwritten by the UK Government.

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. The total gross carrying value of the Group's Loans to Customers due from customers with total portfolio exposures over £10.0m is analysed below by product type.

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
Buy-to-let mortgages	154.3	149.7
Development finance	240.0	212.7
Structured lending	72.7	78.8
Asset finance	-	-
	<u>467.0</u>	<u>441.2</u>

The threshold of £10.0m is used internally for monitoring large exposures.

## NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2020

## 27. CREDIT RISK (CONTINUED)

*Credit grading*

An analysis of the Group's loans to customers by absolute level of credit risk at 30 September 2020 is set out below. The analysed amount represents gross carrying amount.

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
<b>30 September 2020</b>					
Very low risk	8,771.2	453.3	20.8	45.9	9,291.2
Low risk	1,229.2	120.9	10.7	21.7	1,382.5
Moderate risk	742.2	184.7	12.1	32.8	971.8
High risk	285.2	143.9	50.7	32.0	511.8
Very high risk	48.3	67.9	49.9	22.9	189.0
Not graded	253.6	74.7	31.9	6.7	366.9
Total gross carrying amount	11,329.7	1,045.4	176.1	162.0	12,713.2
Impairment	(22.2)	(15.8)	(43.4)	(0.4)	(81.8)
Total loans to customers	11,307.5	1,029.6	132.7	161.6	12,631.4
<b>30 September 2019</b>					
Very low risk	8,693.9	92.8	26.5	49.4	8,862.6
Low risk	1,267.2	77.5	6.7	26.5	1,377.9
Moderate risk	781.9	75.0	9.3	45.2	911.4
High risk	353.2	153.0	67.9	48.5	622.6
Very high risk	86.0	47.0	44.0	38.7	215.7
Not graded	200.4	13.2	13.5	10.7	237.8
Total gross carrying amount	11,382.6	458.5	167.9	219.0	12,228.0
Impairment	(6.0)	(3.7)	(32.2)	-	(41.9)
Total loans to customers	11,376.6	454.8	135.7	219.0	12,186.1

Gradings above are based on credit scorecards or internally assigned risk ratings as appropriate for the individual asset class. These measures are calibrated across product types and used internally to monitor the Group's overall credit risk profile against its risk appetite.

These gradings represent current credit quality on an absolute basis and this may result in assets in higher IFRS 9 stages with low risk grades, especially where a case qualifies through breaching, for example, an arrears threshold but is making regular payments. This will apply especially to Stage 3 cases reported in note 11, other than those shown as 'realisations'.

Examples of these cases include fully up-to-date receiver of rent cases, customers who may be up to date on accounts with other lenders and accounts where the default on the Group's loan has yet to impact on external credit score.

**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK****For the year ended 30 September 2020****27. CREDIT RISK (CONTINUED)**

A small proportion of the loan book (2020: 2.9%, 2019: 1.9%) is classed as ‘not graded’ above. This rating relates to loans that have been fully underwritten at origination but where the customer falls outside the automated assessment techniques used post-completion. This disclosure is expected to be developed further in future.

***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 2020 is set out below. LTVs for second charge mortgages are calculated allowing for the interest of the first charge holder, based on the most recent first charge amount held by the Group, while for acquired accounts the effect of any discount on purchase is allowed for.

	First charge mortgages		Second charge mortgages	
	2020 %	2019 %	2020 %	2019 %
<b>Loan to value ratio</b>				
Less than 70%	59.9	54.3	74.5	66.5
70% to 80%	35.9	36.2	16.7	18.5
80% to 90%	2.3	7.2	5.2	8.9
90% to 100%	0.4	0.6	1.2	2.7
Over 100%	1.5	1.7	2.4	3.4
	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
<b>Average LTV ratio</b>	<u>65.7</u>	<u>67.3</u>	<u>62.2</u>	<u>65.7</u>
<i>Of which:</i>				
Buy-to-let	65.8	67.4		
Owner-occupied	49.2	53.2		

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 5.0% in the year ended 30 September 2020 (2019: 0.2%).

**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK**  
**For the year ended 30 September 2020**

**27. CREDIT RISK (CONTINUED)**

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

	First Charge		Second Charge	
	2020	2019	2020	2019
	%	%	%	%
East Anglia	3.2	3.2	3.3	3.3
East Midlands	5.4	5.3	6.1	6.3
Greater London	18.7	18.9	8.2	7.8
North	3.2	3.3	3.9	4.2
North West	10.4	10.1	7.4	8.0
South East	31.6	31.9	39.5	37.7
South West	8.7	8.9	8.0	7.9
West Midlands	5.4	5.1	7.3	7.6
Yorkshire and Humberside	8.4	8.6	5.9	6.2
Total England	95.0	95.3	89.6	89.0
Northern Ireland	0.1	0.1	1.7	1.9
Scotland	1.7	1.4	5.2	5.6
Wales	3.2	3.2	3.5	3.5
	100.0	100.0	100.0	100.0

*Development finance*

Development finance loans have an average term of 21 months (2019: 20 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.

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	2020	2020	2019	2019
	By value	By number	By value	By number
	%	%	%	%
50% or less	7.6	4.8	8.5	3.4
50% to 60%	22.4	13.2	18.2	15.5
60% to 65%	34.0	41.0	31.6	39.1
65% to 70%	31.3	36.1	32.3	32.4
70% to 75%	2.8	4.0	6.8	8.2
Over 75%	1.9	0.9	2.6	1.4
	100.0	100.0	100.0	100.0

The average LTGDV cover at the year end was 63.1% (2019: 64.8%).

**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK****For the year ended 30 September 2020****27. CREDIT RISK (CONTINUED)**

LTGDV is calculated by comparing the current expected end of term exposure with the latest estimate of the value of the completed development based on surveyors' reports. The Covid-19 pandemic had yet to have a significant impact on expected valuations by the year end.

At 30 September 2020, the development finance portfolio comprised 229 accounts (2019: 207) with a total carrying value of £609.0m (2019: £506.5m). Of these accounts only 7 were included in Stage 2 at 30 September 2020 (2019: six), with 1 account classified as Stage 3 (2019: none). In addition, 1 account acquired in the Titlestone purchase had been classified as POCI (2019: three). An allowance for these losses was made in the IFRS 3 fair value calculation.

The geographical distribution of the Group's development finance loans by gross carrying value is set out below.

	<b>2020</b>	<b>2019</b>
	%	%
East Anglia	5.1	3.1
East Midlands	5.5	2.9
Greater London	8.2	12.1
North	1.8	1.0
North West	0.4	0.1
South East	58.8	56.8
South West	14.0	13.9
West Midlands	4.0	7.2
Yorkshire and Humberside	1.1	1.5
Total England	98.9	98.6
Northern Ireland	-	-
Scotland	1.1	1.4
Wales	-	-
	100.0	100.0

**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK**  
**For the year ended 30 September 2020**

**27. CREDIT RISK (CONTINUED)**

*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 IFRS 16 (2019: IAS 17). The average contractual life of the asset finance loans was 52 months (2019: 56 months) while that of the motor finance loans was 60 months (2019: 57 months), but it is likely that a significant proportion of customers will choose to settle their obligations early.

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.

	<b>2020</b>	<b>2019</b>
	%	%
Commercial vehicles	32.0	30.3
Construction plant	33.7	34.8
Technology	6.9	7.8
Manufacturing	6.7	6.1
Print and paper	3.7	4.8
Refuse disposal vehicles	4.8	5.2
Other vehicles	3.6	3.0
Agriculture	2.9	2.7
Other	5.7	5.3
	<u>100.0</u>	<u>100.0</u>

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.

	<b>2020</b>	<b>2019</b>
Number of transactions	8	8
Total facilities (£m)	139.0	135.0
Carrying value (£m)	<u>94.9</u>	<u>88.1</u>

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. These assessments, which are reported to Credit Committee, are used to inform the assessment of expected credit loss under IFRS 9.



**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK****For the year ended 30 September 2020****27. CREDIT RISK (CONTINUED)**

At 30 September 2020, 4 of these facilities were identified as Stage 2 (2019: none) with the remainder in Stage 1.

*CBILS and BBLs*

Loans under these schemes, which were launched in the year as a response to the impact of Covid-19 on UK SMEs, have the benefit of guarantees underwritten by the UK Government.

The Group offers term loans and asset finance loans under the CBIL scheme. Interest and fees are paid by the UK Government for the first twelve months and the government guarantee caps the lender's losses at up to 80% of the outstanding balance.

Loans under the BBL scheme are six year term loans at a standard 2.5% per annum interest rate. The UK Government pays the interest on the loan for the first twelve months and provides lenders with a guarantee covering the whole outstanding balance.

The Group's outstanding CBILS and BBLs loans at 30 September 2020 were:

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
<b>CBILS</b>		
Term loans	20.6	-
Asset finance	1.0	-
	<hr/>	<hr/>
Total CBILS	21.6	-
<b>BBLs</b>	3.6	-
	<hr/>	<hr/>
	<u>25.2</u>	<u>-</u>

At 30 September 2020, all of these accounts were considered to be performing accounts.

*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 remain in excess of those implicit in the purchase prices.

**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK**  
**For the year ended 30 September 2020**

**27. 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 2020 and 30 September 2019, compared to the industry averages at those dates published by UK Finance ('UKF') and the FLA, was:

	<b>2020</b>	<b>2019</b>
	%	%
<b>First mortgages</b>		
Accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	0.15	0.18
Buy-to-let accounts excluding receiver of rent cases	0.10	0.07
Owner-occupied accounts	3.72	2.44
UKF data for mortgage accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	0.52	0.42
Buy-to-let accounts excluding receiver of rent cases	0.50	0.37
Owner-occupied accounts	0.90	0.81
All mortgages	0.82	0.73
	<hr/>	<hr/>
<b>Second charge mortgage loans</b>		
Accounts more than 2 months in arrears		
All accounts	14.77	14.08
Post-2010 originations	0.62	0.38
Legacy cases (Pre-2010 originations)	21.17	19.85
Purchased assets	17.85	16.05
FLA data for secured loans	8.40	8.70
	<hr/>	<hr/>
<b>Motor finance loans</b>		
Accounts more than 2 months in arrears		
All accounts	4.58	5.25
Originated cases	1.76	1.27
Purchased assets	13.10	12.13
FLA data for point of sale hire purchase	*	2.70
	<hr/>	<hr/>
<b>Asset finance loans</b>		
Accounts more than 2 months in arrears	1.75	0.43
FLA data for business lease / hire purchase loans	1.70	1.10
	<hr/> <hr/>	<hr/> <hr/>

\* Not published

No published industry data for asset classes comparable to the Group's other books has been identified. Where revised data at 30 September 2019 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.

It should be noted that, where customers have been allowed to defer payments as part of Covid-19 reliefs, these deferrals are not included in arrears measures above.

**NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK****For the year ended 30 September 2020****27. CREDIT RISK (CONTINUED)**

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.

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. No additional loans to customers treated as POCI were acquired in the year ended 30 September 2020. 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 (which will be treated as POCI under IFRS 9), 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.

## NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2020

## 27. CREDIT RISK (CONTINUED)

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.

	2020 £m	2019 £m	2018 £m
<b><i>All purchased consumer assets</i></b>			
Carrying value	235.3	291.1	364.2
84 month ERC	277.8	342.3	434.9
120 month ERC	313.7	387.5	489.6
<b><i>POCI assets only</i></b>			
Carrying value	139.8	168.3	204.4
84 month ERC	176.9	214.1	269.9
120 month ERC	203.7	246.0	306.2

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

**NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION**  
**For the year ended 30 September 2020**

*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 preliminary financial information have been prepared required by legislation and accounting standards.*

**28. ACCOUNTING POLICIES**

The Group prepares its annual financial statements in accordance with International Financial Reporting Standards as endorsed by the European Union, as required by UK company law. Despite the UK's exit from the European Union, this requirement remains in place for the time being. The condensed financial statements have been prepared on the basis of the accounting policies set out in the Annual Report and Accounts of the Group for the year ended 30 September 2019, except for the adoption of IFRS 16 – 'Leases' ('IFRS 16'), described in note 29. This basis has been used in the preparation of the financial statements of the Group for the year ending 30 September 2020.

**Comparability of information**

As described in note 29 below, the balance sheet information at 30 September 2018 and 30 September 2019 and the profit and loss information for the periods ended on these dates is not required to be restated on the adoption of IFRS 16. The information presented is derived in accordance with IAS 17 - 'Leases' ('IAS 17'), and therefore may not be directly comparable with the balance sheet at 30 September 2020 and the profit and loss account for the year then ended which are prepared under IFRS 16.

**29. CHANGES IN ACCOUNTING STANDARDS**

**a) IFRS 16 – 'Leases'**

The Group is required to adopt IFRS 16, which replaces IAS 17, the standard currently governing the accounting for operating and finance leases, in preparing its financial statements for the year ended 30 September 2020. It has transitioned to the new standard with effect from 1 October 2019, in accordance with the transitional provisions set out in the standard, using the modified retrospective approach. The standard addresses accounting by lessees and lessors which are considered separately below.

**Lessor accounting**

The provisions for lessor accounting under IFRS 16 are little changed from those in IAS 17 and so the accounting for the Group's finance lease receivables is not materially changed.

**NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION**  
**For the year ended 30 September 2020****29. CHANGES IN ACCOUNTING STANDARDS (Continued)****Lessee accounting**

Accounting by lessees is changed significantly under IFRS 16, with a right of use asset recognised on the balance sheet for all leases, representing the economic benefit of controlling the underlying asset over the term of the lease. This includes leases previously treated as operating leases and not recognised on the balance sheet under IAS 17. The right of use asset on initial recognition is based on the discounted value of future minimum lease payments. It is recognised within fixed assets and depreciated over the term of the lease.

A corresponding liability arises representing the present value of future lease commitments and this is recognised within other liabilities. This balance is reduced over the life of the lease by lease payments made and the unwinding of the initial discount is recognised in interest expense.

Under IAS 17, the Group disclosed arrangements to lease office buildings, equipment and motor vehicles as operating leases and these have been restated in accordance with IFRS 16. Additionally, the Group has undertaken an exercise to identify potential lease agreements arising from service contracts. No such arrangements were identified. The Group had no involvement as a lessee in finance leases, as defined by IAS 17.

The Group has made use of practical expedients within IFRS 16 when performing its transition accounting. These include the right to exclude contracts that have not previously been classified as leases before the implementation date, and the ability to exclude leases of low value and those with a short term.

At transition, on 1 October 2019, the Group recognised a right of use asset of £7.0m and a corresponding liability of £7.3m, in accordance with the provisions of IFRS 16 paragraph C5(b), referred to as the modified retrospective approach. Under this approach, there is no impact on equity on transition.

The difference between the asset and liability on recognition represents amounts prepaid or accrued in respect of lease rentals in the Group's balance sheet at 30 September 2019.

The leasing activities of the Company are limited to the lease of an office building from a subsidiary entity. At transition the Company recognised a right of use asset of £18.8m and a corresponding liability of £18.8m in accordance with the modified approach. There was no impact on the Company's equity at transition.

The discount rate used to derive the right of use asset was 2.5% based on a 5-year corporate bond yield, while the minimum lease payments used were materially similar to those disclosed as operating lease commitments at 30 September 2019 in note 51 to the annual accounts for the year then ended, except that irrecoverable VAT was excluded.

There was no immediate tax impact from transition and the Group's regulatory capital is unaffected. Under IFRS 16, the amount charged to profit and loss represents depreciation on the ROU asset and a finance charge on the liability instead of rents or similar charges. While this is a change of classification, the overall effect on profit is insignificant. There is no impact on reported cash flows, nor on earnings per share.

IFRS 16 does not require the restatement of comparative information and therefore all balance sheets and results for periods on or before 30 September 2019 are presented in accordance with IAS 17.

**NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION**  
**For the year ended 30 September 2020****29. CHANGES IN ACCOUNTING STANDARDS (Continued)****b) IAS 39 amendments ‘Interest Rate Benchmark Reform’**

This amendment was issued by the IASB to address the impact of uncertainties arising from IBOR reform (including the withdrawal of LIBOR) on hedge accounting. The Standard excludes the effect of such uncertainties from the evaluation of hedging relationships for accounting purposes and allows the continuation of IBOR based hedging relationships despite these uncertainties, all other things being equal.

This amendment is applicable for periods beginning on or after 1 January 2020, but early application is permitted. The Group has elected to early apply this amendment retrospectively in these financial statements. As the amendment allows the continuation of existing arrangements, its adoption has no impact on reported amounts.

**c) Accounting changes at 1 October 2018**

The accounting changes affecting equity at 1 October 2018 relate to the adoption of IFRS 9 – ‘Financial Instruments’ and IFRS 15 – ‘Revenue’ and are described in detail in note 62 to the accounts for the year ended 30 September 2019.

**30. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS**

The critical accounting estimates and judgements affecting the preliminary financial information are the same as those described in notes 64 and 65 to the accounts of the Group for the year ended 30 September 2019. However, the economic impact of the Covid-19 pandemic, which began to significantly affect the UK economy just before the period end, has both increased the levels of uncertainty affecting those judgments and estimate and reduced the availability of information on which they can be based as at 30 September 2020.

The Group’s judgements relating to Significant Increase in Credit Risk and estimates relating to impairment losses on customers loans, income recognition and impairment of goodwill are particularly affected by Covid-19, and these considerations are set out 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 an 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.

**NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION**  
**For the year ended 30 September 2020****30. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (CONTINUED)**

In determining whether an account has a SICR in the Covid-19 environment the granting of Covid-19 reliefs, including payment holidays and similar arrangements, may mean that a SICR may exist without this being reflected in either arrears performance or credit bureau data. The Group has accepted the advice of UK regulatory bodies that the grant of Covid-19 relief does not, of itself, indicate an SICR, but has carefully considered internal credit and customer data to determine whether there might be any accounts with SICR not otherwise identified by the process.

Where accounts have received secondary periods of relief beyond the initial three month period, this has generally been considered to be strongly indicative of underlying problems and such accounts have been identified as having an SICR. Furthermore, adjustments to correct probabilities of default in models will also have a consequent result of identifying more SICRs.

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

**(b) 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.

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.

All of this information may be impacted by Covid-19, its economic effect on customers and the forms of the reliefs given to ameliorate that impact. These may both change the underlying data and impact on the derivation of metrics normally used to monitor credit performance.

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.



**NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION****For the year ended 30 September 2020****30. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (CONTINUED)**

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. These scenarios at 30 September 2020 have been derived specifically in light of the Covid-19 situation, modelling a variety of possible outcomes. It should be noted, however, that there is currently little agreement between economists on the longer-term prospects for the UK and there is unlikely to be so until the country's path out of lockdown becomes clearer.

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.

In addition to uncertainty created by the economic scenarios, the Group recognises that the present situation lies outside the range of situations considered when it originally derived its IFRS 9 approach to impairment. It therefore considered, for each class of asset, whether any adjustment to the normal approach was required to ensure sufficient provision was created and also reviewed other available data, both from account performance and customer feedback to form a view of the underlying reasons for observed customer behaviours and of their future intentions and prospects.

The position after considering all these matters is set out in note 11, together with further information on the Group's approach and sensitivity analysis. The Covid-19 economic scenarios described above and their impact on the overall provision are also set out in that note.

**(c) Effective interest rates**

In order to determine the EIR applicable to loans and borrowings an estimate must be made of the expected life of each asset or liability and hence the cash flows relating thereto, including those relating to early redemption charges. For purchased loan accounts this will involve estimating the likely future credit performance of the accounts at the time of acquisition. These estimates are based on historical data and reviewed regularly. For purchased accounts historical data obtained from the vendor will be examined. The accuracy of the EIR applied would therefore be compromised by any differences between actual repayment profiles and those predicted, which in turn would depend directly or indirectly (in the case of borrowings) on customer behaviour.

In the case of purchased loan accounts, the assessment of future cash flows is significantly complicated by the uncertain impacts of Covid-19. The likely future cash flows have been assessed by the management on the basis of available performance data and customer contacts. The amount of income recognised to date at 30 September 2020 has been revised to allow for reduced future collections based on these assessments.

No evidence has so far been identified which would require the adjustment of EIR income for other products as a result of Covid-19.

**NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION**  
**For the year ended 30 September 2020**

**30. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (CONTINUED)**

**(d) Going Concern Basis**

The consolidated financial statements have been prepared on the going concern basis.

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 Financial Reporting Council in September 2014.

Particular focus is given to the Group's financial forecasts to ensure the adequacy of resources available for the Group to meet its business objectives on both a short term and strategic basis.

In compiling the most recent forecast, for the period commencing 1 October 2020, particular attention was paid to the potential consequences of Covid-19 on the Group's operations, customers, funding and prospects, both in the short and longer term. This included consideration of a number of different scenarios with impacts of varying duration and severity. In common with the Group's approach to IFRS 9, the economics used in the forecasting process were updated in October in light of the continuing development of the Covid-19 crisis, based on updated external projections. Future business activity was reforecast reflecting the potential impacts of the pandemic on markets and products.

The forecast was based on the best available information at the time of its approval, but the uncertainties surrounding the potential ongoing impact of Covid-19 and the nature, duration and effectiveness of government and regulatory measures to address it, mean that accurate forecasting is a more complex task than in normal circumstances. Therefore, further scenario modelling was undertaken to evaluate the impact of adverse stresses of the forecast variables with the greatest impact.

The key stresses modelled in detail to evaluate the forecast were:

- An increase of 10% in buy-to-let volumes. This examined the impact of volumes on profitability and illustrated the extent to which capital resources and liquidity would be stretched due to the higher cash and capital requirements
- Higher funding costs – 20bps higher cost on all new savings deposits throughout. This scenario illustrates the impact of a significant margin squeeze on profitability and whether this would cause significant impacts on any capital, liquidity or encumbrance ratios
- An increase in impairment due to more Covid-19 disruption. This scenario models a significant short-term profitability stress and the consequent stress on capital
- A 10% reduction in development finance volumes. Development finance is the highest yielding product and this scenario illustrates the effect of product mix on contribution and other ratios
- A stress combining higher funding costs and more Covid-19 disruption, without reducing lending. Although it is not deemed likely that such a scenario would materialise, since severe stresses almost always result in lower lending volumes, the output from this stress provides a benchmark for a plausible worst-case position that impacts all aspects of business performance and ratios, in particular, capital

**NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION****For the year ended 30 September 2020****30. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (CONTINUED)**

These stresses did not take account of management actions which might mitigate the impact of the adverse assumptions used. They were designed to demonstrate how such stresses would affect the Group's financing, capital and liquidity positions and highlight any areas which might impact the Group's going concern and viability assessments. Under all these scenarios, the Group had the ability to meet its obligations over the forecast horizon and maintain a surplus over its regulatory requirements for both capital and liquidity through normal balance sheet management activities.

A further, more material impairment stress was modelled, based on the Group's severe macroeconomic scenario. This, together with the outputs from the other stresses described, presents the Board with enough information to assess the Group's ability to continue on a going concern basis and ensure that there are enough management actions within their control to mitigate any plausible and foreseeable failure scenario.

The Group started the Covid-19 period with a strong capital surplus and has also built up a significant liquidity buffer during the second half of the year, as described below, to ensure that any significant outflows of deposits and / or reduced inflows from customer receipts can be managed. Overall, the forecasts, even under reasonable further levels of stress show the Group retaining sufficient equity, capital, cash and liquidity throughout the forecast period to satisfy its regulatory and operational requirements.

The availability of funding and liquidity is a key consideration, including retail deposit, wholesale funding, central bank and other contingent liquidity options.

The Group's retail deposits of £7,856.6 million (note 14), raised through Paragon Bank, are repayable within five years, with 71.9% of this balance (£5,650.2 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 2020 Paragon Bank held £1,637.1 million of balance sheet assets for liquidity purposes, in the form of central bank deposits. A further £150.0 million of liquidity was provided by an off balance sheet swap arrangement, bringing the total to £1,787.1 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 £684.0 million. Holdings of the Group's own externally rated mortgage backed loan notes can also be used to access the Bank of England's liquidity facilities or other funding arrangements. At 30 September 2020 the Group had £1,063.5 million of such notes available for use, of which £872.9 million were rated AAA.

The Group's securitisation funding structures, described in, ensure that a significant proportion of its originated loan portfolio is match-funded, although this was reduced in the period by the retirement of five securitisation transactions. 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. While the Group has not accessed the public securitisation market in the year, the market has remained active throughout the Covid-19 crisis and remains a potential funding source.

**NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION****For the year ended 30 September 2020****30. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (CONTINUED)**

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, of £60.0 million matures. The Group's TFS borrowings also start to mature in the coming financial year, with £700.0 million falling due within twelve months.

The Group's access to debt is enhanced by its corporate BBB rating, affirmed by Fitch Ratings in March 2020, and its status as an issuer is evidenced by the BB+ rating of its £150.0 million Tier 2 bond. It has regularly accessed the Capital markets for warehouse funding and corporate and retail bonds over recent years and continues to be able to access these markets.

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

As described in note 26 the Group's capital base is subject to consolidated supervision by the PRA. Its capital at 30 September 2020 was in excess of regulatory requirements and its forecasts indicate this will continue to be the case.

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.

Contingent consideration arising on acquisitions is first recognised in the accounts at its fair value at the acquisition date and subsequently revalued at each accounting date until it falls due for payment or the final amount is otherwise determined.

**(e) Impairment of goodwill**

The carrying value of goodwill recognised on acquisitions is verified by use of an impairment test based on the projected cash flows for the CGU, based on management forecasts and other assumptions described in note 13, including a discount factor.

The accuracy of this impairment calculation would therefore be compromised by any differences between these forecasts and the levels of business activity that the CGU is able to achieve in practice. The impact of Covid-19 means that there is a greater risk of inaccuracy in compiling these forecasts. This test will also be affected by the accuracy of the discount factor used.

The sensitivity of the impairment test to reasonably possible movements in these assumptions is discussed in note 13.

**NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION**  
**For the year ended 30 September 2020**

**31. 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 2020 or the year ended 30 September 2019 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 summarises the Group's financial assets and liabilities which are carried at fair value.

	Note	2020 £m	2019 £m
<b>Financial assets</b>			
Derivative financial assets	12	463.3	592.4
		<u>463.3</u>	<u>592.4</u>
<b>Financial liabilities</b>			
Derivative financial assets	12	132.4	80.5
Contingent consideration		13.5	23.7
		<u>145.9</u>	<u>104.2</u>

All of these financial assets and financial liabilities are required to be carried at fair value by IFRS 9.

**NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION**  
**For the year ended 30 September 2020**

**31. 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 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 the 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 PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2020

## 31. 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	2020 Carrying amount £m	2020 Fair value £m	2019 Carrying Amount £m	2019 Fair value £m
<b>The Group</b>					
<b>Financial assets</b>					
Cash	9	1,925.0	1,925.0	1,225.4	1,225.4
Loans to customers	10	12,631.4	12,856.1	12,186.1	12,370.1
Sundry financial assets		125.3	125.3	90.3	90.3
		<u>14,681.7</u>	<u>14,906.4</u>	<u>13,501.8</u>	<u>13,685.8</u>
<b>Financial liabilities</b>					
Short term bank borrowings		0.4	0.4	1.0	1.0
Asset backed loan notes		3,270.5	3,270.5	4,419.4	4,419.4
Secured bank borrowings		657.8	657.8	787.5	787.5
Retail deposits	14	7,856.6	7,900.6	6,391.9	6,408.9
Corporate and retail bonds		446.6	455.7	446.1	474.9
Other financial liabilities	16	74.6	74.6	83.1	83.1
		<u>12,306.5</u>	<u>12,359.6</u>	<u>12,129.0</u>	<u>12,174.8</u>

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 PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION****For the year ended 30 September 2020****31. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)***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.



**APPENDICES TO THE PRELIMINARY ANNOUNCEMENT****For the year ended 30 September 2020**

Additional financial information supporting the amounts shown in the management report but not forming part of the preliminary financial information.

**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 Group's 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.

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.

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
Profit on ordinary activities before tax	118.4	159.0
Less: Gain on disposal of financial assets	-	(9.7)
Add back: Fair value adjustments	1.6	15.1
	<u>120.0</u>	<u>164.4</u>
Underlying profit	<u>120.0</u>	<u>164.4</u>

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

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
Underlying profit	120.0	164.4
Tax at effective rate (note 7)	(27.5)	(32.7)
	<u>92.5</u>	<u>131.7</u>
Underlying earnings	<u>92.5</u>	<u>131.7</u>
Basic weighted average number of shares (note 8)	<u>253.6</u>	<u>257.6</u>
Underlying earnings per share	<u>36.5p</u>	<u>51.1p</u>

**APPENDICES TO THE PRELIMINARY ANNOUNCEMENT**  
**For the year ended 30 September 2020**

**A. UNDERLYING RESULTS (CONTINUED)**

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

	<b>2020</b>	<b>2019</b>
	<b>£m</b>	<b>£m</b>
Underlying earnings	92.5	131.7
Amortisation of intangible assets	2.0	2.4
Adjusted underlying earnings	<u>94.5</u>	<u>134.1</u>
Average tangible equity (note 26(b))	<u>961.6</u>	<u>920.7</u>
Underlying RoTE	<u>9.8%</u>	<u>14.6%</u>

## APPENDICES TO THE PRELIMINARY ANNOUNCEMENT

For the year ended 30 September 2020

## B. INCOME STATEMENT RATIOS

Net interest margin ('NIM') and cost of risk (impairment charge as a percentage of average loan balance) for the Group are calculated as follows:

*Year ended 30 September 2020*

	Note	Mortgage Lending £m	Commercial Lending £m	Idem Capital £m	Total £m
Opening loans to customers	10	10,344.1	1,452.1	389.9	12,186.1
Closing loans to customers	10	10,819.5	1,514.8	297.1	12,631.4
Average loans to customers		10,581.8	1,483.4	343.5	12,408.7
Net interest NIM		190.0 1.80%	82.1 5.53%	26.1 7.60%	278.1 2.24%
Impairment provision Cost of risk	11	25.8 0.24%	21.7 1.46%	0.8 0.23%	48.3 0.39%

*Year ended 30 September 2019*

	Note	Mortgage Lending £m	Commercial Lending £m	Idem Capital £m	Total £m
Opening loans to customers	10	10,449.5	1,131.3	519.8	12,100.6
Closing loans to customers	10	10,344.1	1,452.1	389.9	12,186.1
Average loans to customers		10,396.8	1,291.8	454.8	12,143.4
Net interest NIM		177.8 1.71%	65.0 5.03%	54.3 11.94%	278.4 2.29%
Impairment provision Cost of risk	11	1.0 0.01%	7.2 0.56%	(0.2) (0.04)%	8.0 0.07%

Not all interest is allocated to segments (note 2)

**APPENDICES TO THE PRELIMINARY ANNOUNCEMENT**  
**For the year ended 30 September 2020**

**C. COST:INCOME RATIO**

Cost:income ratio is derived as follows:

	Note	2020 £m	2019 £m
Cost – operating expenses		126.8	125.2
Total operating income		295.1	307.3
Cost / Income		<u>43.0%</u>	<u>40.7%</u>

Underlying cost:income ratio is derived as follows:

		2020 £m	2019 £m
Cost – as above		126.8	125.2
Adjusted cost		<u>126.8</u>	<u>125.2</u>
Income – as above		295.1	307.3
Gain on disposal of financial asset		-	(9.7)
Adjusted income		<u>295.1</u>	<u>297.6</u>
Underlying cost:income ratio		<u>43.0%</u>	<u>42.1%</u>

**D. NET ASSET VALUE**

	Note	2020	2019
Total equity (£m)		1,156.0	1,108.4
Outstanding issued shares (m)	18	261.8	261.6
Treasury shares (m)	20	(5.2)	(5.2)
Shares held by ESOP schemes (m)	20	(3.6)	(3.9)
		<u>253.0</u>	<u>252.5</u>
Net asset value per £1 ordinary share		<u>£4.57</u>	<u>£4.39</u>
Tangible equity (£m)		985.9	937.3
Tangible net asset value per £1 ordinary share		<u>£3.90</u>	<u>£3.71</u>