RNS Announcement
Paragon Banking Group PLC
7 December 2021

Record profits underpinned by strong lending and margin growth

Paragon Banking Group PLC ('Paragon' or 'the Group'), the specialist lender and banking group, today announces its full year results for the year ended 30 September 2021

Nigel Terrington, Chief Executive of Paragon said:

"We have delivered an outstanding performance in 2021, which is testament to the strength of our operating model, the quality of our customer base and the capability and adaptability of our people.

"Every lending business in the Group has this year made excellent progress, and at over £2.6 billion, aggregate new lending now comfortably exceeds pre-pandemic levels. We have made huge strides on the funding side, growing retail deposits by 18.4% at attractive rates, and have delivered significant digital improvements as part of the Group's cloud-based strategy.

"We delivered strong earnings *growth with a 62% increase in profits to £194 million, an 81.1% increase in earnings per share and a total dividend for the year of 26.1 pence. This performance allowed us to return an additional £38 million through a buyback, and we still ended the year with stronger capital ratios, including CET1 at 15.4%.*

"These results validate our longstanding strategy to concentrate on specialist lending markets where we add value for our customers with complex requirements.

"We enter 2022 with strong pipelines at near record levels, improved margins and the capital to continue to invest in and grow our business, as well as deliver additional returns for shareholders via a new buyback programme and materially increasing our full year dividend. We remain confident in our outlook and are on track with our plans to become the UK's leading technology-enabled specialist bank."

Financial highlights

- Underlying profit increased by 61.8% to £194.2 million (2020: £120.0 million)
- Statutory profit before tax increased by 80.5% to £213.7 million (2020: £118.4 million)
- Impairment coverage reduced to 49 basis points reflecting strong credit performance (2020: 64 basis points). Model overlays broadly maintained
- Reported EPS up 81.1% to 65.2p (2020: 36.0p), underlying EPS up 62.5% to 59.3p (2020: 36.5p)
- Full year dividend of 26.1p (2020: 14.4p)
- Capital ratios remain strong after accruing for the dividend; CET1 ratio at 15.4% (30 September 2020: 14.3%)
- Net interest margin of 239 basis points up from 224 basis points in 2020

- Return on Tangible Equity increased to 16.2% on a statutory basis, 14.7% on an underlying basis
- 2022 share buyback of up to £50 million announced (in addition to remaining £2.2 million from the 2021 buyback)

Operational highlights

- Excellent operational capability sustained throughout the pandemic, delivering record new lending volumes and new delivery systems
- Strong lending growth in core divisions:
  - Mortgage Lending advances up 29.4% to £1.63 billion, year-end buy-to-let pipeline exceeds £1 billion
  - Commercial Lending advances up 22.9% to £0.97 billion, year-end development finance pipeline up 63.2% to £0.37 billion
- Retail deposits grew 18.4% to £9.3 billion (2020: £7.9 billion) at attractive rates
- Accessed £2.75 billion under the SME Term Funding Scheme ('TFSME') by 30 September 2021
- First UK Green Tier-2 bond issued
- LIBOR transition successfully delivered
- Phase 2 of IRB application ongoing, good progress made

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The Group will be holding a call for sell-side analysts on 7 December 2021 at 9:30am, a recording of which will be available on the Group's website at 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
Your attention is drawn to the cautionary statement set out at the end of this document.

Introduction

The Group has delivered record profits and an outstanding operational performance reflecting the strength of its franchise, the resilience of its operating platform and the commitment and professionalism of its people.

The Group's business model has been designed, using its extensive through-the-cycle experience, to be resilient in its operational performance and to maintain a strong balance sheet. Having developed an effective working approach at the onset of the crisis, the business was well placed to deal with the changing Covid conditions, particularly over the winter months, maintaining new business activities and paying close attention to the needs of our customers, employees and business partners as the situation developed.

This testing period brought out the best in our people and has given us the opportunity to demonstrate the strong fundamentals of the Group as we continue to generate improved returns and higher growth rates.

Despite the operational challenges the lockdowns brought, we have strengthened our franchise by building stronger relationships with customers, intermediaries and other business partners. Alongside this, we have delivered a number of key technology developments during the year. We also have an active change programme in progress, designed to optimise customer journeys, operational efficiencies and data and control needs across the business. The delivery of these, together with accessing the capacity and efficiencies they bring, will form a core part of our strategy in continuing to drive strong growth in a prudent manner in the UK's specialist financial services markets.

Financial performance

The Group delivered a strong financial performance reflecting the improvements in the UK economy and strong underlying trading. A combination of strong loan growth, improving net interest margins, tight cost control and a reversal of some of the Covid-related impairments enabled underlying profits to increase by 61.8% to £194.2 million.

Impairments for expected credit losses fell materially from their 2020 level, ending 2021 with a £4.7 million write-back compared to the £48.3 million charge in 2020. Notwithstanding this impairment volatility, pre-provision profits were up 12.6% on their 2020 level at £189.5 million. With the credit for impairments in the year, and strong fair value gains reflecting yield curve movements, overall reported profits before tax were 80.5% higher than their 2020 equivalent at £213.7 million.

Basic earnings per share were 59.3 pence on an underlying basis and 65.2 pence on a statutory basis. We continue to operate with a 40% dividend pay-out policy, which results in a dividend for the year of 26.1 pence, reflecting the strong underlying performance, impairment releases and fair value movements.

Trading performance

The Mortgage Lending and Commercial Lending divisions have each outperformed expectations during 2021, delivering strong new business flows, low arrears and finishing the period with record pipelines.

In Mortgage Lending, where we celebrated 25 years of serving the Private Rented Sector ('PRS'), we have continued to see strong demand from professional landlords, who generated 97% of new buy-to-let completions in the year. Total buy-to-let completions exceeded £1.6 billion in the year, generating an 8% increase in balances to £11.4 billion. Strong house price inflation and stable arrears have created a lower impairment requirement year-on-year and the portfolio remains conservatively leveraged with an average loan to value ('LTV') of 61.2% and only 1.9% of the portfolio having an LTV over 80%. The pipeline at the year end exceeded £1 billion, boding well for continued strong flows into the new financial year. With our half-year results we announced the cessation of lending on second charge mortgages, with the business being unattractive at our chosen risk appetite. All employees were offered redeployment in the wider business, with only six choosing the alternative of voluntary redundancy.

New business flows in Commercial Lending exceeded £0.97 billion, up 22.9% on their 2020 levels and above their 2019 equivalent. The growth was strongest in development finance, where new advances rose 32.5%, year-on-year, reflecting the continued high demand for residential property development in the UK and the Group's investment in expanding the relationship team. The development finance year end pipeline was up 63.2% from its equivalent level in 2020. SME lending saw a 17.0% increase in origination flows, but these remain below the pre-Covid equivalent given sector-wide challenges and the broad take-up of government-backed loans under the CBILS, BBLS and RLS during the year. However, growth was strongest in the longer-term, asset-secured part of the operation. The new portal delivered during the year leaves the business well placed to seize opportunities going forward as this sector recovers. Motor Finance volumes were broadly flat year on year, but this disguises a strong second-half recovery and strong momentum being carried through to 2022. Finally, our structured lending team has now refocused its attentions from account management to business development, driving portfolio growth and adding new facilities during the second half of the year.

Capital and funding

The past year has seen a material change in our funding structure, with our savings proposition delivering an 18.4% growth in balances at attractive rates. System enhancements during the year enabled increased levels of deposits to be sourced from third party platforms, while the SME savings market was accessed for the first time. During March 2021 we became the first UK bank to successfully issue a Green Tier-2 Bond, at a coupon of almost 3% less than the bond it was replacing. We have also refinanced the majority of our legacy securitisation structures, substantially repaid borrowings under the Bank of England Term Funding Scheme ('TFS') and drawn further on the Term Funding Scheme with additional incentives for SMEs ('TFSME'). Overall, the Group's cost of funds has dropped by 39 basis points from its 2020 level.

The refinancing of the legacy securitisation removed over £400 million of derivative assets from the Group's balance sheet against which regulatory capital had previously been carried, reducing capital requirements. The refinancing also facilitated the transition of the bulk of the Group's London Interbank Offered Rate ('LIBOR')-linked loan exposures to a Term SONIA basis. For all remaining LIBOR-linked assets an exit strategy is in place and the Group's remaining LIBOR-linked liabilities were either transitioned during the financial year, or a transition methodology has been agreed with the relevant counterparties.

With the strong capital position at the half-year, the Group declared an interim dividend in line with its guidance (being one half of the previous year's final dividend) and also announced a share buyback of up to £40 million, with £37.5 million (excluding costs) being utilised by the year end. This programme will be completed in the early part of the new financial year, and in December 2021 the Board authorised a further buy-back programme of up to £50.0 million, acknowledging the Group's continuing capital strength

We also benefitted from revised total capital requirements following the regular supervisory review undertaken by the PRA in late 2020. This saw our total capital requirement ('TCR') fall from 10.8% to 8.9% and contributed to a continued strong surplus over regulatory requirements at 30 September.

The Group submitted its buy-to-let Phase 2 IRB application modules to the PRA during the year. The process remains protracted, but we continue to receive constructive engagement from the PRA. In addition to further phases of the buy-to-let accreditation, our preparations to submit an IRB application for our development finance business, which represents the next stage in the IRB roadmap are well advanced.

Business model developments

Key developments during the year include the completion and roll-out of our Commercial Lending portal and the introduction of auto-decisioning to SME lending. We have also developed a new digital system for our surveyors, established a single payment platform across our banking relationships and implemented Mambu, a cloud-based core banking module, for managing our portfolio of savings platform relationships. Complementing these completed developments, our teams are actively managing process improvements in our Mortgage Lending division, embedding Mambu into development finance, reviewing post-completion systems across the Group and broadening the scope of our savings proposition to support additional future capacity.

People

Our people have made a remarkable effort during the past year, working flexibly to support the business and showing great agility as the operating and working environment has changed. Against this backdrop, the wellbeing of our people has been a primary consideration for the Board and has been demonstrated through numerous initiatives and regular engagement to ensure that effective feedback and communications were maintained throughout the year.

Our 2021 employee survey demonstrated exceptional levels of engagement, with an engagement score of 87% and an employee NPS of +24 , where +21 is the industry norm. 95% of our people agreed that they are proud to say that they work at Paragon.

I am pleased to confirm that the Group has also met all its diversity targets under the Women in Finance Charter, set in 2017, while the Group's EDI network, designed to ensure Paragon is a fully inclusive employer, was launched in the year. The new network has already contributed to a number of Group initiatives in this area.

Having spent much of the year with a working-from-home focus, the Group is now undertaking a series of hybrid working pattern trials, designed to optimise the efficiency, control, flexibility and wellbeing features of our longer-term operating model.

Sustainability

Climate change and sustainability considerations have been at the heart of our efforts during 2021. Against a backdrop of creating the appropriate focus and governance around the Group, we launched the first green capital bond to be issued by a UK bank in March 2021, to replace our existing Tier-2 bond. The establishment of the Green Bond Framework and associated deployment commitments reflect the importance of the sustainability agenda within the Group.

A new Sustainability Committee was established in the year. Products to promote more energy-efficient properties have been launched in both the buy-to-let mortgage and development finance areas. Our motor finance operation began lending on electric vehicles after the year end, following substantial preparatory work during the year. There has also been material board engagement regarding the actions the Group needs to take to support the UK's path to net-zero by 2050.

Internally the Group relocated its London operations to more energy-efficient premises, reducing its carbon footprint while affirming its commitment to office-based working and the City as a physical venue for doing business.

The requirements of the Taskforce on Climate-related Financial Disclosures ('TCFD') become binding on the Group in 2022. Our disclosures for 2021 are materially enhanced and substantially meet these standards, and we have signed up as a TCFD supporter. Alongside the annual report and accounts we are publishing our first separate sustainability report, the Responsible Business Report, which will be accessible via the Group's website.

Outlook

Despite the challenging environment, Paragon leaves its 2021 year with strong lending pipelines, an increasingly diversified funding structure and strong capital resources to continue to take advantage of opportunities going forward, both organic and potentially through further acquisitions, if appropriate. We are accelerating our investment in technology, enhancing our customer proposition while preserving the key specialisms that are embedded within our operating model. Careful consideration of impairment coverage levels leaves us appropriately provisioned in the event of future macro-economic volatility or idiosyncratic examples of Covid-related scarring amongst our customers. With a CET1 ratio of 15.4% and good progress being made with our IRB applications, our capital position remains strong, supporting further growth and returns to stakeholders.

MANAGEMENT REPORT

This section reviews the activities of the Group in the year under these headings

Business review	Funding	Capital	Financial results	Operations
Lending and performance for each business line	*Deposit taking and other sources of finance*	*Regulatory capital, liquidity and distributions*	*Results for the year*	*Systems, people, sustainability and risk*
1	2	3	4	5

1 BUSINESS REVIEW

The Group reports its results analysed between three segments, 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	
	2021	**2020**	**2021**	**2020**
	£m	**£m**	**£m**	**£m**
Mortgage Lending	1,630.0	1,259.7	11,608.7	10,819.5
Commercial Lending	971.5	790.8	1,568.8	1,514.8
Idem Capital	-	-	225.1	297.1
	2,601.5	2,050.5	13,402.7	12,631.4

The Group's total loan balance increased by 6.1% in the year following a 3.7% increase in the preceding twelve months. This highlights the Group's ability to continue to pursue its strategy despite the economic impacts of Covid through the last eighteen months. Total advances increased 26.9% as the economy bounced back from the pandemic and exceeded the pre-pandemic levels of 2019, despite lockdowns and other Covid-related restrictions continuing to impact during the year.

1 BUSINESS REVIEW (Continued)

1.1 MORTGAGE LENDING

The Group's Mortgage Lending division principally provides buy-to-let mortgages secured on UK residential property to specialist landlords. The buy-to-let mortgage sector celebrated its 25th anniversary in the year and the Group was one of the first lenders in this market. This gives the Group an unparalleled understanding of this form of mortgage and the landlord customer base it targets.

During the period the Group also offered loans to smaller landlords and limited numbers of owner-occupied first and second charge mortgages on residential property. However, during the year it withdrew from the second charge market entirely, to increase its buy-to-let focus. 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 both mass market and other specialist lenders.

Housing and mortgage market

During the year the housing market in the UK continued to be affected by the Covid pandemic and the associated relief schemes including payment holidays, effective prohibitions on some forms of enforcement action and the continuing availability of stamp duty holidays, which were extended until June 2021. While the period over which payment holidays were available was extended, the maximum relief was capped at six months and the immediate impact of such holidays began to reduce as borrowers reached their maximum allocation. Lockdowns and social distancing requirements at various points in the year also put practical constraints on the operation of the housing market.

Activity in the residential property market recovered in the year, boosted by the stamp duty holiday. Transactions for the year reported by HMRC, at 1,562,000, were 58.3% higher than the 987,000 in the previous year. In their September 2021 Residential Market Survey, RICS noted positive activity levels in the market and a stable outlook for property sales.

Despite the year beginning with a pessimistic outlook for property prices from some forecasters, house prices saw strong growth in the period, with the Nationwide House Price Index recording a year-on-year increase of 10.0% to September 2021. RICS forecast continuing growth in the short to medium term, with demand outstripping supply, however, Nationwide amongst other forecasts remain cautious as to the medium-term outlook as reliefs unwind, and the Group continues to position itself conservatively.

New mortgage lending in the market was strong in the year, with the Bank of England reporting new approvals of £317.3 billion in the year ended 30 September 2021, a 31.0% increase on the £242.3 billion reported for the previous financial year and a higher value than any year since 2007. Particularly high volumes were seen in the months leading up to June 2021, when stamp duty reliefs began to be withdrawn.

1 BUSINESS REVIEW (Continued)

At 30 September 2021 the UK Finance ('UKF') survey of mortgage market arrears and possessions reported arrears remaining at historically low levels, despite the phasing out of continuing availability of Covid reliefs. Indeed, in a significant number of cases, customers had been able to reduce arrears during the pandemic. Possessions remained very low, with the majority relating to cases already in serious difficulties before the onset of Covid. Based on its research, UKF concluded that the availability of payment holidays fulfilled the purpose of enabling borrowers to stay out of arrears through the pandemic.

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

Specialist landlords form the largest part of the Group's target market. Such landlords typically let out four or more properties, run their portfolio as a business and have a high level of personal day-to-day involvement.

The Group considers that the experience of its customers, their level of involvement and the diversification of their income streams across properties make them less vulnerable to cash flow shocks in the event of a downturn and better able to cope when faced with an adverse economic situation. This has proved to be the case in the Covid pandemic to date, with customers engaging quickly to manage any risks they faced.

The Group is amongst a small number of specialist lenders addressing this sector, which is underserved by many of the larger lenders. Some constraint in supply was seen during the pandemic, with certain non-bank lenders withdrawing from the market, although by the end of the year most had resumed activity.

New issuance of buy-to-let mortgages followed the trend in the wider property and mortgage markets. New advances reported by UKF, at £45.1 billion for the year ended 30 September 2021, were 14.8% higher than for the previous year (2020: £39.3 billion). This included a 86.3% increase in house purchase activity with an 8.4% reduction in remortgage activity. Some of this increase was driven by an increase in the number of amateur landlords, seeking investments offering returns not available elsewhere, but the activity amongst professionals was also strong.

In the lettings market RICS' September 2021 UK Residential Market Survey reported rising tenant demand coupled with a scarcity of new landlord instructions driving an increase in rents. ARLA Propertymark, in its September 2021 PRS Report, identified 75% of tenants as having experienced year-on-year increases in rent (2020: 58%) while RICS members continue to predict, on average, rent increases of 3% over the coming year. This continuing demand will benefit affordability and cash flows for the Group's landlord customers.

Landlord confidence measures reached a five-year high in the third quarter of the 2021 calendar year. Independent research carried out for the Group reported that on all five measures of confidence surveyed: rental yields, capital gains expectations, the future of their own business, the prospects for the sector as a whole and the UK financial markets more generally, optimism was higher than at any time since 2016. Larger landlords were particularly confident about prospects for their businesses, with 56% feeling 'good' or 'very good'.

1 BUSINESS REVIEW (Continued)

The proportion of landlords in the survey reporting increasing tenant demand had reached the highest level since the survey began, with six out of ten landlords reporting rising tenant demand, and 30% reporting significant increases. Only 2% of landlords in the survey reported missing a mortgage payment, and only one of the landlords surveyed anticipated missing one in the next three to six months.

Demand for HMO ('house in multiple occupancy') lets remained strong. Despite concerns as to whether student demand might be particularly affected by the effects of Covid, this did not transpire in the year, with strong lettings even where lectures were being delivered online.

The UKF analysis of arrears and possessions also provided analysis of buy-to-let cases, showing a similar picture to the wider mortgage market, with a significant uptake of payment holidays serving to keep arrears and possessions low, even after these reliefs had expired.

All these factors provide a strong indication of the current strength of the buy-to-let mortgage market and the opportunities for the Group going forward.

Mortgage Lending activity

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

	2021 £m	2020 £m
Originated assets		
Specialist buy-to-let	1,562.2	1,119.0
Non-specialist buy-to-let	52.2	86.4
Total buy-to-let	1,614.4	1,205.4
Owner-occupied	1.5	0.3
Second charge	14.1	54.0
	1,630.0	1,259.7

Total mortgage originations in the Group increased by 29.4%, following a 19.7% fall in the preceding year. Activity exceeded the £1,564.4 million of new advances achieved in 2019, before the Covid outbreak, demonstrating the impact of real growth, rather than just a Covid bounce-back on the Group's mortgage business.

1 BUSINESS REVIEW (Continued)

Buy-to-let

Advances continue to be focused on specialist buy-to-let, the main focus of the division's activity. New lending of these products increased by 39.6% following the 14.9% fall in the 2020 financial year. The £1,562.2 million of completions was also 22.8% higher than the result for 2019, prior to the pandemic, demonstrating the strength of the Group's proposition.

Specialist buy-to-let comprised 95.8% of the division's advances, reflecting the sharpening of focus on this area. Other mortgage lending remains modest in comparison, with advances declining by 51.8%, in large part due to the Group's exit from the non-core second charge market during the year. The new business pipeline, being the loans passing through the underwriting process, stood at a record £1,008.1 million at the year-end, 8.8% higher than a year earlier (2020: £926.7 million), providing a strong platform for growth into the 2022 financial year.

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. 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 (2020: 91%), delivering a NPS at offer stage of +43 (2020: +56). Two thirds (66%) of brokers dealing with the Group rated its service as better than that provided by other lenders (2020: 68%). Paragon Mortgages was also named as 'Best Professional Buy-to-let Lender' at the 2021 Your Mortgage awards – the ninth time it has won this title.

During the period the business launched a long-term, in-depth, end-to-end transformation programme to restructure processes and enhance systems, increase the effectiveness of the operation and upgrade the offering to both customers and intermediaries. This represents a significant commitment of time and resources to the future of the business, with enhancements starting to come online from the 2022 financial year.

The Group understands the potential for climate change to impact its mortgage business and seeks to mitigate risk through careful consideration of the properties on which it will lend. It also continues to develop systems and refine data to allow its overall position to be measured and the behaviour of its security portfolio under climate-related stresses to be better understood.

During the year the Group launched its first range of green buy-to-let mortgages. These market-leading products have a maximum 80% loan-to-value ratio and offer, lower interest rates for energy efficient properties with EPC ratings of C or higher. While initially limited to certain property types, this lending was extended to all properties within the Group's lending criteria in October 2021.

The UK Government has identified the provision of more energy efficient housing as a prime objective in its response to climate change, with EPC levels being set as one of the principal benchmarks to be used. It has announced a target of upgrading as many homes as possible in the PRS to an EPC rating of C or higher. In order to achieve this, there is an expectation that lenders will set minimum quality thresholds, and advantage customers with more energy efficient properties, as is the case with the Group's green mortgage products.

1 BUSINESS REVIEW (Continued)

The Group has also designated EPC grades as a principal metric for evaluating climate change risk in its mortgage book and has continued to develop systems to analyse this data and to ensure that it has reliable and up-to-date information on as much of its book as possible, including legacy cases. It is unfortunate that some public information sources are not currently configured in a way which easily facilitates in-life monitoring and analysis or allows customers in need of support in improving their properties to be identified.

The Group's latest analysis identified EPC grades for 88.3% of its mortgage book by value at 30 September 2021 (2020: 85.1%). Of these 98.4% were graded E or higher (2020: 98.1%) with 37.6% rated A, B or C (2020: 37.7%). The year-on-year movements are principally a result of refining the data, with 39.7% of new originations in the year having one of the top three grades (94.2% coverage).

The Group's advances volumes on green buy-to-let lending, which have increased by 27.7% in the year, are set out below.

	2021	2020
	£m	£m
EPC rated A or B	134.3	112.7
EPC rated C	443.4	339.8
Total rated A to C	577.7	452.5
Coverage (England and Wales)	93%	94%

While the Group monitors EPC performance it is also conscious of the need to avoid unintended consequences by focussing lending on this. While upgrading existing properties is beneficial to overall emissions, the demolition and replacement of properties may be less so.

The Group also monitors the potential physical risks to security values arising from climate change. This includes assessing a property's flood risk as part of the underwriting process. At 30 September 2021, approximately 2.5% by number of properties securing the Group's buy-to-let mortgages in England and Wales were considered to be at medium or high risk of flooding from the sea or rivers, based on data from the Environment Agency (2020: 2.2%).

The Group continues to refine and develop its use of both internal and external data to manage climate change risk. However, it recognises the important part that the development of reliable and easily accessible information sources by the UK authorities must play in quantifying these exposures. It would therefore welcome any initiatives by the UK Government to enhance national reporting as part of its own response to climate change.

The business is currently working with the Green Finance Institute on a number of industry initiatives to develop standards for mortgage products which would encourage energy and carbon efficiency for the future, and this work continues to inform the development of the Group's own buy-to-let product range. Given that RICS has highlighted cost as one of the principal barriers to energy efficiency improvements in residential property, the provision of financial solutions will be key to the achievement of climate goals.

1 BUSINESS REVIEW (Continued)

Other lending

Other first and second charge mortgage lending is ancillary to the Group's main buy-to-let focus and is carefully managed to ensure that only lending with appropriate risks which provides an acceptable return on capital is undertaken.

Lending in the Group's second charge mortgage operation was scaled back in summer 2020 in response to Covid, with people transferred to provide support to other business areas, and lending remaining low in the first half of the year. The Group took this opportunity to review the long-term strategic potential of second charge lending in light of its capital requirements and the Group's overall risk appetite and announced its withdrawal from this market in May 2021. Completions in the year were £14.1 million compared to £54.0 million in 2020.

The Group's exposure to first charge residential lending is strictly limited, given the yields available in this market at acceptable levels of risk, and a limited demand for products where its specialist approach is cost-effective and adds value. The opportunities for the Group in this area principally relate to complex propositions, which will arise on an opportunistic basis, including lending to the existing professional landlord customer base.

Performance

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

	2021	2020
	£m	£m
Post-2010 assets		
First charge buy-to-let	7,379.0	6,202.5
First charge owner-occupied	35.6	51.2
Second charge	148.1	182.6
	7,562.7	6,436.3
Legacy assets		
First charge buy-to-let	4,045.3	4,381.3
First charge owner-occupied	0.7	1.9
	11,608.7	10,819.5

At 30 September 2021, the total net mortgage portfolio was 7.3% higher than at the start of the financial year, reflecting strong lending and retention performance in spite of the on-going impacts of Covid. The balance of post-2010 buy-to-let lending grew by 19.0% and it now represents 63.6% of the division's total loan assets (2020: 57.3%).

The annualised redemption rate on buy-to-let mortgage assets, at 6.9% (2020: 6.6%), has continued at a low level, partly due to the continued seasoning of five-year fixed rate loans, partly to customers adopting a cautious approach to remortgaging during Covid, but also as a result of the Group's strategic initiatives to retain customers whose mortgage accounts reach the end of their fixed rate period.

1 BUSINESS REVIEW (Continued)

Covid-related payment holidays were granted on 13,503 of the Group's buy-to-let accounts which were still live at the year end, representing 19.9% of the book by number. 5,165 of these holidays were extended (7.6%), but all of them had expired by 30 September 2021.

Arrears on the buy-to-let book increased in the year to 0.21% (2020: 0.15%), although part of the increase is attributable to the suppression of arrears by payment holidays at the previous year end. Arrears on post-2010 lending were at 0.09% (2020: 0.03%). Despite the small increases, these arrears remain very low compared to the national buy-to-let market, with UKF reporting arrears of 0.45% across the buy-to-let sector at 30 September 2021 (2020: 0.52%).

While the principal credit metrics for the buy-to-let mortgage portfolio have remained positive throughout the year, the extent to which these have been influenced by UK Government interventions, such as furlough payments and other income support, underpinning tenant rental payments, funding from government-backed loan schemes accessed by landlords and the stamp duty holiday, cannot be established from data available. Therefore, the long-term prospects for the book, as these initiatives begin to be withdrawn, remains subject to a significant level of uncertainty.

The Group's buy-to-let underwriting is focussed on the credit quality and financial capability of its customers, underpinned by a robust assessment of the available security. This approach relies on a detailed and thorough assessment of the value and suitability of the property as security and this approach to valuation, including the use of a specialist in-house valuation team, provides it with significant security in the face of economic stress.

The loan-to-value coverage in its buy-to-let book, at 61.2% (2020: 65.8%) represents significant security, enhanced over the year by the generally rising levels of house prices. Levels of interest cover and stressed affordability in the portfolio remain substantial, leaving customers well placed to develop their businesses going forward.

Second charge arrears increased to 1.18% from 0.62% in the year, reflecting the increased seasoning and size of the portfolio and the effect of payment holidays on the 2020 measure. Of the live second charge accounts at the year end 470, representing 17.9% of the book by number, had been given payment holidays during the pandemic, with 256 of those extended (9.8%). No payment holidays remained in place at the year end.

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 was able to manage tenant rental flows and occupancy levels through the various pandemic restrictions in the year, to ensure good outcomes for customers and their tenants. At the year end 553 properties were managed by a receiver on the customer's behalf, a reduction of 11.2% since 2020 (2020: 623 properties). Almost all these cases currently relate to pre-2010 lending, with cases being resolved on a long-term basis.

1 BUSINESS REVIEW (Continued)

Outlook

The division's operations were affected by Covid in the year, however, the buy-to-let mortgage portfolio continued to grow, with strong credit performance, despite the circumstances. The year-end pipeline was at record levels, signposting strong completions into the new financial year. In the wider market, transactions are increasing, tenant demand is strong and rental projections are encouraging, with positive landlord and broker sentiment.

These combine to provide an outlook for the Mortgage Lending business in which it should be able to accelerate out of the pandemic and generate high quality assets and returns for the Group, while contributing to the development and renewal of the nation's housing stock.

1.2 COMMERCIAL LENDING

The Group's Commercial Lending division includes four key specialist business streams lending to, or through, commercial organisations, mostly on a secured basis. This division had been a major source of growth within the Group before the impact of Covid and remains a focus for growth going forward.

The four business lines address:

- 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

Each of these businesses is led by a managing director, supported by a specialist team with a strong understanding of their market. The principal competitors for each of the business lines are small banks and non-bank lenders. The Group operates principally in markets where the largest lenders have little presence, creating both a credit availability issue for customers and significant opportunities for the Group.

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

The SME sector has been the focus of government-mandated support programmes throughout the pandemic including payment reliefs from lenders, VAT deferral schemes and the provision of loans under the Coronavirus Business Interruption Loan Scheme ('CBILS'), Coronavirus Large Business Interruption Loan Scheme ('CLBILS') Bounce Back Loan Scheme ('BBLS') and Recovery Loan Scheme ('RLS'). These reliefs have resulted in significant increases in cash balances held in the sector, which makes long-term prospects more difficult to gauge.

1 BUSINESS REVIEW (Continued)

During the period the Group has continued to enhance operational functionality in this area, developing technological solutions and investing in systems, particularly focussing on administration systems for SME lending and development finance. These enhancements should provide benefits for both customer service and in the procuration processes, enabling potential customers or their brokers to access appropriate finance solutions more easily and efficiently, while providing the Group with the information needed to support increasingly technologically advanced decision-making and the adoption of an IRB capital model for this business.

The division continues to develop its approach to green financing, where funding can be deployed in support of more climate conscious business activities, such as supporting local authorities in replacing refuse collection fleets with greener vehicles. Work is also in progress to classify the environmental impacts of lending in accordance with the UK's Green Taxonomy, although the Group's lending connected to 'brown' industries (those with a high environmental impact) has already been assessed as low.

Commercial Lending activity

The Commercial Lending segment saw a 22.9% increase in new business during the year following the 18.3% reduction in 2020. Development finance continued its growth trajectory while SME lending also grew, particularly in its longer term asset finance product lines. Motor finance operated at a reduced level through the early part of the year, but returned strongly to the market in the spring.

The new lending activity in the segment during the year is set out below, analysed by principal business line. As the structured lending business comprises revolving credit facilities, the net movement in the period is shown.

	2021 £m	2020 £m
Development finance	510.4	385.3
SME lending	336.9	288.0
Structured lending	24.0	7.6
Motor finance	100.2	109.9
	971.5	790.8

The impact of this new business has been to increase the Group's overall Commercial Lending exposure by 3.6% in the year to £1,568.8 million (2020: £1,514.8 million).

Development finance

The continuing growth of the Group's development finance business saw it reach the milestone of £1.5 billion of total lending over the last three years, with 13,000 new homes financed in that time. Enhancements to the product range and the expansion of the relationship team continued throughout the current year, which alongside an active market, helped drive volumes higher.

1 BUSINESS REVIEW (Continued)

The Group's target customer is a small to medium-sized developer of UK residential property. Projects currently in progress have an average development value of £7.8 million against which the Group has extended average facilities of £5.0 million, giving a substantial level of security cover. These projects are generally focussed on the more liquid parts of the residential market (houses and smaller blocks of flats), avoiding developments with high unit values.

The development finance business remained robust throughout the period, although Covid-related restrictions and supply chain issues meant that many projects progressed more slowly than they might have done in normal times, especially in the first half of the year. This, however created an element of pent-up demand moving into the second half with advances, pipeline and enquiries strengthening as the year progressed. Market sentiment appears positive with developers generally optimistic about the future, despite the short-term supply issues.

While the business has been historically concentrated in the English Home Counties, with 63.6% of balances at the year end located in London and the South East (2020: 67.0%), the Group's strategic objective is to lend more widely across the UK. Central London property hot-spots have generally been avoided with approximately 4% of the balance located in this area.

During the year the product range was expanded to include finance for projects in the £0.4 million to £1.0 million range, widening its potential market to include smaller, growing developers as they expand their businesses as well as expanding options for existing customers. It also reintroduced lending of up to 70% of total development value, suspended in response to the pandemic, for the highest quality propositions. Together these will expand the range of projects the business is able to consider.

Following the end of the year, the business launched a Green Homes Initiative to promote the development of energy efficient properties, by halving exit fees if EPC ratings of A are achieved on 80% or more of units within a development, incentivising developers to meet the demand for greener properties and to support the UK's net zero target.

The Group's customers have remained resilient through the Covid pandemic with delays minimised and completed projects being taken to market. To safeguard its investments, the Group engages independent monitoring surveyors to review progress and costs on a regular basis through the build phase of each project.

The volume of new proposals being received increased steadily during the second half of the year, with the increased amounts of undrawn approvals, at record levels at the year end, providing a springboard for the beginning of the new the financial year. Undrawn amounts on live facilities at 30 September 2021 at £500.4 million were 31.4% higher than at the previous year end (2020: £380.9 million) while the post-offer pipeline of £298.6 million was 74.1% higher (2020: £171.5 million).

During the year, the business invested in both people and systems, while increasing its national and regional coverage with the recruitment of experienced specialist relationship directors and portfolio managers. These initiatives will support the further growth and broadening of the business going forward. The Group has also made progress on the development of an IRB capital model for this business, which should reduce the cost of capital in the longer term, as well as enhancing capital discipline.

1 BUSINESS REVIEW (Continued)

The performance of the development finance business through the pandemic has demonstrated the attractiveness of the proposition going forward. The demand for new housing in the UK shows no sign of reducing and smaller developers, who have historically struggled with credit availability, will be needed if the country's needs are to be met. Sentiment in the market appears positive entering the new financial year and the Group's business model, its investment in systems and people and the developments in its product range mean it is well-placed to support the aspirations of its developer customers and to help support housing provision across the UK.

SME lending

The SME lending business continued to perform well in the face of Covid-related constraints throughout the financial year, although certain business lines were particularly affected by either reduced economic activity, logistical difficulties in equipment sourcing, payment deferrals reducing the need for finance or the availability of cost-effective CBILS and BBLS funding. Lending strengthened considerably in the second half of the year, with the growth in longer term asset-backed lending particularly encouraging for income.

Research carried out for the Group during the second half of the year suggested that 92% of UK SMEs were confident about their ability to bounce back from Covid, while 22% had already seen their turnover return to pre-Covid levels. Cash flow was identified as the principal issue for most SMEs, with UK Government support accessed by the majority. Levels of available cash remained the principal concern for SMEs looking forward.

This confidence in the sector led to a 17.0% growth In the Group's SME lending advances in the year, although the performance varied across product types. Generally all lines reported a stronger second half, with the UK economy opening up and business confidence beginning to increase.

In the division's core asset leasing business volumes increased by 19.3% to £198.2 million, excluding government-backed balances (2020: £166.1 million), with business levels strengthening towards the end of the period. This reflects the performance of the asset finance market in general, with the Finance and Leasing Association ('FLA') reporting depressed volumes through the winter months and business picking up through the summer. Investment in operating leases has also continued with £13.0 million of assets acquired in the period (2020: £12.9 million).

The Group continued to advance loans under the UK Government-sponsored British Business Bank's CBILS and BBLS programmes to support SMEs potentially affected by the Covid pandemic, until those schemes closed for new applications in March 2021. The Group has been authorised to take part in the follow-on RLS programme and began lending under the scheme in the second half of the year. RLS loans have the benefit of an 80% government guarantee (after the proceeds of any business assets are applied for leasing balances), but unlike CBILS lending, customers will be required to meet interest payments from the outset of the loan.

The existing RLS scheme closes for new offers from 31 December 2021 and will be replaced by a scheme with a 70% government guarantee. The Group expects to use these schemes to provide support to SME customers until 30 June 2022, the currently expected end date of the schemes. The Group's lending in this area has been primarily focussed on its existing customers, and the majority of both BBILS and RLS lending has been on asset-secured products.

1 BUSINESS REVIEW (Continued)

During the year £64.2 million was advanced under schemes backed by a government guarantee (2020: £25.9 million), of which £50.4 million was asset leasing business. The Group continues to closely monitor the portfolio for any adverse indications, particularly at the point at which customers, rather than the Government, are expected to commence payments.

Short-term lending to professional services firms outside the government supported schemes fell by 21.6% to £62.0 million (2020: £79.1 million). Despite this fall in volumes, this represents a recovery in the second half to the year following twelve months of very low volumes during the pandemic. This resulted from both the deferral of tax balances, where customers had customarily taken out short-term loans to spread the impact, and of the wide availability of cheap CBILS and BBLS lending in the market. The second half of the year saw the impact of these factors diminishing and lending moving back towards pre-Covid levels with the underlying requirement for finance remaining for the longer term.

The Group has continued to invest in system improvements to create efficiency gains in this business throughout the year despite the pandemic. Enhancements to the new lending process were rolled out in April, offering improvements for customers and brokers including the launch of a new finance broker portal, providing enhanced functionality, in response to extensive research amongst the broker community.

The finance broker portal, which provides significant benefits in terms of process automation and response speed was rolled out to a larger population following the year end and the reengineering programme will continue into the new financial year, enhancing controls, operational agility and the customer experience.

With the FLA quarterly industry outlook survey showing 90% of providers expecting new business growth in the next twelve months, growing confidence in the customer base, a strengthening new business pipeline and system developments coming on line, the Group is optimistic for the future prospects for the business.

Structured lending

The Group's structured lending exposure has seen an increased level of activity in the year, with several new facilities agreed, diversifying the business' exposures and the overall balance increasing.

Structured lending facilities generally fund non-bank lenders of various kinds providing the Group with increased product diversification. The facilities are constructed to provide a buffer for the Group in the event of default in the ultimate customer population. The Group's experienced account managers have received regular reporting on the performance of the security assets, and they maintained a high level of contact with the Group's customers throughout the Covid crisis to safeguard its position.

The Group has a number of well-progressed additional facilities in the pipeline, with an expectation of more drawings in the new financial year. These include new asset classes, spreading the risk inherent in such lending. The Group continues to actively seek new opportunities in this field, with a particular interest in facilities linked to green initiatives.

1 BUSINESS REVIEW (Continued)

Motor finance

The Group's motor finance business is a focussed operation targeting propositions which are not addressed by mass-market lenders, including specialist makes and vehicle types, such as light commercial vehicles, motorhomes and caravans.

During the first part of the year the Group operated tighter lending criteria and temporarily diverted resources from the new business teams in the area to support the wider Group's customer servicing requirements through the pandemic, including the provision of payment reliefs. In the second half the Group relaunched its proposition with a renewed focus as dealerships began to open and market activity increased.

Following the year end the operation extended its lending criteria to include battery electric cars for the first time, following consultation with dealers and brokers. This will help to support the UK's move away from petrol and diesel powered vehicles.

The Group's advances in the year reflect this operational strategy, with £100.2 million of completions in the year, a broadly similar level to the £109.9 million achieved in 2020. However, this represents a significant post-Covid recovery with £71.4 million of advances in the second half of the year, compared to £28.8 million in the first half and £35.1 million in the second half of 2020. This returns completions to the level seen in the first half of 2020, before the outbreak when advances of £74.8 million were made.

This Group's performance follows the trajectory of the wider motor finance market, with the FLA reporting falling volumes until February 2021, before a recovery beginning to take hold in March.

Performance

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

	2021 £m	2020 £m
Asset leasing	468.7	478.0
Professions finance	33.1	22.3
CBILS, BBLS and RLS	83.8	25.2
Invoice finance	20.9	13.5
Unsecured business lending	10.3	15.0
Total SME lending	616.8	554.0
Development finance	608.2	609.0
Structured lending	118.9	94.9
Motor finance	224.9	256.9
	1,568.8	1,514.8

1 BUSINESS REVIEW (Continued)

Credit quality in the development finance book has been good, and the overall performance of the projects has been in line with expectations, with the pandemic having no significant impact on the disposal of completed developments. Accounts are regularly monitored and graded on a case-by-case basis by the Credit Risk function. At 30 September 2021 only one account had been identified as at risk of loss, a long standing legacy case. While the impact of Covid on development finance projects has been limited to issues relating to the progress of some projects, rather than credit concerns, the Group recognises the potential impact of increased economic uncertainty 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 61.7% (2020: 63.1%), which gives the Group a substantial buffer if any project encounters problems. No new serious credit issues arose during the financial year and a number of problem cases identified in prior periods were resolved.

Credit performance in the division’s finance leasing portfolios generally remains relatively stable, with arrears in asset leasing at 0.27% and motor finance at 2.30% (2020: 1.75% and 1.76% respectively), however there have been a small number of cases where serious credit issues have been identified and the sector is expected to display more volatile credit performance as government support initiatives unwind.

Of the division’s live motor finance accounts at 30 September 2021, 1,507 cases (9.5%) had been granted payment holidays during the course of the pandemic with 312 (2.0% of cases) of those holidays extended. None of these payment holidays remained in place at the year end.

In SME lending 2,570 of the live accounts at 30 September 2021 had been granted payment holidays with 316 of those extended, of which 28 remained in place at the year end.

The majority of CBILS and BBLS lending remained in its initial twelve-month period where interest payments were met by the UK Government throughout the financial year. Payments from customers began to fall due in the second half of the financial year on a limited number of accounts in the first tranches on lending, and the Group has appropriate systems, processes and resource in place to deal with any issues as they arise. Of the guaranteed portfolio, £5.0 million (2020: £4.6 million) comprises fully guaranteed BBLS loans.

With the exception of a small number of irregularly submitted applications, where claims have been submitted under the guarantee scheme, the Group has yet to encounter any serious credit issues with its CBILS and BBLS portfolios. Any emerging payment behaviours will be kept under close scrutiny.

In the structured lending business, the Group carefully monitors the performance of the underlying asset pool on a monthly basis, to ensure its security remains adequate. The Group relies on its data monitoring and verification processes to ensure that these reviews are able to detect any credit issues. Performance in the year has been in line with expectations, with generally improved metrics across the book and only one loan remaining in IFRS 9 Stage 2 at the year end.

1 BUSINESS REVIEW (Continued)

Outlook

The Group's Commercial Lending division has emerged from Covid well placed for future growth. Work to develop products, systems and services has been ongoing throughout the pandemic and the year ended with increased pipelines and building momentum.

With sentiment largely positive in the division's customer base, and new, green product ranges launched in the new year, the Group is optimistic for its prospects in the Commercial Lending space.

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 success rests on understanding assets, strong analytics, advanced servicing capabilities and the efficient use of funding.

When considering portfolios for acquisition the Group currently focusses on specialist loan portfolios which might augment its own organic origination activities. This model is essentially opportunistic and the flow of appropriate opportunities to the market is both limited and sporadic, even in a normal economic environment.

The Group carefully considers the capital requirements for any potential acquisition, particularly where the asset types offered require relatively large amounts of regulatory capital to be held. It also evaluates the potential for conduct risk issues to arise in portfolios which may contain more vulnerable customers. The Group will only pursue transactions where it considers that its wider capabilities in specialist administration and funding can provide a real benefit and where the projected return is attractive in comparison to the other opportunities for the deployment of its capital.

The Idem Capital back book includes consumer lending portfolios where customers may have historically rescheduled their debt repayments and its processes aim to generate fair outcomes for all customers, recognising any vulnerabilities. This aim has formed a principal focus in the Group's response to Covid in respect of such customers.

New business

Although the UK loan portfolio market remained active in the period, the impact of Covid continued to depress activity levels, and complicated the pricing and execution of potential deals, discouraging vendors from coming to market.

During the period, no portfolio acquisitions were completed (2020: none) although 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 outbreak with customers, many of whom were already identified as vulnerable or who had developed vulnerabilities as a result of the ongoing pandemic.

1 BUSINESS REVIEW (Continued)

Performance

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

	2021 £m	2020 £m
Second charge mortgage loans	133.6	171.9
Unsecured consumer loans	87.2	109.7
Motor finance	4.3	15.5
	225.1	297.1

Balances in the segment have continued to decline as outstanding amounts are collected on existing portfolios, with no additions in the period. Cash flows remained strong across all books, despite the on-going effects of Covid on consumers. This level of collections resulted in the 120 month Estimated Remaining Collections ('ERC'), a measure of future expected cash flows, on acquired consumer assets falling to £245.2 million at 30 September 2021 (2020: £313.7 million).

Arrears on the segment's secured lending business have risen to 24.3% (2020: 18.8%). These arrears levels remain higher than the average for the sector, but this reflects the seasoning of the balances, while the continuing 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 8.6% at 30 September 2021 were reported by the FLA (2020: 8.4%).

Of the division's live secured lending accounts at 30 September 2021, 1,270 cases (14.1%) had been granted payment holidays during the course of the pandemic with 578 (6.4% of cases) of those holidays extended. In the motor finance portfolio 463 live cases (15.6%) had received a payment holiday with 136 (4.6%) having been extended. No payment holidays remained in place at the year end.

None of the live Idem Capital loan portfolios were regarded as materially underperforming at the year end, with cash generation continuing to hold up. The Group monitors actual cash receipts from acquired portfolios against those forecast in the pre-purchase evaluation of the portfolio. Up to 30 September 2021 these collections were 109.8% of those forecast to that point (2020: 109.8%).

The Group continues to invest in systems and people to ensure that Idem Capital customers receive an efficient and effective service which delivers fair outcomes. Given the nature of the books, particular attention is given to providing training and establishing processes to ensure that vulnerable customers are identified, and their needs are addressed.

1 BUSINESS REVIEW (Continued)

Outlook

The Group's strategy for the Idem Capital business is to consider only those opportunities which would enhance its overall positioning, provide attractive returns and represent a productive use of capital. These will be essentially opportunistic, and there is no volume target.

In the meantime, the division will continue to focus on its commitment to providing appropriate outcomes for its existing customers as it has done throughout the Covid pandemic and ensuring any vulnerability issues are carefully addressed.

2 FUNDING

The Group is principally funded by retail deposits but also accesses a variety of other funding sources. This maintains an adaptable and sustainable funding position as the business and its operating environment develop. The Group is therefore able to access cost-effective funding despite issues in any particular funding market, as well as raising funding for strategic initiatives on a timely basis.

Throughout the period the Group raised the majority of its new funding through the retail deposit market, where demand for deposit products has remained strong, with consumers trending towards saving rather than spending in the year, either through increased prudence or merely through the reduction in 'big-ticket' spending opportunities caused by lockdowns and other Covid-related measures. It has also continued to draw on the Bank of England TFSME scheme to support its lending to SME customers.

The Group's funding at 30 September 2021 is summarised as follows:

	2021 £m	2020 £m	2019 £m
Retail deposit balances	9,300.4	7,856.6	6,391.9
Securitised and warehouse funding	1,246.0	3,928.3	5,206.9
Central bank facilities	2,819.0	1,854.4	994.4
Tier 2 and retail bonds	386.1	446.6	446.1
Total on balance sheet funding	13,751.5	14,085.9	13,039.3
Off balance sheet central bank facilities	-	-	109.0
Other off balance sheet liquidity facilities	150.0	150.0	-
	13,901.5	14,235.9	13,148.3

The Group's retail deposit balance grew by 18.4% in the year to £9,300.4 million (2020: £7,856.6 million), representing over two thirds (67.6%) of balance sheet funding (2020: 55.8%), with wholesale borrowings continuing to reduce over the year.

At 30 September 2021 the proportion of easy access deposits, which are repayable on demand, was 24.1% of total on-balance sheet funding (2020: 16.8%). This increase is partly a result of market sentiment with savers reluctant to commit funds to term deposits in a low rate environment, and partly as a result of the Group's maturing liquidity policy. This percentage remains low compared to the rest of the banking sector and can be expected to rise going forward.

With the generally uncertain economic outlook, the Group has maintained a cautious approach to liquidity in the period. Some loosening of policy took place in the period in response to the gradual opening up of the UK economy, but at the end of the year the Group still had £1,236.5 million of cash available for liquidity and other purposes (2020: £1,701.1 million). The Group's contingent liquidity policy will be kept under review as the ultimate outcome of the Covid crisis becomes clearer and longer-term trends become more evident, but the Group intends to maintain a conservative approach.

The Group's long-term funding strategy, following the granting of its banking licence in 2014, has been to move to using retail deposits as its primary funding source, using the debt markets on an opportunistic basis for additional funding requirements.

2 FUNDING (Continued)

The Group's response to the withdrawal of LIBOR, due at the end of the calendar year, is well progressed. While LIBOR had been the principal benchmark rate used by the Group, a transition to other, risk-free rates, notably rates linked to SONIA, has been ongoing for more than two years.

No new LIBOR-linked derivative contracts have been entered into since February 2020 and remaining LIBOR-linked derivatives will transition to SONIA in accordance with the International Swaps and Derivatives Association ('ISDA') protocol. Meanwhile, all the Group's LIBOR-linked borrowings have either been retired, transitioned or have an agreed transition process in place.

A transition process for the Group's principal LIBOR-linked asset class, legacy buy-to-let mortgages, was communicated to customers and completed in the second half of the year. Other LIBOR-linked assets have either been transitioned, have an agreed transition methodology or are expected to fall due before the LIBOR transition data. Overall, the Group considers that it is well placed to meet the withdrawal deadline of 31 December 2021.

2.1 RETAIL FUNDING

The Group considers the retail deposit market to be a reliable, scalable and cost-effective source of funding, which has remained fully functional throughout the Covid crisis. The Group's offering has been centred on sterling household deposits, although it began to access the SME sterling deposit market in the year.

A variety of products are offered, including term deposits, ISAs and easy access accounts and accesses the market through a variety of in-house and external channels. The proposition is based on competitive rates and value for money, combined with the Group's strong customer service ethic and the protection provided to depositors by the Financial Services Compensation Scheme ('FSCS').

The retail deposit market in the UK is large, deep and well developed. During the year UK household savings balances reported by the Bank of England continued to increase with balances at 30 September 2021 reaching £1,402.5 billion (2020: £1,287.9 billion), an increase of 8.9% in the year. This has resulted from increased saving by consumers during the pandemic and has also depressed market interest rates. Some of this increase may be reversed as the UK economy returns to a more normal footing, but as a small participant the Group is less likely to be affected by this than larger banks and building societies.

The Group's retail deposit franchise has continued to perform strongly in the year with a reduced funding cost, reflecting the improvements, increased channels to market and downward market pressures on rates.

2 FUNDING (Continued)

Savings accounts at the financial year end are analysed below.

	Average interest rate		Proportion of deposits	
	2021	2020	2021	2020
	%	%	%	%
Fixed rate deposits	1.25%	1.69%	58.8%	63.3%
Variable rate deposits	0.42%	0.72%	41.2%	36.7%
All balances	0.91%	1.34%	100.0%	100.0%

The average initial term of fixed rate deposits was 26 months (2020: 27 months). Market savings rates in the year have remained at historically low levels, with the Bank of England quoting average interest rates at 30 September 2021 for new 2-year fixed rate deposits at 0.46% (2020: 0.48%) and for instant access balances at 0.10% (2020: 0.07%).

During the year the Group has grown its business both through a focus on its in-house channel and through expanding its offering across other third party platforms. Significant infrastructure investment in the Group's new Mambu platform has enabled the number of external channels where the Group has a presence to be expanded while embedding a strong control environment, providing an effective and efficient service and offering future digital optionality.

Offerings through these channels, which include investment platforms and savings marketplaces operated by digital banks, provide access to a different customer demographic to the Group's mainstream customers. This more diversified sourcing offers enhanced opportunities to manage inflows and costs. The Group has added three new relationships in the period, including one with Aviva Savings, bringing the total to seven. These channels now represent around 12% of the total deposit base and the system investment in the year gives the Group capacity to expand further in this area.

The Group regards the quality of its customer service as a vital component of its savings market strategy and conducts insight surveys throughout the customer journey. In this research 88% of customers opening a savings account with the Group in the year who provided data, stated that they would 'probably' or 'definitely' take a second product (2020: 88%). The NPS in the same survey was +58, similar to that in the previous year (2020: +61).

When customers with maturing savings balances in the year were surveyed, 89% stated that they would 'probably' or 'definitely' consider taking out a replacement product with the Group (2020: 90%) with a NPS at maturity of +52, slightly increased from the 2020 financial year (2020: +50).

These positive responses demonstrate the quality of the Group's customer interaction operations, which support its efforts to retain customers and deposits in the current active and competitive market. This has been enhanced in the year with additional functionality on the Group's website, such as automated password rests, introduced in response to customer feedback.

This level of customer satisfaction is also demonstrated by the Group's continuing success in industry awards. During the year awards won included 'Best Internet Account Provider' at the 2021 Moneyfacts Awards, 'Best Cash ISA Provider' at the 2021 YourMoney awards, 'ISA Provider of the Year' at the 2020 MoneyAge awards, 'Best Notice Savings Provider' at the 2021 Moneynet awards, 'Best Easy Access Savings Provider' and 'Best Easy Access Cash ISA Provider' in the MoneyComms 2021 Top Performers list and 'Best Cash ISA Provider' in the 2021 Savings Champion Awards.

2 FUNDING (Continued)

Both aspects of the Group's savings infrastructure, its outsourced deposit administration system and its infrastructure supporting external savings platforms, continue to provide a solid and scalable operating model for the business. Service standards and customer satisfaction have been maintained despite the effects of ongoing Covid restrictions, and servicing resources have continued to develop with the business.

The retail deposit funding stream provides a stable principal funding base for the Group's operations where volumes and rates can be effectively and flexibly managed. The operation will continue to develop on a strategic basis, expanding its offerings, addressing wider demographics and expanding its presence on third party platforms. This increasing diversification and the FSCS guarantee are likely to reduce the potential for liquidity impacts and the Group's profiling of its target customers suggests they may be more resilient than average in the event of future economic stresses.

2.2 CENTRAL BANK FACILITIES

The Bank of England Term Funding scheme for SMEs ('TFSME') continued to be available throughout the year to support lenders in providing credit to SME customers through the Covid pandemic. The Group has continued to draw on these funds to support its lending, particularly in its SME lending and development finance businesses.

During the year the Group's drawings under TFSME increased to £2,750.0 million (2020: £910.0 million). As TFSME provides funding at or very close to base rate, it is a particularly cost-effective form of borrowing for lenders which, like the Group, wish to support their SME customers through the economic uncertainties of the pandemic. Shortly after the year end the Group repaid and redrew all of its TFSME borrowings, extending the maturities.

Drawings under the Bank of England's original Term Funding Scheme ('TFS') which were due to mature in the current financial year began to be retired early during the period, improving the maturity profile of the Group's borrowings. At 30 September 2021 the remaining TFS borrowings provide £69.0 million of the Group's funding (2020: £944.4 million), but will be repaid in the early part of the new financial year. The Group retains access to other Bank of England funding channels but did not utilise them in the year.

The Group expects to continue to make use of these facilities going forward, in accordance with the objectives of the schemes. Where using them is appropriate and cost-effective, mortgage loans pre-positioned with the Bank of England are available to act as collateral for future drawings, if and when required. This provides access to potential liquidity or funding of up to £1,424.2 million (2020: £684.0 million).

2 FUNDING (Continued)

2.3 WHOLESALE FUNDING

The Group's wholesale funding includes securitisation funding, warehouse bank debt and retail and Tier-2 corporate bonds, which are each accessed from time to time as appropriate. The Group's Long-Term Issuer Default Rating was affirmed at BBB by Fitch in March 2021, with the outlook upgraded from negative to stable, reversing the change which was applied to all the major UK banks during 2020 as a result of the Covid crisis.

During the year capital markets remained active, with activity in most areas of funding. The securitisation markets remained open, but with most volume driven by those lenders without access to central bank facilities.

Wholesale pricing has been attractive for issuers, with strong demand for new issuance. Against this backdrop the Group issued a £150.0 million Tier-2 Green Bond in March 2021. This was the first issuance certified under the Group's Green Bond Framework, approved in March 2021, which sets out how the proceeds of the bond will be applied, and which is available on the Group's website at www.paragonbankinggroup.co.uk.

The new bond carries an interest rate of 4.375%, fixed for five years, and will count in full towards tier 2 capital for a five year period. It was rated BB+ by Fitch on issue. This interest rate represents a considerable saving on the Group's previous Tier-2 bond, issued in 2016, which bore interest at 7.25% per annum.

The majority of the Group's £150.0 million 2016 Tier-2 Bond was acquired by the Group in a tender process during March 2021. The remainder was redeemed at the call date in September 2021.

These bond transactions reduce overall funding costs and place the Group's tier 2 capital position on a longer-term footing, as well as accessing the green bond market.

Historically the Group has been one of the principal issuers of UK residential mortgage backed securities ('RMBS'), however its reliance on this funding source has been significantly reduced over recent years, with the most recent issuance held internally rather than issued in the market.

The Group's four mature legacy securitisation transactions were refinanced during the period. An agreement was also reached in the period to transition the only other LIBOR-linked deal, Paragon Mortgages (No. 25) PLC, from its interest payment date in February 2022. These transactions benefit the Group's overall long-term funding position by releasing cash collateral; removing LIBOR-linked liabilities ahead of transition; crystallising derivative positions, thereby reducing the Group's TRE for capital purposes; and releasing loan assets for use in creating eligible securities which can be used to access TFSME and other forms of funding.

A fully-retained securitisation transaction, Paragon Mortgages (No. 28) PLC, was completed in the year. In this transaction £703.1 million of rated notes were issued to group companies, to be used as collateral in other funding transactions, such as TFSME. This repeats the structure of Paragon Mortgages (No. 27) PLC, issued in 2020.

2 FUNDING (Continued)

The Group renegotiated its £400.0 million warehouse funding facility during the period reducing the interest margin from 1.05% above LIBOR to 0.60% above LIBOR. This facility is used to provide 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. After the year end this facility was extended to £450.0 million and the interest rate was transitioned to 0.50% over SONIA. These changes will make this funding more cost effective and practical going forward.

The Group's retail bond issued in 2013 was repaid at maturity in December 2020. The Group also entered into sale and repurchase transactions from time to time, to ensure it retains access to this channel for liquidity purposes.

Overall, these initiatives reduced the Group's dependency on legacy securitisation debt, lowered funding costs, facilitated LIBOR transition, and increased average remaining maturities for its other borrowings. This demonstrates the adaptability of the Group's wholesale funding activities and the Group will continue to access all these funding sources on a strategic and opportunistic basis as appropriate.

2.4 FUNDING OUTLOOK

The year has seen growth in the Group's savings franchise, while the tenor of its wholesale and central bank borrowings has been extended, with the average cost of funding reduced and the green finance market accessed for the first time.

This has been consistent with the Group's funding strategy, developing and enhancing its access to funding sources while maintaining its principal focus on the retail savings market. The Group is well placed to maintain this diverse, robust and adaptable strategy going forward, which will support the needs of its developing business into the future.

Further information on all the above borrowings is given in note 15

3 CAPITAL

The Group's capital policy is designed to provide appropriate returns to shareholders, preserve the strength of its balance sheet, maintain strong regulatory capital and liquidity positions to safeguard its depositors and to ensure sufficient capital is available to meet strategic objectives in opportunities going forward. The safeguarding of this capital strength has been a fundamental objective of the Group's ongoing Covid response.

This enabled the Group to return to a more normal approach to capital and distributions in the year ended 30 September 2021, with an interim dividend declared and share buy-backs undertaken. The Group's position was also enhanced by a favourable result from the most recent regulatory review of its capital position, which reduced its requirement to hold regulatory capital.

For regulatory purposes the Group's capital comprises shareholders' equity and its tier-2 green bond. It has no outstanding Additional Tier 1 ('AT1') issuance, but has the capacity to issue such securities, if considered appropriate, under an authority granted by shareholders at the 2021 Annual General Meeting ('AGM'), which will be proposed for renewal at the 2022 meeting.

3.1 REGULATORY CAPITAL

The Group continued to maintain strong regulatory capital ratios throughout the year, with capital balances having grown as a result of its prudent approach to capital management through the Covid pandemic. During the period the PRA conducted a supervisory review of the Group's capital requirements, based on the Internal Capital Adequacy Assessment Process ('ICAAP') analysis. The results of this review were very positive, with the regulator significantly reducing its capital requirement based on its assessment of the Group's risk exposures and management systems.

The Group is subject to supervision by the Prudential Regulation Authority ('PRA') on a consolidated basis, as a group containing an authorised bank. As part of this supervision, the regulator will issue a Total Capital Requirement ('TCR') 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'), which was transposed to the PRA Rulebook as part of the Brexit arrangements.

The TCR includes elements determined based on the Group's total risk exposure together with fixed elements, and 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. It was granted transitional relief on the adoption of IFRS 9, along with most other banks, with additional relief granted in 2020 for the impact on capital of provisions created in response to the Covid pandemic.

A4 REVIEW OF THE YEAR (Continued)

A4.3 CAPITAL (Continued)

The PRA requires firms to disclose capital measures both on the regulatory basis and as if these reliefs had not been given, referred to as the 'fully loaded' basis. The Group's principal capital measures, CET1 and Total Regulatory Capital ('TRC') are set out below on both bases.

	Regulatory basis		Fully loaded basis	
	2021	2020	2021	2020
	£m	£m	£m	£m
Capital				
CET1 capital	1,055.8	991.2	1,026.1	948.9
Total Regulatory Capital ('TRC')	1,205.8	1,141.2	1,176.1	1,098.9
Requirement				
TCR	604.2	749.6	601.8	745.3

As the value of IFRS 9 reliefs will taper over time, the difference between measures on the regulatory and fully loaded bases will narrow and eventually converge.

The Group's CET1 capital comprises its equity shareholders' funds, adjusted as required by the CRD IV rules and can be used for all capital purposes. TRC, in addition, includes tier-2 capital representing the Tier 2 Bonds. This tier 2 capital can be used to meet up to 25% of the Group's TCR. The increase in capital over the year is a result of the positive trading performance, which outweighed the impact of dividend payments and share buy-backs in the period.

The TCR is specific to the Group and is set by the regulator, based on its supervisory reviews. The reduction in TCR on both the regulatory and fully loaded bases shown above has arisen principally as a result of the successful outcome of the most recent review process.

This saw the TCR on both bases reduced to 8.9% of TRE from 10.8% of TRE at 30 September 2020, compared to the minimum TCR allowed under the Basel III framework of 8.0%. This represents a significant benefit to the Group's capital management and reflects the maturity of the Group's systems for the management of capital and risk.

CET1 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. The CCoB remained at 2.5%, its long-term rate, throughout the year (2020: 2.5%), while the UK CCyB remained at 0.0% (2020: 0.0%), having been reduced from 1.0% during 2020 as a regulatory response to the pandemic. However, it has been stated by the Financial Policy Committee of the Bank of England that the long-term standard rate of the CCyB will be 2.0% and this requirement for additional capital in the future has been factored into the Group's capital planning.

CET1 capital required to cover CRD IV buffers therefore reduced to £170.9 million at the year end on the regulatory basis (2020: £173.7 million).

Further buffers may be set by the PRA on a firm-by-firm basis but cannot be disclosed.

A4 REVIEW OF THE YEAR (Continued)

A4.3 CAPITAL (Continued)

The Group's capital ratios, after allowing for the proposed dividend for the year, are set out below.

	Basic		Fully loaded	
	2021	**2020**	**2021**	**2020**
CET1 ratio	15.4%	14.3%	15.1%	13.7%
Total capital ratio	17.6%	16.4%	17.3%	15.9%
UK leverage ratio	7.5%	7.1%	7.3%	6.8%

All of the Group's capital ratios show strong improvement over the period, despite the resumption of distributions to shareholders. This reflects the trading profits, including a reduction in Covid-based impairment provisions, a gain on the pension scheme liability and reductions in risk weighted asset values following the repackaging of legacy securitisations.

The Basel Committee on Banking Supervision ('BCBS') has set the implementation date for its revisions to the Basel III framework as 1 January 2023. This is, however, subject to those revisions being enacted in the relevant jurisdiction. Following the UK's exit from the EU, these rules are expected to be enacted for UK banks through the PRA Rulebook. The PRA has also launched a more extensive consultation on its approach to regulating non-systemically important banks without international activities. The Group is monitoring these developments and will respond through its capital planning as appropriate.

The Group submitted the second stage of its application for the accreditation of its IRB approach to buy-to-let credit risk for capital adequacy purposes to the PRA in March 2021. The project continues to progress to plan, and work continues into the new financial year on both the buy-to-let portfolio and on development finance lending, which represents the next step in the Group's IRB roadmap.

3.2 LIQUIDITY

It is Group policy to hold sufficient liquidity in the business to meet 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. This policy has a consequent effect on the Group's operational capital and funding requirements.

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 LCR measures short-term resilience and compares available highly liquid assets to forecast short-term outflows, calculated according to a prescribed formula, with a 30 day horizon. The monthly average of the Bank's LCR for the period was 165.6% compared to 173.7% during the 2020 financial year. The reduction is a liquidity policy response to the reduction in Covid-related impacts to the business and in the wider economy.

A4 REVIEW OF THE YEAR (Continued)

A4.3 CAPITAL (Continued)

The NSFR is a longer-term measure of liquidity with a one year horizon, supporting the management of balance sheet maturities. At 30 September 2021 the Bank's NSFR stood at 119.6% (30 September 2020: 114.7%), reflecting the strengthening of the overall funding and capital position over the year.

3.3 DIVIDENDS AND DISTRIBUTION POLICY

The Group's distribution policy over recent years has been based on the objective of enhancing shareholder returns on a sustainable basis, while protecting the capital base. In order to achieve this, its stated policy has been to distribute 40% of consolidated earnings to shareholders in ordinary circumstances, achieving a dividend cover ratio of approximately 2.5 times. It has also undertaken buy-backs of shares in the market from time to time as part of its management of overall capital, where these enhance shareholder value.

The Group managed its capital cautiously through the pandemic and accumulated a capital and cash surplus over its requirements, including its regulatory requirements, to the level that it was considered appropriate to resume distributions to its shareholders, both in the form of dividends, and in a share buy-back, addressing the needs of different investor groups.

An interim dividend for the year of 7.2 pence per share (2020: nil pence per share) was paid in July 2021 and the Board is proposing, subject to approval at the AGM on 2 March 2022, a final dividend for the year of 18.9 pence per share (2020: 14.4p per share). This would give a total dividend of 26.1 pence per share (2020: 14.4p per share). This dividend would be in line with the stated policy, giving a dividend cover of 2.50 times (2020: 2.50 times).

The 81.3% increase in total dividend from 2021 reflects the increase in group earnings, including the impact of Covid-related impairment provisions made in 2020 reversing in the current year, which effectively deferred dividend to 2021. The 2021 dividend is also inflated by the high level of fair value gains in the year, which would not necessarily be repeated in a future year. Care must therefore be taken in extrapolating future dividend levels from the current year dividend alone.

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

In addition, the Board authorised a buy-back of up to £40.0 million of shares in the market, initially to be held in treasury. The Group has the authority to make such purchases under a resolution approved by shareholders at the AGM in February 2021. £37.5 million (excluding costs) was expended during the year on the buy-back programme, and it is the Board's intention to complete the programme following the announcement of the annual results.

As part of its review of the Group's capital and dividend policy following the completion of its annual results and the financial forecasts for the coming period, the Board concluded that a further buy-back programme of up the £50.0 million, initially to be held in treasury, was appropriate, and this will commence following the completion of the initial £40.0 million. In this way, the Group seeks to balance the expectations of different investor groups, while maintaining a strong capital position.

A4 REVIEW OF THE YEAR (Continued)

A4.3 CAPITAL (Continued)

Any purchases made under either of these programmes will be announced through the Regulatory News Service ('RNS') of the London Stock Exchange on the day of the transaction.

The Board has affirmed the existing dividend policy going forward, subject to an assessment of prevailing conditions at the time, but noted that, given the unusual factors affecting the 2021 distribution, any interim dividend declared for 2022 would not necessarily bear the normal relation to the preceding final distribution.

3.4 CAPITAL OUTLOOK

The Group's current and forecast capital position is kept under regular review, in light of the level and form of capital demanded by current business, regulatory and economic conditions, as well as the Group's strategic objectives.

The capital and liquidity position of the Group had strengthened through the year. The Group's operations increased the capital balance, the Tier-2 issuance has been replaced at a lower cost and the positive result of the regulatory review of the Group's capital management systems has resulted in a lowering of the minimum capital requirement.

The Group ends the year well capitalised, even after the resumption of distributions to shareholders in the form of dividends and buy-backs, and allowing for the return of CCyB requirements and withdrawal of IFRS 9 reliefs in the longer term. This position is both prudent and sustainable and helps ensure the viability of the business for the benefit of all stakeholders.

4 FINANCIAL RESULTS

The Group's trading performance before impairment charges in the year ended 30 September 2021 highlights the level of progress towards its strategic objectives, in spite of the impact of the Covid pandemic on the UK economy and the necessary steps taken to address this. Income and margins both increased, generally in line with expectations.

As the UK economy began to open up towards the end of the year, and the level of the effectiveness of the UK's vaccination programme became evident, the assumptions underlying the Group's impairment provisioning were revisited, resulting in a release of provision. However the Group remains well provided in the face of what remains an uncertain economic outlook.

These factors leave the Group's results significantly improved, year-on-year, with underlying profit (Appendix A) for the year, at £194.2 million, 61.8% higher than for the preceding twelve months (2020: £120.0 million), with a provision release of £4.7 million (2020: charge of £48.3 million), unwinding some of the previous year's Covid-related impacts. On the statutory basis, which also includes the impact of fair value gains on hedging, profit before tax increased 80.5% to £213.7 million, the largest pre-tax profit the Group has ever recorded (2020: £118.4 million).

Earnings per share increased by 81.1% to 65.2 pence (2020: 36.0 pence) on the statutory basis, and by 62.5% to 59.3 pence excluding the effect of the fair value gains (2020: 36.5 pence) (Appendix A).

4.1 CONSOLIDATED RESULTS

CONSOLIDATED RESULTS
For the year ended 30 September 2021

	2021	**2020**
	£m	**£m**
Interest receivable	484.2	491.7
Interest payable and similar charges	(173.7)	(213.6)
Net interest income	**310.5**	**278.1**
Net leasing income	3.5	3.0
Other income	10.9	14.0
Total operating income	**324.9**	**295.1**
Operating expenses	(135.4)	(126.8)
Provisions for losses	4.7	(48.3)
	194.2	120.0
Fair value net gains / (losses)	19.5	(1.6)
Operating profit being profit on ordinary activities before taxation	**213.7**	**118.4**
Tax charge on profit on ordinary activities	(49.2)	(27.1)
Profit on ordinary activities after taxation	**164.5**	**91.3**

4 FINANCIAL RESULTS (Continued)

	2021	2020
Dividend – rate per share for the year	26.1p	14.4p
Basic earnings per share	65.2p	36.0p
Diluted earnings per share	63.0p	35.6p

Income

The Group's total operating income in the year increased by 10.1% to £324.9 million (2020: £295.1 million). Net interest income increased in the year by 11.7% to £310.5 million (2020: £278.1 million). Part of this increase was a result of growth in the average loan book in the year, 4.9% higher at £13,017.0 million (2020: £12,408.7 million) (Appendix B), but the business also generated a 15 basis point increase in net interest margin ('NIM') for the year.

NIM in the year ended 30 September 2021 was 239 basis points (2020: 224 basis points) (Appendix B). Each of the Group's segments showed improved NIM in the period as a result of yield management activities in the business areas, coupled with tighter funding costs. Excluding the impact of the declining Idem Capital business, NIM increased by 19 basis points, from 209 basis points in 2020, to 228 basis points in the current year.

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

	Total Basis points	Excluding Idem Capital Basis points
Year ended 30 September		
2021	**239**	**228**
2020	224	209
2019	229	192
2018	219	153
2017	213	141

Other operating income was £14.4 million for the year, with the reduction from the £17.0 million reported in 2020 principally representing a reduction in income from non-core servicing contracts.

Costs

The Group's operating expenses for the year were £135.4 million, increasing by 6.8% year-on-year (2020: £126.8 million). The majority of the increase is attributable to charges for share-based payments (including related National Insurance 'NI' provision) which increased by £8.7 million, following a low charge in 2020 when Covid impacted on vesting expectations and depressed the Group's share price, on which the NI provision calculation is based.

The Group's average number of employees increased to 1,426 for the period, an increase of 2.9% over 2020 (2020: 1,385), generating an increase in non-share-based employment costs of 3.0%.

4 FINANCIAL RESULTS (Continued)

Costs unrelated to employment reduced in the year. The administration cost of the Group's outsourced savings deposits is determined by reference to the balance outstanding and increased by £0.5 million in the year, as a result of the 18.4% year-on-year growth in the Group's savings balance. These increases were offset by reductions in other areas, including travel and accommodation and office running costs, which reflect the direct impacts of the pandemic and of the associated lockdowns through much of the year.

Despite the impact of Covid, the Group has continued to invest in the development of systems to improve customer service and operational efficiency. Significant improvements were delivered to capabilities in the retail deposit business and new functionality was introduced to the SME lending business.

Much of the Group's IT systems and infrastructure development is carried out by its experienced in-house resource, and the Group has therefore tended to capitalise less software than might be seen elsewhere in the sector, with more costs being taken immediately to profit. During the period £0.7 million of software was capitalised (2020: £1.0 million).

The Group's IRB project made further progress through the period, with the second stage of the application for buy-to-let submitted in March 2021. Costs for the year include expenditure of around £1.3 million on this project, relating to both internal resources and external advice.

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

	Underlying	Idem excluded	Statutory
	%	%	%
Year ended 30 September			
2021	41.7	42.8	41.7
2020	43.0	44.9	43.0
2019	42.1	48.5	40.7
2018	40.6	54.2	37.8
2017	40.5	55.6	40.5

Cost:income reduced in the year as a result of income rising faster than costs, as described above.

The Group considers that the ongoing management of costs is key to the achievement of its operational strategy and seeks to enhance cost-effectiveness from efficiencies and scale, with targeted investment in people and systems. However, the costs of these investments, coupled with new business initiatives and increasing regulatory expectations mean that the achievement of a sustainably lower ratio is a longer-term goal.

Impairment provisions

The Group's Expected Credit Loss ('ECL') evaluation at the year end has resulted in a net release of impairment provision for the year of £4.7 million (2020: charge of £48.3 million). This movement arises from a careful consideration of the factors impacting the Group's loan portfolio, including the progress and impact of the Covid pandemic, both generally and on particular customers, and requires a significant exercise of judgment.

4 FINANCIAL RESULTS (Continued)

The progress of the impairment charge and cost of risk in the three years since the introduction of IFRS 9 in 2019 is set out below.

	(Release) / charge £m	Cost of risk %
Year ended 30 September		
2021	(4.7)	(0.04)
2020	48.3	0.39
2019	8.0	0.07

The high level of provisions in 2020 arose as the initial impact of the Covid pandemic was recognised, attempting to represent a weighted average expected loss based on many plausible outcomes of significantly varying severity. This exercise was skewed by the natural asymmetry of provision for secured lending – increased stress will, on average, increase loss more than decreased stress reduces it.

The ongoing development of the pandemic since 30 September 2020 has differed, to a greater or lesser degree, from the scenarios advanced by commentators at the year end, but has generally been more benign, particularly following the rollout of the UK vaccination programme.

To date, little of the provision established at the previous year end has been utilised in writing off defaulted accounts, nor have arrears or enforcement actions generally seen significant increases. However, credit issues, some significant, have been identified with a small number of customers and the Group remains cautious on the future prospects of those loans for which provision is being carried. Support schemes from the UK Government, including furlough support to households and businesses, remain in place and, as at 30 September 2021, levels of CBILS and BBLS loans where customers have so far been required to make repayments have been low. This means that significant uncertainty as to the future behaviour of both directly and indirectly supported customers still exists.

At 30 September 2021, therefore, the Group had to consider whether sufficient hard evidence of both customer performance and a sustainable improvement in UK macro-economic conditions was available to justify a reduction in provision levels, and whether factors existed that suggested that its statistical impairment models might not be able to fully interpret current economic conditions.

Payment holidays and outcomes

The Group offered payment relief to a significant number of its customers during the initial period of the pandemic. Most of these came to an end before the previous year end on 30 September 2020, but some continued into the current financial year. By 30 September 2021, the number of the Group's customers remaining on these arrangements was minimal, with the requirement to make monthly payment arrangements back in place.

4 FINANCIAL RESULTS (Continued)

The post-relief behaviour in the Group's principal class, buy-to-let mortgages, at 31 October 2021 is summarised in the table below. This highlights, separately for accounts which did not receive payment holidays, those which received a single three month relief and those which had extended relief, the relative change between the October 2021 arrears position and the 29 February 2020, pre-Covid position.

	No relief	Single relief only	Extended relief	Total
	£ billion	**£ billion**	**£ billion**	**£billion**
Balance	**9.24**	**1.39**	**0.74**	**11.37**
Proportion	*81.2%*	*12.2%*	*6.6%*	*100.0%*
% with arrears deterioration	0.3%	0.8%	5.2%	0.7%
% with arrears improvement	0.4%	0.9%	7.1%	0.9%

Payment holiday status (31 October 2021)

Whilst the overwhelming majority 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 identifying such accounts as, on the whole, riskier than average and transferring accounts with extended payment holidays from Stage 1 to Stage 2 for impairment purposes.

Performance across the books has been generally strong, with arrears metrics and loss experience broadly in line with pre-pandemic experience, while external credit measures, such as credit bureau information have also remained positive. However, due to government interventions and lender forbearance across the sector, it is unclear whether these measures are fully representative of underlying credit quality.

From the Group's customer surveys and interactions with its customers it is clear that while many customers may have taken payment reliefs for precautionary reasons, these accounts may have been able to perform due to external support. Examples of this might include tenants of buy-to-let landlords accessing furlough payments to meet rent demands and SME customers using drawings under CBILS and BBLS schemes to meet day-to-day payments. These reliefs would still have an impact at the end of the financial year, but have a limited time scale and the current level of performance may not be fully representative of the true underlying credit position.

As a result, management have maintained the approach of critically assessing the outputs of business-as-usual provisioning methodologies to ensure all elements of credit quality in the portfolio are adequately addressed. This approach has been taken throughout the Covid crisis and has resulted in substantial overlays to model outputs.

4 FINANCIAL RESULTS (Continued)

Multiple economic scenarios and impacts

While there is somewhat more consensus on the likely direction than at the previous year end, the setting of economic scenarios for the purposes of IFRS 9 remains complex. The broad thrust of economic data for the UK over the past six months has been positive, but this has been in a period where government interventions have continued and there is continuing uncertainty over the direction the economy will take once these begin to be withdrawn, with potentially radically different medium term outcomes.

The approach to setting economic scenarios for IFRS 9 impairment at 30 September 2021 is broadly aligned to that used at the half year. The Group has adopted a two-part approach

- the three main scenarios, central, upside and downside, were derived as they would be at a 'normal' year end with the central scenario based on public forecasts and the upside and downside scenarios more benign or severe variants of this. This follows the general sentiment towards the UK economy, assuming a continuation of the easing of Covid restrictions and no significant impact from a new wave of infections.
- The severe scenario has been set to represent a potential negative outturn, either for the economy, for the pandemic, or for both. This is largely based on the Bank of England's stress testing scenarios, but with a less optimistic outlook on house prices, the variable which has the most significant impact on the value of the Group's ECLs. This scenario models a radically different future course for the UK, which is plausible and potentially has a very different impact on the Group's customers.

The weightings applied to each scenario have been held at those used at both 30 September 2020 and 31 March 2021, in the light of the continuing economic uncertainty described above. The forecast economic assumptions within each scenario, and the weightings applied, are set out in more detail in note 11.

To illustrate the impact of these scenarios, the impairment provision at 30 September 2021 before post-model adjustments ('PMA's) has been recalculated, weighting each of the central scenario and the severe scenario at 100%, with the results shown below.

	Provision before PMAs £m	Cover ratio
Weighted average	46.0	0.34%
Central scenario	33.3	0.25%
Severe scenario	86.7	0.64%

The level of provisions calculated by the Group's models are lower than might be expected, given the economic conditions. The Group has therefore considered the extent to which this is due to weaknesses in the modelling approach, and should be corrected by PMAs.

4 FINANCIAL RESULTS (Continued)

Post-model adjustments

It is important to note that the impairment model focusses principally on the impact of future economic changes on the portfolio. Where accounts are currently only being kept from defaulting by external short-term support measures they may still default when these are removed, despite an improved economic climate. The models may also fail to fully allow for longer-term damage caused to particular industries or customers' businesses by the pandemic.

It is also clear that positive movements in economic indicators such as house prices, unemployment and UK Gross Domestic Product ('GDP'), both in actual and forecast terms have had a positive impact on the modelled outputs for cases benefitting from support measures without any broader evidence of improvement in the underlying credit quality of the customer balances being available.

Therefore the Group applies PMAs, based on its experience and its understanding of current customer positions, to allow for the potential for losses in such cases not being identified by the modelling approach.

In order to size the requirement for PMAs across the loan book the Group has considered, on a portfolio-by-portfolio basis the extent to which modelled provisions diverge from long-run experience and the appropriateness of such differences given the underlying economic environment at the period end. All available external information on general customer performance was analysed and the impact of the potential take-up of government support and other reliefs was assessed. The Group also considered whether there were any issues of post-Covid scarring applying to any particular industry.

Notwithstanding this data analysis, the Group considered the potential for apparently well-performing accounts to default, for the reasons set out above, applying the market understanding and credit judgement of its experienced team. The SME lending business was a particular area of focus, given the prevalence of CBILS / BBLS funding in the customer base and the identification of potential credit issues on certain large exposures.

The PMAs generated by this process, analysed by division are set out below.

	2021 £m	2020 £m
Mortgage Lending	8.9	14.0
Commercial Lending	10.2	5.8
Idem Capital	0.3	-
	19.4	19.8

These broader assessments were then allocated amongst accounts, focussing on higher risk segments, or accounts where sufficient data existed to identify any. Any accounts identified as at significant risk by the PMA process were restaged appropriately.

The PMAs described above align the overall reported provision with current loss expectations, given the inherent uncertainties on a macro and micro level and based on the Group's internal monitoring of credit risk and customer contact metrics. The Group maintains a cautious approach and will require evidence as to customer behaviour once government interventions are scaled back, before moving scenario weightings to more normal levels and revising PMA methodologies so that actual emergent behaviour is reflected.

4 FINANCIAL RESULTS (Continued)

Ratios and trends

The impact of the economic scenarios adopted, together with PMAs adopted to address uncertainties over the future performance of accounts, particularly those which may have had payment relief or other government-backed support during the pandemic, has resulted in the overall provision amounts and coverage ratios set out below.

	2021 £m	2020 £m	2019 £m
Calculated provision	46.0	62.0	41.9
PMAs	19.4	19.8	-
Total	65.4	81.8	41.9
Cover ratio			
Mortgage lending	0.30%	0.44%	0.26%
Commercial lending	1.74%	1.85%	0.73%
Idem lending	1.27%	1.62%	1.12%
Total	0.49%	0.64%	0.34%

These ratios demonstrate the movement in the Group’s overall provisioning back towards more normal levels, without yet reaching the 0.34% coverage ratio seen pre-pandemic at 30 September 2019. The extent to which coverage levels revert to these levels will depend on future performance of the UK economy and on the emergence of reliable evidence on the underlying credit quality of the Group’s loan assets.

Fair value movements

The fair value movements reported in the profit and loss account are a consequence of the impact of market movements in spot and forward interest rates on valuations of derivatives held as part of the Group’s hedging strategy. While all these instruments are part of economic hedging relationships, their accounting treatment can result in the recognition of substantial gains or losses, especially in periods of market fluctuation. However, the Group remains appropriately hedged.

Movements in rates in 2021 led to a gain of £19.5 million being recognised. While this is of far greater magnitude than the £1.6 million charge recognised in the year ended 30 September 2020, it is comparable in size to the charge of £15.1 million recognised during 2019. These fair value movements reflect non-cash items and revert to zero over the lives of the instruments involved. This, and the volatility of the balance, leads the Group to consistently exclude this item from its measures of underlying results.

4 FINANCIAL RESULTS (Continued)

Tax

The effective tax rate applied to the Group's profits has increased marginally from 22.9% in 2020 to 23.0% during 2021. 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 impact of the surcharge on the effective rate to increase from 338 basis points to 454 basis points in the current year, with other timing differences representing the reconciling item to the actual charge.

The effective tax rates for both the current and preceding year have been impacted by legislation for changes in future tax rates enacted in each period, impacting on the carrying value of the Group's deferred tax assets and liabilities.

While the Group's future profitability will be affected by the increase in the basic rate of UK corporation tax to 25% legislated for in the year, the proposed reduction in the bank surcharge to 3% and the increase in the profit threshold at which it applies to £100.0 million should reduce the divergence of the Group's effective rate of tax from the standard rate.

Results

Profit before tax for the year was 80.5% higher than in 2020 at £213.7 million (2020: £118.4 million), representing the Group's highest ever annual profit. Profit after tax increased 80.2% to £164.5 million (2020: £91.3 million).

Basic earnings per share for 2021 were 65.2 pence (2020: 36.0 pence) and the diluted measure was 63.0 pence per share (2020: 35.6 pence), driven by both the increase in profit and share buy-backs in the year.

This result increased consolidated equity to £1,241.9 million (2020: £1,156.0 million), representing a tangible net asset value of £4.34 per share (2020: £3.90 per share) and a net asset value on the statutory basis of £5.03 per share (2020: £4.57 per share) (Appendix D).

4 FINANCIAL RESULTS (Continued)

4.2 ASSETS AND LIABILITIES

SUMMARY BALANCE SHEET
30 September 2021

	2021 £m	2020 £m	2019 £m
Investment in customer loans			
Mortgage Lending	11,608.7	10,819.5	10,344.1
Commercial Lending	1,568.8	1,514.8	1,452.1
Idem Capital	225.2	297.1	389.9
	13,402.7	12,631.4	12,186.1
Derivative financial assets	44.2	463.3	592.4
Cash	1,360.1	1,925.0	1,225.4
Intangible assets	170.5	170.1	171.1
Other assets	159.5	315.7	220.5
Total assets	15,137.0	15,505.5	14,395.5
Equity	1,241.9	1,156.0	1,108.6
Retail deposits	9,300.4	7,856.6	6,391.9
Other borrowings	4,451.4	6,229.7	6,648.4
Derivative financial liabilities	43.9	132.4	80.5
Pension deficit	10.3	20.4	34.5
Other liabilities	89.1	110.4	131.6
Total equity and liabilities	15,137.0	15,505.5	14,395.5

The Group's loan portfolio grew by 6.1% during 2021, with growth in both Mortgage Lending and Commercial Lending. Balances in the Idem Capital division continued to pay down. 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 reduced by 2.0% during the year, despite the growth in the business, in response to the Group's cautious relaxation of the liquidity strategy put in place in response to the pandemic and the refinancing of its legacy securitisation transactions. The proportion represented by retail deposits increased to 67.6% in accordance with the Group's long-term funding strategy (2020: 55.8%). The Group's cash balance reduced by £564.9 million, partly due to a £100.1 million reduction in cash held in securitisation vehicles, following the collapse of schemes in the year, and partly due to liquidity policy. Movements in funding balances are discussed in more detail in Section 2.

4 FINANCIAL RESULTS (Continued)

Derivatives

The largest part of the movements in the derivative financial asset balance reflects the retirement of the remaining Group's currency denominated floating rate notes during the year and the consequent settlement of their related hedging instruments. The value of these swaps in the 2020 balance sheet was £445.3 million. These movements do not impact the Group's results.

Derivative assets used for interest rate hedging increased by £24.3 million, while derivative liabilities decreased by £88.3 million, mostly as a result of volatility in the year in market interest rate movements. These were largely offset by a £104.2 million decrease in the hedging adjustment on loans to customers, included in sundry assets above, and a £13.4 million reduction in the adjustment on retail deposits, included in sundry liabilities.

Pension obligations

The International Accounting Standard ('IAS') 19 valuation of the Group's defined benefit pension scheme deficit reduced by £10.1 million in the period. The principal factor in this reduction was the better than expected performance of the scheme assets, as world markets began to recover from losses suffered in the early stages of the pandemic. The deficit at 30 September 2021 stood at £10.3 million (2020: £20.4 million).

The Group's pension arrangements were restructured in the year to limit future exposure. However this has no impact on obligations already accrued, or their valuation.

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 2021 was estimated at £1.0 million, a reduction of £8.7 million in the period (2020: £9.7 million), representing a 99.4% funding level (2020: 93.9%).

Other assets and liabilities

Sundry assets have decreased by £156.2 million over the year. This reduction arose principally as a result of hedging transactions by movements in swap rates which generated the £104.2 million movement in fair value hedging referred to above and generated a £66.9 million decrease in Credit Support Annex ('CSA') collateral deposits as a result of the increased value of derivative liabilities.

Other movements included the recognition of a current tax liability, rather than last year's asset of £5.7 million, with payments on account in the year, based on the 2020 profit, being less than the calculated tax payable; an increase of £8.6 million in mandatory CRD deposits at the Bank of England, which are calculated based on the size of the Group's deposit base; and a £4.3 million increase in property, plant and equipment, mostly related to the recognition of a right of use ('RoU') asset in respect of the lease on the Group's new London office.

Within sundry liabilities, which reduced by £21.3 million, the reduction in the fair value adjustment of £13.4 million, as referred to above, and an £11.8 million reduction in accrued investment interest payable resulting from reduced interest rates, are offset by the £1.4 million tax creditor.

4 FINANCIAL RESULTS (Continued)

4.3 SEGMENTAL RESULTS

The underlying operating profits of the three segments described in the Lending Review in Section A4.1 are detailed fully in note 2 and are summarised below.

	2021 £m	2020 £m
Segmental profit		
Mortgage Lending	213.8	154.3
Commercial Lending	75.7	45.9
Idem Capital	17.1	19.6
	306.6	219.8
Unallocated central costs and other one-off items	(112.4)	(99.8)
	194.2	120.0

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 continued to perform strongly, with a strong lending performance, a reduction in the proportion of older, lower yielding assets and the Group's tighter overall funding costs combining to deliver a 15 basis point improvement in segmental NIM.

With the average mortgage book increasing by 6.0% in the year, this delivered a 15.4% increase in net interest to £219.2 million (2020: £190.0 million).

The Group's mortgage accounts continued to perform well in the year, generating a provision release of £5.9 million (2020: charge of £25.8 million). Despite this release, coverage levels remain in excess of pre-Covid levels, in response to the uncertainties still prevalent in the UK economy.

Overall these factors drove a 38.6% increase in segment profit for the year, to £213.8 million (2020: £154.3 million).

4 FINANCIAL RESULTS (Continued)

Commercial Lending

The contribution to profit of the Commercial Lending segment for the year was £75.7 million, rising by 64.9% year-on-year (2020: £45.9 million), with the improvement generated by improved NIM and a reduced provision charge.

The average loan balance increased by 3.9% in the year, but within this there were important mix changes, with the average development finance balance increasing by 9.1% and structured lending by 16.8%. Government-backed loans, where margins are low, had increased to form 5.3% of the portfolio by the year end.

The combination of these changes and tighter funding costs across the Group saw divisional NIM increase from 5.53% to 6.13%, delivering a 15.1% increase in net interest for the year to £94.5 million (2020: £82.1 million).

The impairment charge for the division reduced to £2.9 million (2020: £21.7 million). While the majority of accounts in the segment have continued to perform satisfactorily, provisions have not yet been returned to pre-Covid levels of cover, particularly in the SME lending business. As discussed under 'Impairment' above, many SME customers will potentially have been in receipt of CBILS and BBLS funds or other government support for their business operations. It is therefore too early to conclude that the current positive performance is sustainable in the long-term as the impact of these interventions fades. At the same time, a limited number of SME lending cases with serious credit issues have already been identified and appropriately provided for.

Idem Capital

The acquired Idem Capital loan portfolios continued to run off through the year, with no new transactions completed. As a result the average loan balance fell by 24.0%, following the trend of the previous year. Net interest decreased by 22.6%, to £20.2 million (2020: £26.1 million), as a consequence of this reduction.

While annualised NIM improved in the year to 7.74% (2020: 7.60%), reversing the long-term decline in NIM is this segment, this was principally a result of a Covid related interest adjustment in 2020 which depressed the margin in that period. On an underlying basis NIM in the segment continues to move down as higher margin portfolios pay off more rapidly than lower margin secured assets.

The performance of the division's portfolios in the year has been satisfactory, with cash flows in line with expectations. As a result of this and the improving economic outlook an impairment provision write back of £1.7 million was recognised (2020: charge of £0.8 million).

Overall, these factors restricted the decline in the segment profit to 12.8%, with a contribution of £17.1 million to the Group result (2020: £19.6 million).

5 OPERATIONS

Throughout the pandemic, while the Group's business has inevitably been impacted by the impact of the virus on its people, customers and other stakeholders, and by the changing official guidance and levels of restrictions imposed in the UK, its priority has been to maintain business-as-usual, as far as possible. This has largely been achieved and has played a large part in both delivering the outstanding results for the period and in ensuring the Group is well placed to take advantage of the recovering economy.

It is still too early to say how the experiences of the pandemic will impact both the Group's business model and the way it operates in the longer term, but, with most of the Group's people returning to its offices for at least part of the week by the end of the year, the process of developing working models for the future is well in hand.

5.1 OPERATIONS

The Group employs almost 1,450 people, with the majority normally based in its Solihull offices. However, from the onset of the Covid pandemic approximately 90% of employees worked from home.

As a result, the Group was able to continue to provide a full service to customers, intermediaries and other business partners throughout the various lockdowns, while at the same time continuing to develop the business and address issues arising from the pandemic, particularly in dealing with the transition of customers from payment reliefs back to normal payment profiles.

For the vast majority of employees, working from home continued until September 2021 when hybrid working pilots were introduced. New hires during the period predominantly joined the Group working from home, with technology-enabled induction and training plans providing them with the support they needed to start their new roles. All employees are now trialling flexible, hybrid ways of working.

The Group is proud that it has been able to continue to develop the business through new systems, processes and products despite the restrictions on contact, rather than simply mark time until the pandemic is concluded.

Instead, the year has seen the Group complete or progress a significant number of technological, operational and regulatory projects. While long-term projects to provide better technology for the development finance, SME lending and savings operations continued in the period, other important projects included enhancing the Group's cyber-security, developing its operational resilience capabilities, putting in place contingency plans in case of negative interest rates and preparing for the transition of LIBOR-linked customer accounts to alternative reference rates. Overall, the year saw more projects delivered than most recent comparable time periods.

The Group continues to envisage that its office hubs will remain important to ensure that its culture and identity can continue to grow, that collaboration is encouraged and that its peoples' sense of belonging is nurtured. To that end it was pleased to sign a lease during the period on a new, more energy efficient, central London base, bringing together its City-based staff, replacing two existing locations, and providing a venue to interface with stakeholders in the capital.

5 OPERATIONS (Continued)

The Group has demonstrated agility and flexibility in how its resources have been deployed throughout the pandemic, with short-term secondments being introduced to support operational volumes resulting from initiatives such as payment holidays.

Throughout the pandemic the Group's strategy has focussed on customer outcomes, particularly for more vulnerable customers and it was very pleasing that the Group's Financial Ombudsman Service ('FOS') complaints data shows no significant increase in the period. The number of complaint cases reported to FOS in the six months ended 30 June 2021, the most recent reporting period, was 50 with an uphold rate of 34.0% while the number for the six months ended 31 December 2020 was 60, with an uphold rate of 43.3%.

Overall, the Group is very pleased with the way that its people and infrastructure have continued to respond to the challenges posed by the pandemic.

5.2 GOVERNANCE

Through most of the year the Group continued to operate on a pandemic footing, with board and committee meetings being held remotely. However in June 2021, at its annual offsite strategy conference, the Board was able to meet in person for the first time since March 2020 and resumed physical board meetings in September 2021.

The impact of the pandemic on all the Group's stakeholders has continued to be an area of significant focus for the Board and the Group's ongoing response has been thoroughly reviewed. The Group's 2021 AGM was held in February on a closed basis, in accordance with UK Government guidance and the Board was disappointed that shareholders could not be given the opportunity to attend in person. However, arrangements were made to allow shareholders to view the meeting online and they were encouraged to participate in the meeting by completing and returning their proxy voting forms. The Board is hopeful that the 2022 AGM, due to be held in March, can be conducted on a more normal basis.

Throughout the year ended 30 September 2021 the Group continued to comply with the principles and provisions of the UK Corporate Governance Code ('the Code'). The Group adopted the 'comply and explain' approach under Provision 19 of the code to extend the Chair's tenure past nine years for succession planning purposes and to ensure the appointment of a suitable replacement Chair, as set out below.

Board of Directors

Fiona Clutterbuck's nine-year term on the Board came to an end in September 2021 since she was first appointed in 2012. However, the Board and Nomination Committee considered Fiona's re-appointment beyond nine years and agreed that, in the interests of succession planning purposes and to ensure a smooth transition of duties to Fiona's successor, her appointment be extended to September 2022. Fiona will therefore stand for re-election at the Annual General Meeting in March 2022. A search process, led by Hugo Tudor, the Senior Independent Director, is taking place and the results will be communicated to stakeholders once the process is complete.

5 OPERATIONS (Continued)

As announced in the Group's 2020 year end results announcement, Finlay Williamson stepped down from the Board on 31 December 2020. Peter Hill, who was appointed to the Board on 27 October 2020, assumed the role of Risk and Compliance Committee Chair from 31 December 2020.

Peter Hill was appointed to the Board following a robust search and selection process. He was Chief Executive Officer of Leeds Building Society, one of the UK's largest building societies, from 2011 until his retirement in 2019, having previously worked in a number of senior management positions within the society. Peter is currently a non-executive director of Pure Retirement Limited and chair of its risk committee and is also chair of the board at Mortgage Brain. He 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.

As at 30 September 2021, the Board has three female directors, including the Chair of the Board, out of a total of eight board members, forming 37.5% of the Board.

A4.5.3 MANAGEMENT AND PEOPLE

The Group employs almost 1,450 people and during the period headcount has grown by 3.6% (1.4% 2020), largely driven by the creation of new roles in customer facing and risk and compliance functions.

People and development

During the period the Group's priority has continued to be the wellbeing of employees and ensuring that they were provided with adequate support as the pandemic continued. The Group's Wellbeing team has played an important role in helping employees with their mental, physical, financial, and emotional wellbeing over the year through numerous initiatives. Wellbeing pulse surveys ensured that the Group continually monitored and responded to how employees were coping with the pandemic and feedback continued to reflect that employees were pleased with the quality and frequency of communications and how the Group was responding to the ongoing situation.

No employees were placed on furlough or made redundant as a result of Covid, and no use was made of the UK Government Coronavirus Job Retention Scheme in the year.

The Group conducted an employee engagement survey in June 2021, its first since December 2017; this produced a very strong set of positive indicators, including an overall engagement score of 87% (2017: 81%) and an employee net promoter score of +24 (2017: -3, industry norm: +21).

Retention of employees continues to remain high, with the attrition rate of 8.6% (2020: 10.4%) continuing to track below the national average. These high levels of retention are further bolstered by 57% of employees achieving over 5 years' service, 13% achieving over 20 years with the Group and 5% achieving over 30 years' service.

5 OPERATIONS (Continued)

Employees continued to show flexibility during the year with many undertaking secondments to different areas of the business to ensure that the Group continued to meet the needs of its customers. Although the decision was made to close the Second Charge Mortgage business in the year, all 26 affected employees were offered alternative roles, with only a small number deciding to take voluntary redundancy.

The Group maintains its accreditation from the UK Living Wage Foundation and minimum pay continues to meet the levels set by the Foundation, while holiday entitlement for all employees was enhanced during the year.

A new performance management approach was rolled-out, removing the need for a formal annual appraisal and replacing this with more frequent and timely conversations about performance throughout the year. This not only supports individual performance and personal development, but also helps the Group to effectively manage rising talent and fulfil its succession planning objectives.

The third cohort of the Group’s senior leadership development launched this year with a further nine delegates. The programme is aimed at developing those identified as successors for the executive management team and their direct reports. During this year two members of this programme from previous cohorts secured promotions within the Group. To support the Group’s wider training objectives, a new learning management system, Learn Amp was launched in February. This hosts internally designed content alongside relevant subscription material to ensure there is a broad, yet relevant range of learning available for all employees to access.

Equality and diversity

The Group made significant progress on its diversity and inclusion strategy during the year. Richard Rowntree, Managing Director – Mortgages, has taken on the role of executive sponsor for equality, diversity and inclusion (‘EDI’) and sponsors the Group’s EDI Network which was launched in October 2020. The Network has had a significant impact in a short space of time and has been involved in the launch of a number of training offerings to all employees, including new EDI eLearning, a new ‘Inclusive Workplace’ course and an ‘Inclusive Leadership’ course for all managers.

The Network also worked with Human Resources to run a diversity data capture campaign in September 2021. 63% of employees completed a diversity profile on the HR management system and the collation of this data from employees provides the Group with an enhanced ability to monitor and improve the diversity of the workforce going forward.

The Group has made further important commitments to improving the diversity of its workforce by signing up to Business in the Community’s Race at Work Charter and becoming accredited as a Disability Confident employer. These commitments complement the pledge the Group previously made to HM Treasury’s Women in Finance Charter in 2016.

The Group is pleased to report that is has now achieved each of its targets set under the Women in Finance Charter in 2017, which focussed on female and ethnic minority representation in the workforce and management. The Group is currently considering the next phase of this initiative.

5 OPERATIONS (Continued)

Details of progress against our targets can be found below.

Measure	Target	Sep 2021	Status
Female representation in senior management *	35%	38.7%	Achieved
Females in workforce	50%	52.5%	Achieved
Females as a percentage of employees receiving management career development and leadership training	50%	52%	Achieved
Managers from an ethnic minority background	10%	13.4%	Achieved
Workforce on flexible working	10%	24.0%	Achieved
Flexible working on a part time basis	50%	73.6%	Achieved

*Senior management is defined using the FTSE Women Leaders definition, while the ethnicity measure is based on those employees who self-identified.

To support its efforts to improve gender equality the Group has continued to participate in the 'Women Ahead 30% Club' cross-company mentoring scheme. This programme has proven popular with both mentors and mentees and a similar scheme is being piloted for employees from ethnic minorities over the coming year.

The Group welcomes the increasing interest in the diversity and inclusion agenda from all its stakeholders and has participated in the recent FCA Diversity and Inclusion survey.

Remuneration policy

The PRA remuneration rules applicable to the Group changed with effect from 1 October 2021, as the Group qualifies as a Proportionality Level 2 ('Level 2') bank from that date, bringing it within the scope of more onerous rules. This is a result both of the reduction in the asset threshold defining a Level 2 bank from £15 billion to £13 billion, announced by the PRA in December 2020, and of the development of the rules themselves in response to Capital Requirements Directive V ('CRD V').

A full gap analysis was performed against the updated rules, with affected employees being identified and remuneration arrangements appropriately adjusted. The majority of the significant changes required to remuneration policies were prospectively approved at the 2020 AGM, with more minor changes approved by the Remuneration Committee in the period.

The Group has also taken steps to assess the status of the small number of off-payroll workers in the business and made necessary changes to ensure the Group does not enter into engagements with workers who are paid through personal service companies and similar arrangements and fall within IR35 status for tax purposes, avoiding the complexities of such arrangements.

5 OPERATIONS (Continued)

5.4 SUSTAINABILITY

Sustainability, including resilience in the face of climate change risks, is core to the Group's strategy: to focus on specialist markets, delivering long-term sustainable growth and returns through a low risk and robust business model. Sustainability influences every aspect of the Group's business and means:

- Reducing the impact of the Group's operations on the environment
- Ensuring that the Group has a positive effect on our stakeholders and communities
- Delivering sustainable lending through the design of products offered and the choices of sectors in which to operate

The Group intends to publish a Responsible Business Report, its first sustainability report, in December 2021, providing more detailed information on its sustainability initiatives.

Climate change

Climate change is designated as a principal risk within the Group's Risk Management Framework. Information and measures on climate change risks are considered at board level and the Group's responses are considered within the Board's overall strategy. These risks fall into two main groups:

- Physical risks (which arise from weather-related events)
- Transitional risks (which come from the adoption of a low-carbon economy)

The Group has an internal Climate Change Forum, sponsored at executive level and containing representation from across the business, to share information on initiatives within business areas and to help develop the Group's overall response.

During the year the first issuance was made under the Group's Green Bond Framework, which was published in the year and which reflects the Group's commitment to embed sustainability throughout its strategy, operations, and product offerings including funding and capital raising activities. This was the first issue of a green capital instrument by a bank in the UK. The Sustainability Committee, established in the year under the oversight of the Executive Committee, is responsible for the Framework.

Developments in sustainable products and climate-related exposures are discussed in the relevant business reviews.

While the Group is not required to report on climate change risk and exposures under the TCFD framework until its 2022 year end, it has signed up as a TCFD supporter, and the disclosures made in respect of the year have been organised using TCFD as a template.

5 OPERATIONS (Continued)

Social engagement

Despite the difficulties for fund-raisers created by the pandemic, the Group's Charity Committee raised over £43,000 for Macmillan Cancer Support, the Group's chosen charity for the 2020 calendar year. For the 2021 calendar year the Group is supporting the Alzheimer's Society with £22,000 raised by September 2021.

The Group has begun to restart its community and volunteering initiatives as pandemic restrictions cease, with employees looking forward to reengaging as soon as possible.

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.

Inevitably the ongoing impacts of the pandemic have, and continue to be, a priority for the Group and the longer-term implications are still unclear. The Group continues to monitor closely the economic impacts, changes to lending profiles, business volumes and customer credit risk as the immediate restrictions necessitated by the pandemic are released. It is recognised that the wider pandemic is still a global challenge and the possibility of further waves and subsequent lockdowns may pose further issues during the coming months.

However, given the work done over the last 18 months the Group feels it is well-placed to respond to any further Covid-related disruption. 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.

The Group continues to focus on specific risk issues that have arisen as a direct result of the pandemic. These include:

- Ensuring a Covid-safe return to office-based working and in the longer-term trialling more flexible and hybrid ways of working which are core to the strategy of attracting and retaining highly skilled employees, through a Group-wide pilot scheme
- Continuing oversight of the impacts of government schemes and initiatives implemented during the onset of Covid which necessitated rapid deployment of resources and innovation in processes. A small number of remaining payment holidays continue to be managed and where appropriate forbearance solutions necessitated through Covid are tailored to individual customer circumstances and that are aligned to regulatory guidance and expectation
- Continuing oversight of risks related to the provision of government-backed lending schemes to support businesses through Covid. Given the effective implementation of process changes and underwriting decisions the Group is positioned well to support any further government lending programmes of this nature

Whilst Covid has clearly dominated the risk landscape since early 2020, the Group has successfully continued to evolve and embed its risk management framework. Good progress has been made in further developing its ability to manage all categories of risk through the maturing ERMF.

5 OPERATIONS (Continued)

The evolution of the Group's risk framework remains a core priority and ongoing work is being undertaken to ensure it remains effective and proportionate in line with the Group's strategic aspirations. Significant recruitment has been undertaken during the year to bolster capability, external benchmarking has been undertaken to validate work undertaken and future plans, and a detailed roadmap for further development over the next 18 months has been agreed. Good progress has already been made in line with these commitments.

Despite the pervasive impact of the pandemic, the Group has identified and focussed on a number of non-Covid related strategic risk issues including:

- Strategy, operational and conduct-related risk implications of the changes in product design, funding and operations required to transition all LIBOR-linked customers to an alternative rate following the withdrawal of LIBOR in December 2021
- Further embedding operational resilience capabilities which have proven to be critical in handling the Covid situation. Importantly, lessons learned from the handling of the pandemic have been incorporated into the operational resilience framework together with continued refinement of the overarching approach in line with regulatory expectation
- Addressing the impact of climate change on managing financial risks and considering this as part of the wider ESG agenda across the Group
- Continuing to develop advanced models and embed the overarching model risk framework to enhance credit risk management and support the Group's IRB application process
- The impact of issues relating to defective cladding on high-risk buildings where these form the security for mortgage loans. Underwriting guidelines continue to be reviewed to ensure these remain in line with emerging best practice
- Enhancing stress testing procedures to ensure the robustness of capital and liquidity positions
- Ensuring effective cyber-security controls and a robust data protection approach particularly as these evolve in response to changing working practices

The Group continues to review its exposure to emerging developments in the Brexit process as further clarity is received as to future dealings with the EU. However, the end of the transition period on 31 December 2020 caused no immediate impact to the Group. Whilst 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. In particular, it has continued to monitor the issues related to the supply of essential goods which are causing shortages in a number of sectors. Whilst the Group is not directly affected by these issues at present the Board is keeping the situation under ongoing review as supply issues in areas such as building materials and IT equipment could impact the Group's operations.

5 OPERATIONS (Continued)

The principal challenges in the risk environment faced by the Group during the coming year and moving forward into 2023 and beyond include:

- Management of risks arising from changes introduced in response to Covid. With the ending of payment reliefs and the wider economic impacts of the crisis beginning to emerge, there will be a need to ensure appropriate treatment of ongoing arrears and the 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

- Addressing an increasing level of regulatory compliance standards, where the Group is committed to ensuring it remains compliant in all areas of its business. Particular focus in the Group is on ensuring that it meets regulatory expectations in respect of its anti-money laundering and wider financial crime control frameworks following the publication of the Dear CEO letter in May 2021

- Risks associated with climate change remain an ever-present challenge. The UK Government has confirmed its goal of net zero carbon by 2050 in November 2020 and the Group, and the rest of the financial services industry, have a vital role to play in that commitment. As global strategies continue to be refined the Group is looking to ensure both its operational impacts, and the impact of its lending activities, explicitly consider climate change risk as a core strategic driver

5.5 REGULATION

Paragon Bank is authorised by the PRA and regulated by the PRA and the FCA. The Group is subject to consolidated supervision by the PRA and a number of its subsidiaries are authorised and regulated by the FCA. As a result, current and projected regulatory changes continue to pose a significant risk for the Group. The impact and pace of change necessitated through the ongoing programme of revisions to the Basel supervisory regime continue to pose a significant risk for the Group. These together with other potential regulatory changes to the business are closely monitored through the comprehensive governance and control structures in place.

Since March 2020, the impact of Covid has largely driven the priorities of both UK and European regulators. The Group has continued to respond effectively to these ongoing challenges despite short consultation and implementation periods. All regulatory publications have been considered by the Group, any implications identified and required changes implemented within an appropriate timeframe. Over the last few months the Group has experienced data requests from the FCA on arrears and forbearance increasing in both scale and frequency. The Group continues to respond to these requests, and to focus controls on the delivery of fair customer outcomes.

5 OPERATIONS (Continued)

In addition to requirements introduced in response to Covid, the following developments currently in progress have the greatest potential impact on the Group:

- The Bank of England published a Consultation Paper ('CP') setting out proposed changes to the Minimum Requirement for Own Funds and Eligible Liabilities ('MREL') on 22 July 2021. The CP builds on the Discussion Paper published in December 2020 and factors in the responses it received from impacted banks and building societies. On 3 December 2021 the Bank of England published a Statement of Policy based upon this consolidation. Although the Group is not currently subject to MREL requirements, given its potential for growth it may be required to issue MREL eligible instruments at some point in the future.

- The Bank of England MPC confirmed in February 2021 that negative interest rates still form part of its monetary policy toolkit. In response, the PRA issued a 'Dear CEO' letter requesting firms initiate the implementation of tactical solutions to process zero and negative rates by August 2021. The Group has undertaken the analysis which confirmed that it is well-placed to meet any operational requirements should rates fall to zero or below

- The FCA's issued its consultation on "A New Consumer Duty" in May 2021. This seeks to set higher expectations for the standard of care provided to customers and will result in new rules relating to communications, products and services, customer service and price and value. The Group will continue to engage with UKF throughout the consultation period to ensure adequate preparation prior to the new rules coming into force

- The treatment of vulnerable customers continues to be a strong focus for the FCA, with further guidance having been finalised in February 2021. The Group continues to take its responsibilities in this regard seriously. Significant work continues to be undertaken to revise existing procedures, controls and training provisions to meet regulatory and industry expectations

- The FCA, PRA and Bank of England published their final rules and guidance on building operational resilience in financial services on 29 March 2021. As expected, this did not differ significantly from consultation papers and considerable work had already been undertaken by the Group to adhere to the draft proposals. Good progress has been made against the roadmap and the Group is well-positioned to meet the March 2022 policy implementation deadline including setting of impact tolerances, embedding a scenario testing approach and undertaking a self-assessment against the regulatory framework

- The Group continues to work towards embedding its approach to managing climate-related financial risks by the end of 2021 in line with the PRA expectations. A detailed plan of work has been developed which reflects regulatory and wider requirements and will continue to be refined as new thinking emerges. Managing the impacts of climate change is seen as a key strategic priority for the Group and significant effort has been made during 2021 to incorporate climate risk considerations within the Group's ERMF. The improved Governance which now includes the Sustainability Committee alongside the existing executive level risk committees ensures comprehensive consideration across all aspects of the business and ensure the Group is well-positioned to address the emerging challenges

5 OPERATIONS (Continued)

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 continues to monitor the impact of Brexit on its operations, but the longer-term regulatory changes are still unclear. With the extension of the temporary transitional powers for the regulators until 31 March 2022 by HM Treasury, regulatory obligations for firms generally remain the same. The Bank of England has commenced the consultation process for the incorporation of the prudential regulation regime previously set out in European legislation into the PRA Rulebook.

However, further clarity has yet to be provided as to how the regulatory landscape may evolve post March 2022. It is expected that the majority of requirements will be directly transcribed although the PRA has indicated it is willing to depart from EU text where this may enhance regulatory oversight in the UK.

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.

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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

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

Th Group has Enterprise Risk Management Framework ('ERMF') in place to ensure that these risks are monitored and managed in accordance with the Group's risk appetite.

DIRECTORS' RESPONSIBILITIES

The following statement of directors' responsibilities in respect of financial statements is included in the Annual Report and Accounts of the Group for the year ended 30 September 2021.

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 2021, that law includes the Companies Act 2006 ('the Companies Act'). That law requires the directors to prepare the consolidated financial statements in accordance with IFRS in conformity with the requirements of the Companies Act and they have also elected to prepare the financial statements of the Company on the same basis.

In addition the UK Disclosure and Transparency Rules ('DTR') of the FCA requires that the consolidated financial statements for the current year are prepared in accordance with IFRS adopted pursuant to EU Regulation (EC) No 1606/2002 (the 'IAS Regulation') as it applies in the EU.

IAS 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 and company financial statements have been prepared in accordance with IFRS in conformity with the requirements of the Companies Act
- state whether the consolidated financial statements have been prepared in accordance with IFRS as adopted by the EU pursuant to the IAS Regulation
- 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 Companies Act.

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

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

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

Confirmation by the Board of Directors

The Board of Directors currently comprises

F S Clutterbuck (Chair of the Board)

N S Terrington (CEO)

R J Woodman (CFO)

H R Tudor (SID)

B A Ridpath (Non-executive director)

G H Yorston (Non-executive director)

A C M Morris (Non-executive director)

P A Hill (Non-executive director)

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

- The financial statements, prepared in accordance with applicable accounting standards, 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 DTR, 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 position, performance, business model and strategy

Approved by the Board of Directors as the persons responsible within the Company

Signed on behalf of the Board

MARIUS VAN NIEKERK

Company Secretary

7 December 2021

PRELIMINARY FINANCIAL INFORMATION

D1.1 CONSOLIDATED STATEMENT OF PROFIT OR LOSS

For the year ended 30 September 2021

	Note	2021 £m	2021 £m	2020 £m	2020 £m
Interest receivable	3		484.2		491.7
Interest payable and similar charges	4		(173.7)		(213.6)
Net interest income			310.5		278.1
Other leasing income		20.4		19.2	
Related costs		(16.9)		(16.2)	
Net operating lease income		3.5		3.0	
Other income	5	10.9		14.0	
Other operating income			14.4		17.0
Total operating income			324.9		295.1
Operating expenses			(135.4)		(126.8)
Provisions for losses	11		4.7		(48.3)
Operating profit before fair value items			194.2		120.0
Fair value net gains / (losses)	6		19.5		(1.6)
Operating profit being profit on ordinary activities before taxation			213.7		118.4
Tax charge on profit on ordinary activities	7		(49.2)		(27.1)
Profit on ordinary activities after taxation for the financial year			164.5		91.3

	Note	2021	2020
Earnings per share			
- basic	8	65.2p	36.0p
- diluted	8	63.0p	35.6p

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

D1.2 CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended 30 September 2021

	Note	2021 £m	2021 £m	2020 £m	2020 £m
Profit for the year			164.5		91.3
Other comprehensive income					
Items that will not be reclassified subsequently to profit or loss					
Actuarial gain / (loss) on pension scheme	17	8.2		(7.4)	
Tax thereon		(0.9)		2.1	
			7.3		(5.3)
Items that may be reclassified subsequently to profit or loss					
Cash flow hedge (losses) taken to equity	12	(3.0)		(0.6)	
Tax thereon		0.5		0.1	
			(2.5)		(0.5)
Other comprehensive income / (expenditure) for the year net of tax			4.8		(5.8)
Total comprehensive income for the year			169.3		85.5

D1.3 CONSOLIDATED BALANCE SHEET

30 September 2021

	Note	2021 £m	2020 £m	2019 £m
Assets				
Cash – central banks	9	1,142.0	1,637.1	816.4
Cash – retail banks	9	218.1	287.9	409.0
Loans to customers	10	13,408.2	12,741.1	12,250.3
Derivative financial assets	12	44.2	463.3	592.4
Sundry assets		69.2	128.0	92.8
Current tax assets		-	5.7	-
Deferred tax assets		14.4	6.2	6.2
Property, plant and equipment		70.4	66.1	57.3
Intangible assets	13	170.5	170.1	171.1
Total assets		15,137.0	15,505.5	14,395.5
Liabilities				
Short term bank borrowings		0.3	0.4	1.0
Retail deposits	14	9,297.4	7,867.0	6,395.8
Derivative financial liabilities	12	43.9	132.4	80.5
Asset backed loan notes (‘Notes’)	15	516.0	3,270.5	4,419.4
Secured bank borrowings	15	730.0	657.8	787.5
Retail bond issuance	15	237.1	296.8	296.5
Corporate bond issuance	15	149.0	149.8	149.6
Central bank facilities	15	2,819.0	1,854.4	994.4
Sundry liabilities	16	90.7	100.0	112.7
Current tax liabilities		1.4	-	15.2
Retirement benefit obligations	17	10.3	20.4	34.5
Total liabilities		13,895.1	14,349.5	13,287.1
Called up share capital	18	262.5	261.8	261.6
Reserves	19	1,056.1	932.0	887.3
Own shares	20	(76.7)	(37.8)	(40.5)
Total equity		1,241.9	1,156.0	1,108.4
Total liabilities and equity		15,137.0	15,505.5	14,395.5

Approved by the Board of Directors on 7 December 2021.

Signed on behalf of the Board of Directors

N S Terrington — Chief Executive

R J Woodman — Chief Financial Officer

D1.5 CONSOLIDATED CASH FLOW STATEMENT

For the year ended 30 September 2021

	Note	2021 £m	2020 £m
Net cash generated by operating activities	22	878.1	1,028.7
Net cash (utilised) by investing activities	23	(4.3)	(2.8)
Net cash (utilised) by financing activities	24	(1,438.6)	(325.7)
Net (decrease) / increase in cash and cash equivalents		(564.8)	700.2
Opening cash and cash equivalents		1,924.6	1,224.4
Closing cash and cash equivalents		1,359.8	1,924.6
Represented by balances within:			
Cash	9	1,360.1	1,925.0
Short term bank borrowings		(0.3)	(0.4)
		1,359.8	1,924.6

D1.7 CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY

For the year ended 30 September 2021

Year ended 30 September 2021

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Cash flow hedging reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m	£m
Transactions arising from								
Profit for the year	-	-	-	-	-	164.5	-	164.5
Other comprehensive income	-	-	-	-	(2.5)	7.3	-	4.8
Total comprehensive income	-	-	-	-	(2.5)	171.8	-	169.3
Transactions with owners								
Dividends paid (note 21)	-	-	-	-	-	(54.6)	-	(54.6)
Own shares purchased	-	-	-	-	-	-	(42.2)	(42.2)
Exercise of share awards	0.7	1.4	-	-	-	(3.3)	3.3	2.1
Charge for share based remuneration	-	-	-	-	-	8.9	-	8.9
Tax on share based remuneration	-	-	-	-	-	2.4	-	2.4
Net movement in equity in the year	0.7	1.4	-	-	(2.5)	125.2	(38.9)	85.9
Opening equity	261.8	68.7	50.3	(70.2)	2.5	880.7	(37.8)	1,156.0
Closing equity	262.5	70.1	50.3	(70.2)	-	1,005.9	(76.7)	1,241.9

D1.7 CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY

For the year ended 30 September 2021

Year ended 30 September 2020

	Share capital £m	Share premium £m	Capital redemption reserve £m	Merger reserve £m	Cash flow hedging reserve £m	Profit and loss account £m	Own shares £m	Total equity £m
Transactions arising from								
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
Transactions with owners								
Dividends paid (note 21)	-	-	-	-	-	(35.9)	-	(35.9)
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)
Net movement in equity in the year	0.2	0.4	-	-	(0.5)	44.8	2.7	47.6
Opening equity	261.6	68.3	50.3	(70.2)	3.0	835.9	(40.5)	1,108.4
Closing equity	261.8	68.7	50.3	(70.2)	2.5	880.7	(37.8)	1,156.0

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2021

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 2019, 30 September 2020 or 30 September 2021, 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 2019 and 30 September 2020 have been delivered to the Registrar of Companies and those for the year ended 30 September 2021 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 2021 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.

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 2021

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.

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.

All 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 2021

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 2021

	Mortgage Lending £m	Commercial Lending £m	Idem Capital £m	Unallocated Items £m	Total Segments £m
Interest receivable	345.8	114.2	22.7	1.5	484.2
Interest payable	(126.6)	(19.7)	(2.5)	(24.9)	(173.7)
Net interest income	219.2	94.5	20.2	(23.4)	310.5
Other operating income	6.1	8.0	0.3	-	14.4
Total operating income	225.3	102.5	20.5	(23.4)	324.9
Operating expenses	(17.4)	(23.9)	(5.1)	(89.0)	(135.4)
Provisions for losses	5.9	(2.9)	1.7	-	4.7
	213.8	75.7	17.1	(112.4)	194.2

Year ended 30 September 2020

	Mortgage Lending £m	Commercial Lending £m	Idem Capital £m	Unallocated Items £m	Total Segments £m
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
Operating expenses	(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

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

	2021 £m	2020 £m
Results shown above	194.2	120.0
Fair value items	19.5	(1.6)
Operating profit	213.7	118.4

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

2. SEGMENTAL INFORMATION (CONTINUED)

The assets of the segments listed above are:

	2021	2020	2019
	£m	£m	£m
Mortgage Lending	11,732.0	11,488.2	11,279.9
Commercial Lending	1,608.1	1,554.3	1,488.4
Idem Capital	225.2	297.1	389.9
Total segment assets	13,565.3	13,339.6	13,158.2
Unallocated assets	1,571.7	2,165.9	1,237.3
Total assets	15,137.0	15,505.5	14,395.5

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

3. INTEREST RECEIVABLE

	2021	2020
	£m	£m
Interest receivable in respect of		
Loans and receivables	440.0	440.4
Finance leases	40.4	44.3
Factoring income	2.3	2.4
Interest on loans to customers	482.7	487.1
Other interest receivable	1.5	4.6
Total interest on financial assets	484.2	491.7

The above interest arises from:

	2021	2020
	£m	£m
Financial assets held at amortised cost	443.8	447.4
Finance leases	40.4	44.3
	484.2	491.7

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

4. INTEREST PAYABLE AND SIMILAR CHARGES

	Note	2021 £m	2020 £m
On retail deposits		120.5	129.7
On asset backed loan notes		17.9	42.2
On bank loans and overdrafts		6.6	5.4
On corporate bonds		9.3	10.9
On retail bonds		15.4	18.5
On central bank facilities		2.2	4.5
On repurchase agreements		0.1	-
Total interest on financial liabilities		172.0	211.2
On pension scheme deficit	17	0.3	0.4
Discounting on contingent consideration		0.3	0.4
Discounting on lease liabilities		0.2	0.2
Other finance costs		0.9	1.4
		173.7	213.6

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

5. OTHER INCOME

	2021 £m	2020 £m
Loan account fee income	5.1	5.7
Broker commissions	1.9	1.7
Third party servicing	3.5	5.0
Other income	0.4	1.6
	10.9	14.0

All loan account fee income arises from financial assets held at amortised cost.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

6. FAIR VALUE NET GAINS / (LOSSES)

	2021	2020
	£m	£m
Ineffectiveness of fair value hedges		
Portfolio hedges of interest rate risk		
Deposit hedge	(0.3)	0.2
Loan hedge	6.6	0.1
	6.3	0.3
Ineffectiveness of cash flow hedges	-	-
Other hedging movements	9.9	(2.9)
Net gains / (losses) on other derivatives	3.3	1.0
	19.5	(1.6)

The fair value net gain / (loss) represents the accounting volatility on derivative instruments which are matching risk exposures 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 2021 is charged at an effective rate of 23.0% (2020: 22.9%), 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 year was 19.0% (2020: 19.0%), based on currently enacted legislation. During the year ended 30 September 2020, 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 standard rate for the year ended 30 September 2020 from 18.0% to 19.0%, and the expected rate in subsequent years from 17.0% to 19.0% on deferred tax balances were accounted for in the year ended 30 September 2020.

During the current financial year, the UK Government enacted legislation increasing the standard rate of corporation tax in the UK to 25.0% from April 2023. The impact of this change on deferred tax balances has been accounted for in these accounts.

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.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

8. EARNINGS PER SHARE

Earnings per ordinary share is calculated as follows:

		2021	2020
Profit for the year (£m)		164.5	91.3
Basic weighted average number of ordinary shares ranking for dividend during the year (m)		252.3	253.6
Dilutive effect of the weighted average number of share options and incentive plans in issue during the year (m)		8.9	2.5
Diluted weighted average number of ordinary shares ranking for dividend during the year (m)		261.2	256.1
Earnings per ordinary share	- basic	65.2p	36.0p
	- diluted	63.0p	35.6p

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For the year ended 30 September 2021

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.

	2021 £m	2020 £m	2019 £m
Deposits with the Bank of England	1,142.0	1,637.1	816.4
Balances with central banks	1,142.0	1,637.1	816.4
Deposits with other banks	218.1	287.9	409.0
Balances with other banks	218.1	287.9	409.0
Cash and cash equivalents	1,360.1	1,925.0	1,225.4

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:

	2021 £m	2020 £m	2019 £m
Available cash	1,236.5	1,701.1	872.1
Securitisation cash	123.3	223.4	353.1
ESOP cash	0.3	0.5	0.2
	1,360.1	1,925.0	1,225.4

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.

10. LOANS TO CUSTOMERS

	Note	2021 £m	2020 £m	2019 £m
Loans to customers		13,402.7	12,631.4	12,186.1
Fair value adjustments from portfolio hedging		5.5	109.7	64.2
		13,408.2	12,741.1	12,250.3

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For the year ended 30 September 2021

The Group's loans to customers at 30 September 2021, analysed between the segments described in note 2 are as follows:

	Mortgage Lending £m	Commercial Lending £m	Idem Capital £m	Total £m
At 30 September 2021				
First mortgages	11,460.6	-	-	11,460.6
Consumer loans	148.1	-	220.9	369.0
Motor finance	-	224.9	4.3	229.2
Asset finance	-	468.7	-	468.7
Development finance	-	608.2	-	608.2
Other commercial loans	-	267.0	-	267.0
Loans to customers	11,608.7	1,568.8	225.2	13,402.7
At 30 September 2020				
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	-	478.0	-	478.0
Development finance	-	609.0	-	609.0
Other commercial loans	-	170.9	-	170.9
Loans to customers	10,819.5	1,514.8	297.1	12,631.4
At 30 September 2019				
First mortgages	10,172.5	-	-	10,172.5
Consumer loans	171.6	-	352.3	523.9
Motor finance	-	281.3	37.6	318.9
Asset finance	-	492.2	-	492.2
Development finance	-	506.5	-	506.5
Other commercial loans	-	172.1	-	172.1
Loans to customers	10,344.1	1,452.1	389.9	12,186.1

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

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 year
- Impairments charged to income
- Economic inputs to provision calculations
- Sensitivity analysis

(a) Basis of provision

IFRS 9 requires that impairment is evaluated on an ECL basis. ECLs are based on an assessment of the probability of default ('PD') and 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').

The Group's process for determining its provisions for impairments is summarised below. This includes:

i. The methods used for the calculation of ECL
ii. How it defines SICR
iii. How it defines default
iv. How it identifies which loans are credit impaired, as defined by IFRS 9
v. How the ECL estimation process is monitored and controlled
vi. How the Group develops and enhances the models it uses in the ECL estimation process
vii. How the Group uses PMA's to ensure all elements of credit risk are fully addressed

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

i) 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.

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 (including cases 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 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 (such as accounts 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 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 2021 the impact of reduced economic activity in the UK from the Covid 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 and 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.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

During the year the trend of economic performance has been generally upward, albeit from a low level, meaning that the principal economic indicators are more positive than at 30 September 2020, though still more depressed than pre-Covid levels. The economic forecasts indicate continued recovery, but this upward trend will reduce calculated probabilities of default, even where the absolute levels of metrics remain low and where underlying credit issues on accounts have not emerged, which may result in rising defaults as government support initiatives unwind.

These factors have led management to conclude that in the current economic conditions, the Group's models do not fully represent loss expectations, and PMA's have been made to compensate for these weaknesses.

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

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

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

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 environment the granting of Covid-related 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 initial Covid relief did 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.

When reviewing the subsequent payment patterns of accounts that have been granted Covid-related reliefs, it has been evident that there is higher payment volatility (both in terms of account improvement and deterioration) in these cases, particularly in cases where an extension to the payment holiday has been granted. This indicates an increased credit risk, though the impact is not significant in scale in all cases. As a result of this analysis the accounts of customers who have been granted extended payment reliefs have been placed in Stage 2, regardless of other indicators. 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.

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

The effect of this override is to transfer accounts with gross balances of £599.8m (2020: £576.3m) to Stage 2. The additional provision on transfer is included within PMAs.

This overall approach remains consistent with that taken at 30 September 2020. In reviewing account performance during the current year the Group has not yet identified any positive evidence which would cause it to begin to unwind this position. It will be reviewed going forward as other government economic interventions are scaled back and the post-relief credit characteristics of such accounts become more evident.

iii) 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 broadly 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 90 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.

iv) Credit Impaired loans

IFRS 9 defines a credit impaired account as one where an account has suffered one or more events which have 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 90 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 probationary accounts, receiver of rent accounts, accounts subject to realisation / enforcement procedures and long term managed accounts, all of which are treated as credit impaired. While other indicators of default are in use, the categories shown account for the overwhelming majority of Stage 3 cases.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

v) Monitoring of ECL estimation processes

The Group's ECL models are compiled on the basis of the analysis of relevant historical data. Before a model is adopted for use its operations and outputs are examined to ensure that it is expected to be appropriately predictive and, if it is an updated model, expected to be more predictive than any existing model. Before a new model is adopted the changes and impacts will be considered by the CFO, alongside any advice from the Group's independent model review functions.

The performance of all models is reviewed on an ongoing basis, by senior finance and risk management, including the CFO. Monitoring packs comparing actual and predicted loss levels are produced at regular intervals, set on the basis of the materiality of each model. The continuing appropriateness of model assumptions is also reviewed as part of this process.

Models are revisited on a regular basis to ensure that they continue to reflect the most recent data as the available information increases over time.

On a monthly basis all model outputs, model overlays and provisions calculated for non-modelled books are reviewed by senior finance management including the CFO in conjunction with the latest credit risk operational and economic metrics to ensure that the impairment provision by assets type remains appropriate. This exercise will be the subject of particular focus at the year end and the half year.

This information is summarised for the Audit Committee on a biannual basis, and they have regard to this data in forming their conclusions on the appropriateness of provisioning levels.

vi) Model development

The models used by the Group are updated from time to time to allow for changes in the business, developments in best practice and the availability of additional data with the passing of time. During the year ended 30 September 2021 a major update to the buy-to-let PD model took place.

All revised models and model enhancements are carefully reviewed and tested before adoption, and are subject to a governance process for their approval.

As a result of the reanalysis of updated historical data, the economic inputs identified as most predictive of future PD performance were changed, with the UK unemployment rate being substituted for UK GDP in the model as the indicator of general UK economic activity levels.

The impacts of the adoption of the new PD model on the calculated provision were not significant.

vii) Post Model Adjustments ('PMA's)

Where management has identified a requirement to amend the calculated provision as a result of either model deficiencies or idiosyncratic behaviour in part of the portfolio, PMAs are applied to the modelled outputs so that the ECL recognised corresponds to expert judgement, taking into account the widest possible range of current information, which might not be factored into the modelling process.

In normal circumstances the Group's objective is to develop its modelling to the point where the level of PMAs required is minimal, but in economic conditions where previous relevant experience is limit or non-existent, as with Covid, some form of PMA is always likely to be necessary.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

The current model behaviour and the potential for unobserved credit issues have meant that the requirement for such adjustments at 30 September 2021 was significant. Evidence considered by management included internal performance data, customer feedback, evidence on the wider economy and quantitative and qualitative data and statements from industry, government and regulatory bodies. These were combined to form a broad estimate of the level of provision required across the Group.

The total amounts of PMAs provided across the Group are set out below by segment.

	2021 £m	2020 £m
Mortgage Lending	8.9	14.0
Commercial Lending	11.2	5.8
Idem Capital	0.3	-
	20.4	19.8

Other than the behaviour of extended payment relief cases noted above, this analysis found no evidence of particular concentrations of credit risk below portfolio level. Given this and the high level nature of the PMA exercise the PMAs have been allocated on a broad brush basis to individual cases.

The Group will continue to monitor the requirement for these PMAs as the economic situation develops and the impact of government interventions recedes.

(b) Impairments by stage and division

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 (those 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 2021

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.

	Stage 1 £m	Stage 2 * £m	Stage 3 * £m	POCI £m	Total £m
30 September 2021					
Gross loan book					
Mortgage Lending	10,303.7	1,206.4	120.0	13.4	11,643.5
Commercial Lending	1,504.2	66.4	19.0	6.9	1,596.5
Idem Capital	92.5	6.3	25.3	104.0	228.1
Total	11,900.4	1,279.1	164.3	124.3	13,468.1
Impairment provision					
Mortgage Lending	(1.7)	(10.2)	(22.9)	-	(34.8)
Commercial Lending	(12.9)	(1.0)	(13.6)	(0.2)	(27.7)
Idem Capital	(0.4)	(0.1)	(2.4)	-	(2.9)
Total	(15.0)	(11.3)	(38.9)	(0.2)	(65.4)
Net loan book					
Mortgage Lending	10,302.0	1,196.2	97.1	13.4	11,608.7
Commercial Lending	1,491.3	65.4	5.4	6.7	1,568.8
Idem Capital	92.1	6.2	22.9	104.0	225.2
Total	11,885.4	1,267.8	125.4	124.1	13,402.7
Coverage ratio					
Mortgage Lending	0.02%	0.85%	19.08%	-	0.30%
Commercial Lending	0.86%	1.51%	71.58%	2.90%	1.74%
Idem Capital	0.43%	1.59%	9.49%	-	1.27%
Total	0.13%	0.88%	23.68%	0.16%	0.49%

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

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

	Stage 1 £m	Stage 2 * £m	Stage 3 * £m	POCI £m	Total £m
30 September 2020					
Gross loan book					
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
Total	11,329.7	1,045.4	176.1	162.0	12,713.2
Impairment provision					
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)
Total	(22.2)	(15.8)	(43.4)	(0.4)	(81.8)
Net loan book					
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
Total	11,307.5	1,029.6	132.7	161.6	12,631.4
Coverage ratio					
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%
Total	0.20%	1.51%	24.65%	0.25%	0.64%

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

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

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.

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.

Cases which have been greater than one month in arrears in the last three months, but which are not at the balance sheet date are shown as 'recent arrears' in the tables below. These cases have been analysed separately for the first time in the current year.

Levels of Stage 2 assets increased substantially during the early part of the Covid outbreak, and has been broadly stable over the course of the year. The largest part of the Stage 2 balance at 30 September 2021 related to extended payment holiday accounts transferred from Stage 1 These are shown in the < 1 month arrears column in the table below. As fewer extensions were granted after 30 September 2020, the rate of increase of such Stage 2 cases has been much reduced in the period.

While the number of Stage 2 arrears accounts across the portfolios has increased since September 2020 in the Mortgage Lending segment as payment reliefs unwind, levels remain far lower than those seen in September 2019 in more normal payment conditions.

Coverage levels in Stage 2 across the portfolios have reduced since 30 September 2020, with an improved economic outlook and increasing security values. However, these remain higher than those seen pre-pandemic, due to the impact of PMAs, particularly on '<1 month arrears' cases. Coverage ratios of '> 1 < = 3 months arrears' cases have been varied due to the composition of the relatively small balances, particularly in the Commercial Lending and Idem Capital divisions.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

	< 1 month arrears	Recent arrears	> 1 <= 3 months arrears	Total
	£m	£m	£m	£m
30 September 2021				
Gross loan book				
Mortgage Lending	1,184.8	8.0	13.6	1,206.4
Commercial Lending	61.1	0.2	5.1	66.4
Idem Capital	2.9	0.7	2.7	6.3
Total	1,248.8	8.9	21.4	1,279.1
Impairment provision				
Mortgage Lending	(9.9)	(0.1)	(0.2)	(10.2)
Commercial Lending	(0.9)	-	(0.1)	(1.0)
Idem Capital	-	-	(0.1)	(0.1)
Total	(10.8)	(0.1)	(0.4)	(11.3)
Net loan book				
Mortgage Lending	1,174.9	7.9	13.4	1,196.2
Commercial Lending	60.2	0.2	5.0	65.4
Idem Capital	2.9	0.7	2.6	6.2
Total	1,238.0	8.8	21.0	1,267.8
Coverage ratio				
Mortgage Lending	0.84%	1.25%	1.47%	0.85%
Commercial Lending	1.50%	-	1.96%	1.51%
Idem Capital	-	-	3.70%	1.59%
Total	0.86%	1.12%	1.87%	0.88%

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

	< 1 month arrears	Recent arrears	> 1 <= 3 months arrears	Total
	£m	£m	£m	£m
30 September 2020				
Gross loan book				
Mortgage Lending	879.9	5.9	17.4	903.2
Commercial Lending	113.2	10.5	8.6	132.3
Idem Capital	4.8	1.6	3.5	9.9
Total	997.9	18.0	29.5	1,045.4
Impairment provision				
Mortgage Lending	(12.0)	(0.2)	(0.4)	(12.6)
Commercial Lending	(2.5)	(0.1)	(0.4)	(3.0)
Idem Capital	(0.1)	-	(0.1)	(0.2)
Total	(14.6)	(0.3)	(0.9)	(15.8)
Net loan book				
Mortgage Lending	867.9	5.7	17.0	890.6
Commercial Lending	110.7	10.4	8.2	129.3
Idem Capital	4.7	1.6	3.4	9.7
Total	983.3	17.7	28.6	1,029.6
Coverage ratio				
Mortgage Lending	1.36%	3.39%	2.30%	1.40%
Commercial Lending	2.21%	0.95%	4.65%	2.27%
Idem Capital	2.08%	-	2.86%	2.02%
Total	1.46%	1.67%	3.05%	1.51%

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11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Analysis of Stage 3 loans

The table below analyses the accounts in Stage 3 between those:

- In the process of sale or other enforcement procedures ('Realisations')
- Where a receiver of rent ('RoR') has been appointed by the Group to manage the property on the customers' behalf
- Which are being managed on a long-term basis and where full recovery is possible, but which are considered to meet regulatory default criteria at the balance sheet date ('>3 month arrears')
- which no longer meet regulatory default criteria but which are being retained in Stage 3 for a probationary period ('Probation')

Where an account meets two of the criteria, it will be assigned to the category shown first in the list above.

In these disclosures probation accounts have been analysed separately for the first time, in order to provide better information for users.

The impact of Covid on the number and value of Stage 3 accounts has been limited so far. Payment reliefs have prevented arrears being recorded and other enforcement activities have been limited by government intervention. This particularly impacts on cases analysed as 'realisations'.

The completion of payment relief periods has led to some increases in > 3 month arrears cases, particularly in the Mortgage Lending business, while credit reviews have identified at risk cases in other areas. This increase is, however, is offset by the continuing realisations from the receiver of rent portfolio as long-term cases are managed out.

Coverage levels have generally reduced a little from 30 September 2020 as a result of increased security values, while remaining substantially in excess of pre-Covid levels. The coverage ratio for Commercial Lending is subject to fluctuations as the number of cases is relatively low and the ratio can be significantly influenced by individual larger cases.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
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11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

	Probation	> 3 month arrears	RoR managed	Realisations	Total
	£m	£m	£m	£m	£m
30 September 2021					
Gross loan book					
Mortgage Lending	7.3	20.7	80.9	11.1	120.0
Commercial Lending	0.6	11.4	-	7.0	19.0
Idem Capital	0.7	21.3	-	3.3	25.3
Total	8.6	53.4	80.9	21.4	164.3
Impairment provision					
Mortgage Lending	(0.3)	(0.9)	(17.4)	(4.3)	(22.9)
Commercial Lending	(0.1)	(10.3)	-	(3.2)	(13.6)
Idem Capital	-	(1.0)	-	(1.4)	(2.4)
Total	(0.4)	(12.2)	(17.4)	(8.9)	(38.9)
Net loan book					
Mortgage Lending	7.0	19.8	63.5	6.8	97.1
Commercial Lending	0.5	1.1	-	3.8	5.4
Idem Capital	0.7	20.3	-	1.9	22.9
Total	8.2	41.2	63.5	12.5	125.4
Coverage ratio					
Mortgage Lending	4.11%	4.35%	21.51%	38.74%	19.08%
Commercial Lending	16.67%	90.35%	-	45.71%	71.58%
Idem Capital	-	4.69%	-	42.42%	9.49%
Total	4.65%	22.85%	21.51%	41.59%	23.68%

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

	Probation	> 3 month arrears	RoR managed	Realisations	Total
	£m	£m	£m	£m	£m
30 September 2020					
Gross loan book					
Mortgage Lending	6.5	12.9	86.7	20.9	127.0
Commercial Lending	3.2	11.2	-	5.8	20.2
Idem Capital	1.0	24.3	-	3.6	28.9
Total	10.7	48.4	86.7	30.3	176.1
Impairment provision					
Mortgage Lending	(0.3)	(1.5)	(20.8)	(8.1)	(30.7)
Commercial Lending	(0.9)	(4.1)	-	(3.2)	(8.2)
Idem Capital	-	(2.8)	-	(1.7)	(4.5)
Total	(1.2)	(8.4)	(20.8)	(13.0)	(43.4)
Net loan book					
Mortgage Lending	6.2	11.4	65.9	12.8	96.3
Commercial Lending	2.3	7.1	-	2.6	12.0
Idem Capital	1.0	21.5	-	1.9	24.4
Total	9.5	40.0	65.9	17.3	132.7
Coverage ratio					
Mortgage Lending	4.62%	11.63%	23.99%	38.76%	24.17%
Commercial Lending	28.12%	36.61%	-	55.17%	40.59%
Idem Capital	-	11.52%	-	47.22%	15.57%
Total	11.21%	17.36%	23.99%	42.90%	24.65%

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.

	2021	2020
	£m	£m
First mortgages	74.7	71.9
Second mortgages	15.4	17.3
Asset finance	4.7	6.7
Motor finance	2.0	1.5
	96.8	97.4

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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 2021		30 September 2020	
	No.	£m	No.	£m
Managed accounts				
Appointment date				
2010 and earlier	333	56.3	369	62.4
2011 to 2013	56	9.1	72	12.4
2014 to 2016	24	3.3	29	4.2
2016 and later	86	12.2	46	7.7
Total managed accounts	499	80.9	516	86.7
Accounts in the process of realisation	54	10.2	104	19.7
	553	91.1	620	106.4

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, no POCI mortgage accounts also had a receiver of rent appointed (2020: 3), making a total of 553 (2020: 623).

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

(c) Movements in impairment provision in the year

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

	Mortgage Lending £m	Commercial Lending £m	Idem Capital £m	Total £m
At 30 September 2020	48.3	28.6	4.9	81.8
(Released) / Provided in period	(5.9)	4.0	(1.2)	(3.1)
Amounts written off	(7.6)	(4.9)	(0.8)	(13.3)
At 30 September 2021	34.8	27.7	2.9	65.4
At 30 September 2019	26.8	10.7	4.4	41.9
Provided in period	25.8	22.7	1.3	49.8
Amounts written off	(4.3)	(4.8)	(0.8)	(9.9)
At 30 September 2020	48.3	28.6	4.9	81.8

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 £1.6m (2020: £1.5m).

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For the year ended 30 September 2021

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 2021 and 30 September 2020 is set out below.

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Loss allowance at 30 September 2020	22.2	15.8	43.4	0.4	81.8
New assets originated or purchased	8.1	-	-	-	8.1
Changes in loss allowance					
Transfer to Stage 1	4.7	(2.6)	(2.1)	-	-
Transfer to Stage 2	(1.4)	2.1	(0.7)	-	-
Transfer to Stage 3	(0.2)	(0.7)	0.9	-	-
Changes on stage transfer	(3.8)	1.8	3.1	-	1.1
Changes due to credit risk	(14.6)	(5.1)	7.6	(0.2)	(12.3)
Write offs	-	-	(13.3)	-	(13.3)
Loss allowance at 30 September 2021	15.0	11.3	38.9	0.2	65.4
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 on stage transfer	(0.5)	7.5	6.2	-	13.2
Changes due to credit risk	7.3	4.4	14.3	0.4	26.4
Write offs	-	-	(9.9)	-	(9.9)
Loss allowance at 30 September 2020	22.2	15.8	43.4	0.4	81.8

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

The principal movements in the impairment provision in the year were downwards, with a more benign economic outlook reducing both the estimated likelihood of losses and the expected loss on defaulted cases as security values improved. However coverage levels still remain in excess of those pre-Covid, with PMAs in place to compensate for the potential impact of credit issues not apparent in the data.

While less accounts have been granted payment holiday extensions in the year than in the year ended 30 September 2020, this has driven further transfers from Stage 1 to Stage 2. Transfers to Stage 3 reflect principally a small number of realisation cases and other cases identified through credit review. Write offs largely relate to the realisation of already provided losses on cases being worked out on a long-term basis.

In the year ended 30 September 2020 the principal factor generating the increase in the loss allowance in the period was the impact of the Covid 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 was also reflected, with extended payment holiday accounts transferred to Stage 2 and PMAs made to allow for the potential delay in the recognition of credit issues due to reliefs.

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For the year ended 30 September 2021

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.

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Balance at 30 September 2020	11,329.7	1,045.4	176.1	162.0	12,713.2
New assets originated or purchased	2,419.4	-	-	-	2,419.4
Changes in staging					
Transfer to Stage 1	158.5	(149.5)	(9.0)	-	-
Transfer to Stage 2	(514.2)	519.6	(5.4)	-	-
Transfer to Stage 3	(23.7)	(21.6)	45.3	-	-
Redemptions and repayments	(1,884.9)	(158.6)	(35.7)	(53.1)	(2,132.3)
Write offs	-	-	(13.3)	-	(13.3)
Other changes	415.6	43.8	6.3	15.4	481.1
Balance at 30 September 2021	11,900.4	1,279.1	164.3	124.3	13,468.1
Loss allowance	(15.0)	(11.3)	(38.9)	(0.2)	(65.4)
Carrying value	11,885.4	1,267.8	125.4	124.1	13,402.7
Balance 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)	(1,662.5)
Write offs	-	-	(9.9)	-	(9.9)
Other changes	50.5	12.4	2.2	21.1	86.2
Balance at 30 September 2020	11,329.7	1,045.4	176.1	162.0	12,713.2
Loss allowance	(22.2)	(15.8)	(43.4)	(0.4)	(81.8)
Carrying value	11,307.5	1,029.6	132.7	161.6	12,631.4

Other changes includes interest and similar charges

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

(d) Economic inputs to provision calculations

Impairment provision under IFRS 9 is calculated on a forward-looking ECL basis, based on expected economic conditions in multiple internally coherent scenarios. While the provision calculation is intended to address all possible future economic outcomes, the Group, in common with most other lenders, uses a small number of differing scenarios as representatives of this universe of potential outturns.

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 data and forecasts produced by the Office of Budget Responsibility ('OBR') and the PRA as well as private sector economic research bodies. The Group also takes account of public statements from bodies such as the Bank of England and the UK Government to inform its final position.

The central scenario used for IFRS 9 impairment purposes is the same scenario which forms the basis of the Group's business planning and forecasting and will therefore generally carry the highest probability weighting. In its September 2021 forecasting cycle (the 'October reforecast') the Group has adopted a central economic scenario derived using a broadly equivalent approach to that used in September 2020, with the starting point of the scenario updated to reflect the actual movements of economic variables in the year. The general trend of the Group's central forecast is consistent with the monetary forecast published by the Bank of England in August 2021.

Compared to the central scenario adopted at 30 September 2020, the new central forecast is broadly similar across the five year period, but more optimistic as to short term prospects. This 2021/2022 upgrade is a result of the opening position being better than implied in the 2020 central scenario, progress made to date in combatting the pandemic in the UK, including the success of the vaccination programme, and a more positive outlook from economists generally.

The upside and downside scenarios continue to be derived from the central scenario, as they have been in previous periods. However, these scenarios are not as markedly different in shape as those used at September 2020 nor as widely divergent from the central position, with a greater level of consensus as to the shape and timing of the post-Covid trajectory of the UK economy emerging amongst analysts and commentors. It should be noted that the 2020 scenarios converged towards the later part of the five-year period, as Covid impacts receded. Therefore, a less divergent starting point for the 2021 scenarios is in line with this expectation.

The severe scenario has been derived from the stress testing scenarios published by the Bank of England, as in previous periods. The stress testing scenario published in January 2021 was used in this iteration of the Group's forecasts. This is a more severe scenario than that published for 2020. The Bank of England scenario includes a house price projection based on a sharp decline and a rapid bounce back, which would have a limited impact on expected losses. As house prices have a significant impact on the Group's modelling of losses, it was determined that the impact of a more protracted slump, would better represent a severe downturn and the Bank of England scenario was adjusted accordingly.

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11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Following a review of the weightings of the different scenarios, set against the overall potential for variability in the future economic outlook, the Group decided to maintain the scenario weightings used at 30 September 2020.

The weightings attached to each scenario are set out below

	2021	2020
Central scenario	40%	40%
Upside scenario	10%	10%
Downside scenario	35%	35%
Severe scenario	15%	15%
	100%	100%

The Group's economic scenarios comprise six variables based on standard publicly available metrics for the UK. These variables are

- Year-on-year change in Gross Domestic Product ('GDP') as measured by the Office of National Statistics ('ONS')
- Year-on-year change in the House Price Index ('HPI') as measured by the Nationwide Building Society
- Bank Base Rate ('BBR'), as set by the Bank of England
- Consumer Price Inflation ('CPI') rate, as measured by the ONS
- Unemployment rate, as measured by the ONS
- Annual change in secured lending, as measured by the Bank of England 'mortgage advances' data series
- Annual change in consumer credit, as measured by the Bank of England 'unsecured advances' data series

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
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11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

The projected average annual values of each of these variables in each of the first five financial years of the forecast period are set out below.

30 September 2021

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

	2022	2023	2024	2025	2026
Central scenario	7.2%	2.0%	1.3%	1.6%	1.9%
Upside scenario	8.6%	2.5%	2.1%	1.8%	1.9%
Downside scenario	3.9%	3.4%	2.1%	1.9%	1.9%
Severe scenario	(3.7)%	8.9%	4.9%	2.6%	2.0%

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

	2022	2023	2024	2025	2026
Central scenario	(0.7)%	2.1%	2.7%	3.2%	3.0%
Upside scenario	4.0%	3.9%	4.5%	4.7%	2.6%
Downside scenario	(4.9)%	(5.9)%	-	2.1%	2.1%
Severe scenario	(10.9)%	(11.6)%	(7.9)%	(1.8)%	0.7%

Bank Base Rate ('BBR') (rate)

	2022	2023	2024	2025	2026
Central scenario	0.1%	0.1%	0.4%	0.7%	0.8%
Upside scenario	0.1%	0.5%	0.9%	1.0%	1.0%
Downside scenario	0.1%	0.1%	0.2%	0.3%	0.5%
Severe scenario	-	(0.1)%	-	-	0.1%

Consumer Price Inflation ('CPI') (rate)

	2022	2023	2024	2025	2026
Central scenario	3.8%	2.3%	1.9%	2.0%	2.0%
Upside scenario	3.0%	2.1%	2.0%	2.0%	2.0%
Downside scenario	4.2%	3.0%	2.1%	2.0%	2.0%
Severe scenario	0.9%	0.4%	0.9%	1.5%	1.9%

Unemployment (rate)

	2022	2023	2024	2025	2026
Central scenario	5.4%	5.1%	4.7%	4.3%	4.2%
Upside scenario	4.6%	4.3%	4.3%	4.0%	3.8%
Downside scenario	5.8%	5.5%	5.1%	4.7%	4.6%
Severe scenario	9.4%	11.5%	8.7%	5.8%	4.9%

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11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Secured lending (annual change)

	2022	2023	2024	2025	2026
Central scenario	4.4%	3.6%	3.1%	3.2%	3.3%
Upside scenario	5.3%	4.8%	4.3%	3.8%	3.8%
Downside scenario	3.3%	2.8%	2.9%	3.6%	3.9%
Severe scenario	1.5%	(2.4)%	(1.0)%	1.3%	2.5%

Consumer credit (annual change)

	2022	2023	2024	2025	2026
Central scenario	2.6%	4.4%	5.5%	6.1%	6.2%
Upside scenario	4.3%	6.5%	7.3%	8.0%	8.3%
Downside scenario	2.3%	2.0%	2.0%	2.0%	2.3%
Severe scenario	0.6%	5.1%	1.2%	1.7%	4.0%

30 September 2020

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

	2021	2022	2023	2024	2025
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)

	2021	2022	2023	2024	2025
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)%	3.8%	3.8%
Severe scenario	(11.8)%	(13.8)%	(5.3)%	1.5%	3.8%

Bank Base Rate ('BBR') (rate)

	2021	2022	2023	2024	2025
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)

	2021	2022	2023	2024	2025
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%

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11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Unemployment (rate)

	2021	2022	2023	2024	2025
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%

Secured lending (annual change)

	2021	2022	2023	2024	2025
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)

	2021	2022	2023	2024	2025
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%

After the end of the initial five year period, the final rate or rate of change (as appropriate) is assumed 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 commencing on the balance sheet date are set out below.

30 September 2021

	Central scenario		Upside scenario		Downside scenario		Severe scenario	
	Max %	Min %	Max %	Min %	Max %	Min %	Max %	Min %
Economic driver								
GDP	11.5	1.1	13.3	1.6	7.3	0.9	14.3	(5.9)
HPI	6.1	(4.0)	7.7	0.6	2.9	(9.8)	2.4	(16.9)
BBR	0.8	0.1	1.0	0.1	0.5	0.1	0.2	(0.1)
CPI	4.0	1.8	3.8	1.8	4.5	1.8	2.0	0.2
Unemployment	5.5	4.1	4.7	3.8	5.9	4.5	11.9	4.8
Secured lending	4.8	3.0	5.5	3.5	4.0	2.5	3.1	(2.5)
Consumer credit	6.4	0.4	8.5	1.9	4.6	(0.1)	9.2	(8.9)

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

11. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

30 September 2020

	Central scenario		Upside scenario		Downside scenario		Severe scenario	
	Max %	Min %	Max %	Min %	Max %	Min %	Max %	Min %
Economic driver								
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	4.0	(10.0)	4.0	(20.0)
BBR	0.8	0.1	1.0	0.1	1.0	0.1	0.8	(0.4)
CPI	2.4	0.6	2.3	0.7	2.3	0.2	2.3	(0.3)
Unemployment	7.6	4.0	7.0	4.0	9.0	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)

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.

	2021	2020
	£m	£m
Calculated provision	65.4	81.8
100% weighted central scenario	52.7	67.4
Effect of multiple economic scenarios	12.7	14.4

Economic conditions

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 are shown below:

	2021		2020	
Scenario	**Provision £m**	**Difference £m**	**Provision £m**	**Difference £m**
Central	52.7	(12.7)	67.4	(14.4)
Upside	47.1	(18.3)	58.0	(23.8)
Downside	68.1	2.7	82.4	0.6
Severe Downside	106.1	40.7	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 impact of post-model stage adjustments at 30 September 2020, the effect on the PD SICR test of 100% weighting has not been taken into account in the calculations at that date.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

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 2021 or the preceding year.

	2021 Assets £m	2021 Liabilities £m	2020 Assets £m	2020 Liabilities £m
Derivatives in hedge accounting relationships				
Fair value hedges				
Interest rate swaps				
Fixed to floating	35.9	(35.8)	-	(130.0)
Floating to fixed	2.8	(5.9)	14.4	-
	38.7	(41.7)	14.4	(130.0)
Cash flow hedges				
Cross-currency basis swaps				
Dollar-sterling	-	-	213.2	-
Euro-sterling	-	-	232.1	-
	-	-	445.3	-
Total derivatives in hedge accounting relationships	38.7	(41.7)	459.7	(130.0)
Other derivatives				
Interest rate swaps	5.5	(2.0)	3.4	(2.4)
Currency futures	-	(0.2)	0.2	-
Total recognised derivative assets / (liabilities)	44.2	(43.9)	463.3	(132.4)

All hedging relationships and strategies at 30 September 2020 described in the 2020 Group Accounts have continued in the period. All remaining borrowings and their related swaps were paid down in the year.

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 2021

13. INTANGIBLE ASSETS

Intangible assets at net book value comprise:

	2021 £m	2020 £m	2019 £m
Goodwill	164.4	164.4	164.4
Computer software	3.4	2.2	2.4
Other intangibles	2.7	3.5	4.3
Total assets	170.5	170.1	171.1

The balance for goodwill at 30 September 2021 shown above includes £113.0m in respect of the Small and Medium sized enterprises lending Cash Generating Unit ('CGU') and £49.8m in respect of the Development Finance CGU.

(a) SME lending

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

An impairment review undertaken at 30 September 2021 indicated that no write down was required.

The recoverable amount of the SME lending 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 in November 2021 covering a five-year period. These forecasts reflect the projected trajectory of the business recovery from the Covid pandemic with the five year average growth rate beginning to normalise following the initial bounce back phase in 2021, as well as the Group's current strategy for the business.

The key assumptions underlying the value in use calculation for the SME lending 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 13.9%, compared with 19.7% used in the calculation at 30 September 2020. Cash flows beyond the five-year budget are extrapolated using a constant growth rate of 1.6% (2020: 1.5%) 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 13.4% (2020: 15.0%)

As an illustration of the sensitivity of this impairment test to movements in the key assumptions, the Group has calculated that a 0% growth rate combined with a 15.0% reduction in profit levels and a 159 basis point increase in the pre-tax discount rate would eliminate the headroom in the projection. A 0% growth rate combined with a 20.7% reduction in profit levels and a 125 basis point increase in the pre-tax discount rate would generate a write down of £10.0m

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

13. INTANGIBLE ASSETS

In the testing carried out at 30 September 2020, a 10.0% reduction in profit levels coupled with a 100 basis point increase in the pre-tax discount rate would eliminate the headroom.

(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 2021 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 in November 2021 covering a five-year period. These forecasts show growth slower than that originally forecast for 2021 which was inflated by the impact of the initial post Covid bounce back.

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 drawdowns over the five-year period of 13.2%, compared with 16.9% used in the calculation at 30 September 2020. Cash flows beyond the five-year budget are extrapolated using a constant growth rate of 1.6% (2020: 1.5%) 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 13.2% (2020: 14.2%)

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 2020.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

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:

	2021 £m	2020 £m	2019 £m
Fixed rate	5,466.0	4,975.9	4,154.4
Variable rates	3,834.4	2,880.7	2,237.5
	9,300.4	7,856.6	6,391.9

The weighted average interest rate on retail deposits at 30 September 2021, analysed by charging method, was:

	2021 %	2020 %	2019 %
Fixed rate	1.25	1.69	2.02
Variable rates	0.42	0.72	1.43
All deposits	0.91	1.34	1.81

The contractual maturity of these deposits is analysed below.

	2021 £m	2020 £m	2019 £m
Amounts repayable			
In less than three months	789.0	565.0	466.6
In more than three months, but not more than one year	3,105.4	2,725.6	2,088.4
In more than one year, but not more than two years	1,580.1	1,541.6	1,158.0
In more than two years, but not more than five years	507.4	664.8	900.9
Total term deposits	5,981.9	5,497.0	4,613.9
Repayable on demand	3,318.5	2,359.6	1,778.0
	9,300.4	7,856.6	6,391.9
Fair value adjustments for portfolio hedging	(3.0)	10.4	3.9
	9,297.4	7,867.0	6,395.8

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

15. BORROWINGS

On 12 March 2021, Fitch Ratings confirmed the Group's Long-Term Issuer Default Rating at BBB. The outlook was upgraded from negative to stable. It affirmed its senior unsecured debt rating at BBB- and the rating of the 2016 £150.0m Tier-2 Bond at BB+.

All borrowings described in the Group Accounts for the year ended 30 September 2020 remained in place throughout the period, except as noted below.

Since 30 September 2020 the Group has made further drawings under the Bank of England Term Funding Scheme for SMEs ('TFSME'), increasing its borrowings under the scheme to £2,750.0m. Borrowings of £875.0m under the original Bank of England Term Funding Scheme ('TFS') which were due for settlement in the current financial year were repaid.

During the period the Group also continued to have access to the Indexed Long-Term Repo ('ILTR') scheme provided by the Bank of England, but did not make any drawings.

On 25 March 2021 the Company issued £150.0m of Fixed Rate Callable Subordinated Tier-2 Notes due 2031 at par. These Notes bear interest at a rate of 4.375% per annum until 25 September 2026 after which interest will be payable at a rate which is 3.956% over that payable on UK Government bonds of similar duration at that time. These Notes are callable at the option of the Company between 25 June 2026 and 25 September 2026 and may be called at any time in the event of certain tax or regulatory changes. The Notes are unsecured and subordinated to all creditors of the Company other than the Tier-2 Notes issued in 2016, with which they rank equally. The Notes are rated BB+ by Fitch. The proceeds of the Notes will be utilised in accordance with the Group's Green Bond Framework, which is available on its investor website.

At the same time as this issuance the Group purchased £130.9m of nominal value of its 2016 Tier-2 Notes by market tender for a total consideration of £134.6m. These Notes were derecognised and the premium paid taken to profit and loss as interest payable and similar charges. The remaining Notes were redeemed at their call date in September 2021.

In March 2021 the Group's warehouse loan facility, held by Paragon Seventh Funding Limited was renegotiated and the margin payable on drawings reduced to 0.60% above LIBOR from 1.05% above LIBOR. On 8 November 2021, after the year end, revisions to the facility were agreed extending the commitment period for an initial 13-month period with the ability to extend monthly until a potential final maturity date of 24 November 2024. The maximum drawing was increased to £450.0m and the interest rate payable was transitioned to 0.5% above SONIA.

On 25 August 2021 an agreement was reached with the senior noteholders of Paragon Mortgages (No. 25) PLC to transition to a SONIA-linked basis for interest charging, effective from the interest payment date on 15 February 2022. From that date the notes will bear interest calculated with reference to SONIA rather than LIBOR and the note margins will be increased by 0.12% in line with the ISDA fallback adjustment rate. Other terms of the notes remain unchanged. The agreement also provided for the transition of hedging arrangements in the securitisation to a SONIA basis.

The Group's £60.0m retail bond was repaid in full at its due date of 5 December 2020.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

15. BORROWINGS (Continued)

On 11 November 2020 a Group company, Paragon Mortgages (No. 28) PLC, issued £703.1m of rated sterling mortgage backed floating rate notes, analysed below, at par.

Class	Fitch rating	Moody's rating	Interest margin above compounded SONIA	Principal value £m
A	AAA	Aaa	0.95%	623.8
B	AA	Aa1	1.35%	39.7
C	A	Aa3	1.65%	21.6
D	BBB-	Baa1	1.95%	18.0
				703.1

All of the above notes were retained by the Group. This gives the Group access to additional liquidity, as described in note 57 to the 2020 Group Accounts.

Of the Group's borrowings at 30 September 2020, the following mortgages backed floating notes were repaid

- Paragon Mortgages (No. 11) PLC in October 2020
- Paragon Mortgages (No. 15) PLC in December 2020
- Paragon Mortgages (No. 13) PLC in April 2021
- Paragon Mortgages (No. 14) PLC in June 2021.

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

During the period agreement was reached with the holders of the debt of Paragon Second Funding Limited to convert the reference rate from LIBOR to SONIA on broadly similar economic terms. This was not accounted for as a modification, as permitted by IFRS 9.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

16. SUNDRY LIABILTIES

Sundry liabilities include £22.1m of amounts falling due after more than one year (2020: £30.7m).

Total sundry liabilities include £7.5m in respect of deferred consideration, of which £2.9m falls due after more than one year (2020: £13.5m), and £9.5m in respect of lease liabilities (2020: £5.6m), of which £8.0m falls due after more than one year (2020: £4.1m).

17. RETIREMENT BENEFIT OBLIGATIONS

The defined benefit obligation at 30 September 2021 has been calculated on a year-to-date basis. Since the last IAS 19 actuarial valuation at 30 September 2020, 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 2021. In particular, over the period since the 30 September 2020 actuarial valuation, the discount rate has increased by 25 basis points per annum, whereas expectations of long-term inflation have increased by around 45 basis points, while the performance of the Plan assets exceeded expectations.

The movements in the deficit on the defined benefit plan during the year ended 30 September 2021 are summarised below.

	2021 £m	**2020 £m**
Opening pension deficit	20.4	34.5
Employer contributions	(4.8)	(24.5)
Amounts posted to profit and loss		
Service cost	1.8	2.0
Past service cost		-
Net funding cost (note 4)	0.3	0.4
Administrative expenses	0.8	0.6
Amounts posted to other comprehensive income		
Return on plan assets not included in interest	(11.0)	1.8
Experience (gain) on liabilities	-	(1.6)
Actuarial loss from changes in financial assumptions	1.7	6.0
Actuarial loss from changes in demographic assumptions	1.1	1.2
Closing pension deficit	10.3	20.4

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.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

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:

	2021 Number	2020 Number
Ordinary shares		
At 1 October 2020	261,777,972	261,573,351
Shares issued	717,213	204,621
Shares cancelled	-	-
At 30 September 2021	262,495,185	261,777,972

During the year, the Company issued 717,213 shares (2020: 204,621) to satisfy options granted under Sharesave schemes for a consideration of £2,196,934 (2020: £585,315).

On 24 November 2021, after the year end 12,100,834 shares, held in treasury at 30 September 2021 were cancelled.

19. RESERVES

	2021 £m	2020 £m	2019 £m
Share premium account	70.1	68.7	68.3
Capital redemption reserve	50.3	50.3	50.3
Merger reserve	(70.2)	(70.2)	(70.2)
Cash flow hedging reserve	-	2.5	3.0
Profit and loss account	1,005.9	880.7	835.9
	1,056.1	932.0	887.3

The merger reserve arose, due to the provisions of UK company law at the time, on a group restructuring on 12 May 1989 when the Company became the parent entity of the Group.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

20. OWN SHARES

	2021 £m	2020 £m
Treasury shares		
At 1 October 2020	23.0	23.0
Shares purchased	37.7	-
Shares cancelled	-	-
At 30 September 2021	60.7	23.0
ESOP shares		
At 1 October 2020	14.8	17.5
Shares purchased	4.5	5.2
Options exercised	(3.3)	(7.9)
At 30 September 2021	16.0	14.8
Balance at 30 September 2021	76.7	37.8
Balance at 1 October 2020	37.8	40.5

At 30 September 2021 the number of the Company's own shares held in treasury was 12,100,834 (2020: 5,218,702). These shares had a nominal value of £12,100,834 (2020: £5,218,702). These shares do not qualify for dividends. All these shares were cancelled on 24 November 2021, after the year end.

The 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 PSP and Deferred Share Bonus Plan. The trustees' costs are included in the operating expenses of the Group.

At 30 September 2021, the trust held 3,732,324 ordinary shares (2020: 3,636,218) with a nominal value of £3,732,324 (2020: £3,636,218) and a market value of £20,359,827 (2020: £12,108,606). Options, or other share-based awards, were outstanding against all of these shares at 30 September 2021 (2020: all). The dividends on all these shares have been waived (2020: all).

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

21. EQUITY DIVIDEND

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

	2021 Per share	2020 Per share	2021 £m	2020 £m
Equity dividends on ordinary shares				
Final dividend for the previous year	14.4p	14.2p	36.5	35.9
Interim dividend for the current year	7.2p	-	18.1	-
	21.6p	14.2p	54.6	35.9

Amounts paid and proposed in respect of the year:

	2021 Per share	2020 Per share	2021 £m	2020 £m
Interim dividend for the current year	7.2p	-	18.1	-
Proposed final dividend for the current year	18.9p	14.4p	46.6	36.4
	26.1p	14.4p	64.7	36.4

The proposed final dividend for the year ended 30 September 2021 will be paid on 4 March 2022, subject to approval at the AGM, with a record date of 28 January 2022. The dividend will be recognised in the accounts when it is paid.

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

22. NET CASH FLOW FROM OPERATING ACTIVITIES

	2021 £m	2020 £m
Profit before tax	213.7	118.4
Non-cash items included in profit and other adjustments:		
Depreciation of operating property, plant and equipment	4.3	3.5
Profit on disposal of operating property, plant and equipment	0.1	-
Amortisation of intangible assets	2.0	2.0
Movements related to asset backed loan notes denominated in currency	(442.3)	(136.8)
Other non-cash movements on borrowings	2.5	1.5
Impairment losses on loans to customers	(4.7)	48.3
Charge for share based remuneration	8.9	2.7
Net (increase) / decrease in operating assets:		
Assets held for leasing	0.2	(3.2)
Loans to customers	(766.6)	(493.6)
Derivative financial instruments	419.1	129.1
Fair value of portfolio hedges	104.2	(45.5)
Other receivables	58.8	(35.6)
Net increase / (decrease) in operating liabilities:		
Retail deposits	1,443.8	1,464.7
Derivative financial instruments	(88.5)	51.9
Fair value of portfolio hedges	(13.4)	6.5
Other liabilities	(15.7)	(39.1)
Cash generated by operations	926.4	1,074.8
Income taxes (paid)	(48.3)	(46.1)
	878.1	1,028.7

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

	2021 £m	2020 £m
Proceeds from sales of operating property, plant and equipment	-	0.1
Purchases of operating property, plant and equipment	(1.9)	(1.9)
Purchases of intangible assets	(2.4)	(1.0)
Net cash (utilised) by investing activities	(4.3)	(2.8)

NOTES TO THE FINANCIAL INFORMATION – ANALYSIS
For the year ended 30 September 2021

24. NET CASH FLOW FROM FINANCING ACTIVITIES

	2021 £m	2020 £m
Shares issued (note 18)	2.1	0.6
Dividends paid (note 21)	(54.6)	(35.9)
Issue of Tier 2 bond	148.9	-
Repayment of asset backed floating rate notes	(2,313.1)	(1,013.3)
Repayment of Tier 2 bond	(153.7)	-
Repayment of retail bond	(60.0)	-
Movement on central bank facilities	964.6	860.0
Movement on other bank facilities	71.9	(130.1)
Capital element of lease payments	(2.5)	(2.0)
Purchase of shares (note 20)	(42.2)	(5.2)
Sale of shares	-	0.2
Net cash (utilised) by financing activities	(1,438.6)	(325.7)

25. RELATED PARTY TRANSACTIONS

During the year, certain 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 £16,000 were outstanding at the year-end (2020: £301,000), and the maximum amount outstanding during the year was £301,000 (2020: £500,000).

The Paragon Pension Plan ('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 key management compensation.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the year ended 30 September 2021

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 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.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the year ended 30 September 2021

26. CAPITAL MANAGEMENT (CONTINUED)

(a) Regulatory capital

The Group is subject to supervision by the PRA on a consolidated basis, as a group containing an authorised bank. As part of this supervision the regulator will issue 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 BCBS and currently implemented in UK law by EU Regulation 575/2013, referred to as the CRR. Following the UK's exit from the EU in December 2020 the PRA launched a consultation in February 2021 which would result in the Basel III rules being applied in the UK through the PRA Rulebook.

The Group's regulatory capital is monitored by the Board, its Risk and Compliance Committee and the ALCO, 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, 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 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 2021 and 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 2021 the Group's regulatory capital of £1,205.8m (2020: £1,141.2m) exceeded the amounts required by the regulator, including £604.2m (2020: £749.6m) in respect of its Total Capital Requirement ('TCR'), which is comprised of fixed and variable elements (amounts not subject to audit).

The total regulatory capital at 30 September 2021 on the fully loaded basis of £1,176.1m (2020: £1,098.9m) was in excess of the TCR of £601.8m (2020: £745.3m) on the same basis (amounts not subject to audit).

During the year the Group's TCR reduced from 10.8% of Total Risk Exposure ('TRE') at 30 September 2020 to 8.8% of TRE at 30 September 2021, principally as a result of the regulator's most recent review of the Group's risk profile and exposures.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the year ended 30 September 2021

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 2021) (2020: 2.5%) and a Counter-Cyclical Buffer ('CCyB'), currently 0.0% of risk weighted assets (2020: 0.0%). The long-term rate of the UK CCyB 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 2021 is set out below.

	Note	Regulatory basis		Fully loaded basis	
		2021	2020	2021	2020
		£m	£m	£m	£m
Total equity		1,241.9	1,156.0	1,241.9	1,156.0
Deductions					
Proposed final dividend	21	(46.6)	(36.4)	(46.6)	(36.4)
IFRS 9 transitional relief	*	29.7	42.3	-	-
Intangible assets	13	(170.5)	(170.1)	(170.5)	(170.1)
Software relief	†	1.4	-	1.4	-
Prudent valuation adjustments	§	(0.1)	(0.6)	(0.1)	(0.6)
Common Equity Tier 1 ('CET1') capital		1,055.8	991.2	1,026.1	948.9
Other tier 1 capital		-	-	-	-
Total Tier 1 capital		1,055.8	991.2	1,026.1	948.9
Corporate bond		150.0	150.0	150.0	150.0
Eligibility cap	Φ	-	-	-	-
Total Tier 2 capital		150.0	150.0	150.0	150.0
Total regulatory capital ('TRC')		1,205.8	1,141.2	1,176.1	1,098.9

* Firms are permitted to phase in the impact of IFRS 9 transition as described above.

§ 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.

† Under a relief enacted by the EU in December 2020 an amount in respect of software assets in intangibles is added back to capital. This is calculated in accordance with Article 36 (1) (b) of the CRR. In July 2021 the PRA reaffirmed its view that software assets would not absorb losses effectively in a stress. It therefore commenced a consultation on a proposal to remove this relief with effect from 1 January 2022.

Φ CRD IV restricts the amount of tier 2 capital which is eligible for regulatory purposes to 25% of TCR.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the year ended 30 September 2021

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	
	2021	**2020**	**2021**	**2020**
	£m	**£m**	**£m**	**£m**
Credit risk				
Balance sheet assets	6,073.5	6,171.7	6,073.5	6,171.7
Off balance sheet	143.9	104.1	143.9	104.1
IFRS 9 transitional relief	29.7	42.3	-	-
Total credit risk	6,247.1	6,318.1	6,217.4	6,275.8
Operational risk	576.0	544.3	576.0	544.3
Market risk	-	-	-	-
Other	13.7	85.7	13.7	85.7
Total risk exposure amount (‘TRE’)	6,836.9	6,948.1	6,807.2	6,905.8
Solvency ratios	**%**	**%**	**%**	**%**
CET1	15.4	14.3	15.1	13.7
TRC	17.6	16.4	17.3	15.9

This table is not subject to audit

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

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the year ended 30 September 2021

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, with retail deposits of over £50.0 billion. In addition, in October 2021 the PRA stated its expectation that all other UK firms should manage their leverage risk so that this ratio does not ordinarily fall below 3.25%

	Note	2021 £m	2020 £m
Total balance sheet assets		15,137.0	15,505.5
Less: Derivative assets	12	(44.2)	(463.3)
Central bank deposits	9	(1,142.0)	(1,637.1)
CRDs		(23.7)	(15.1)
Accrued interest on sovereign exposures		-	-
On-balance sheet items		13,927.1	13,390.0
Less: Intangible assets	13	(170.5)	(170.1)
Add back: Software relief		1.4	-
Total on balance sheet exposures		13,758.0	13,219.9
Derivative assets	12	44.2	463.3
Potential future exposure on derivatives		36.3	92.3
Total derivative exposures		80.5	555.6
Post offer pipeline at gross notional amount		1,380.3	949.1
Adjustment to convert to credit equivalent amounts		(1,128.3)	(773.8)
Off balance sheet items		252.0	175.3
Tier 1 capital		1,055.8	991.2
Total leverage exposure before IFRS 9 relief		14,090.5	13,950.8
IFRS 9 relief		29.7	42.3
Total leverage exposure		14,120.2	13,993.1
UK leverage ratio		7.5%	7.1%

This table is not subject to audit

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the year ended 30 September 2021

26. CAPITAL MANAGEMENT (CONTINUED)

The fully loaded leverage ratio is calculated as follows

	2021 £m	2020 £m
Fully loaded Tier 1 capital	1,026.1	948.9
Total leverage exposure before IFRS 9 relief	14,090.5	13,950.8
Fully loaded UK leverage exposure	7.3%	6.8%

This table is not subject to audit

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

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

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the year ended 30 September 2021

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 2021 is derived as follows:

	Note	2021 £m	2020 £m
Profit for the year after tax		164.5	91.3
Amortisation of intangible assets		2.0	2.0
Adjusted profit		166.5	93.3
Divided by			
Opening equity		1,156.0	1,108.4
Opening intangible assets	13	(170.1)	(171.1)
Opening tangible equity		985.9	937.3
Closing equity		1,241.9	1,156.0
Closing intangible assets	13	(170.5)	(170.1)
Closing tangible equity		1,071.4	985.9
Average tangible equity		1,028.7	961.6
Return on Tangible Equity		16.2%	9.7%

This table is not subject to audit

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the year ended 30 September 2021

26. CAPITAL MANAGEMENT (CONTINUED)

(c) Dividend and distribution 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.

Since the year ended 30 September 2018, the Company has adopted a policy of paying out approximately 40% of its basic earnings per share as dividend (a dividend cover ratio of around 2.5 times), in the absence of any idiosyncratic factors which might make such a dividend inappropriate. This policy is reviewed by the Board at least annually. The Company considers it has access to sufficient cash resources to pay dividends at this level and that its distributable reserves are abundant for this purpose.

To provide greater transparency, the Board also adopted a policy of paying an interim dividend in each year equivalent to half of the preceding final dividend in the absence of any factors which might make such a distribution inappropriate. After consideration of the Group's capital position an interim dividend for the year of 7.2p per share was declared, in line with this policy (2020: nil).

The Group's dividend and distribution decisions in the 2020 financial year were dominated by the potential impact of the Covid pandemic. The strategic decision to build capital in response to the inherent risks posed by the virus meant that no interim dividend was declared for the year. However, at the 2020 year end a dividend was declared in line with the Group's stated policy.

The appropriate level of final dividend for the current year was considered by the Board in light of economic and regulatory developments in the year, and the various potential paths for the UK economy as the pandemic recedes. 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 impacts of stress testing carried out as part of the ICAAP and forecasting processes, discounting the effects of the current temporary reduction in regulatory buffers. 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 Board will therefore propose a final dividend for the year of 18.9p per share (2020: 14.4p per share) for approval of the 2022 AGM, making a total dividend for the year of 26.1p per share (2020: 14.4p per share).

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the year ended 30 September 2021

26. CAPITAL MANAGEMENT (CONTINUED)

In addition, at the time of approving the half year report in June 2021, the Board authorised a buyback of up to £40.0 million of shares in the market, initially to be held in treasury. This programme commenced that month, and by the year end funds of £37.7m (including costs) had been disbursed. This programme will be completed following the publication of the results for the year.

At the time of approving the final dividend for the year the Board also authorised a further buy-back programme of £50.0m. this programme will commence after the completion of the June 2021 programme and the shares purchased will initially be held in Treasury.

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

	Note	2021	2020
Earnings per share (p)	8	65.2	36.0
Proposed dividend per share in respect of the year (p)	21	26.1	14.4
Dividend cover (times)		2.50	2.50

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 2021, also confirmed the existing dividend policy would continue to apply for future periods, subject to the impact of any future events, and the Board 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 2021

27. CREDIT RISK

Loans to customers

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

The Group's balance sheet loan assets at 30 September 2021 are analysed as follows:

	2021		2020	
	£m	%	£m	%
Buy-to-let mortgages	11,424.3	85.2%	10,583.8	83.8%
Owner-occupied mortgages	36.3	0.3%	53.1	0.4%
Total first charge residential mortgages	11,460.6	85.5%	10,636.9	84.2%
Second charge mortgage loans	281.7	2.1%	354.5	2.8%
Loans secured on residential property	11,742.3	87.6%	10,991.4	87.0%
Development finance	608.2	4.5%	609.0	4.8%
Loans secured on property	12,350.5	92.1%	11,600.4	91.8%
Asset finance loans	440.5	3.3%	452.0	3.6%
Motor finance loans	229.2	1.7%	272.4	2.2%
Aircraft mortgages	28.2	0.2%	26.0	0.2%
Structured lending	118.9	0.9%	94.9	0.7%
Invoice finance	20.9	0.2%	13.5	0.1%
Total secured loans	13,188.2	98.4%	12,459.2	98.6%
Professions finance	33.1	0.3%	22.3	0.2%
RLS, CBILS and BBLS	83.8	0.6%	25.2	0.2%
Other unsecured commercial loans	10.3	0.1%	15.0	0.1%
Unsecured consumer loans	87.3	0.6%	109.7	0.9%
Total loans to customers	13,402.7	100.0%	12,631.4	100.0%

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

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

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

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.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the year ended 30 September 2021

27. CREDIT RISK (CONTINUED)

Loans made under the RLS, the CBILS and the 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.

	2021 £m	2020 £m
Buy-to-let mortgages	163.3	154.3
Development finance	217.9	240.0
Structured lending	108.7	72.7
Asset finance	10.4	-
	500.3	467.0

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 2021

27. CREDIT RISK (CONTINUED)

Credit grading

An analysis of the Group's loans to customers by absolute level of credit risk at 30 September 2021 is set out below. The analysed amount represents gross carrying amount.

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
30 September 2021					
Very low risk	9,834.5	563.8	1.3	41.9	10,441.5
Low risk	1,716.9	532.2	78.5	16.3	2,343.9
Moderate risk	149.2	130.2	3.8	22.4	305.6
High risk	42.0	23.7	11.6	21.7	99.0
Very high risk	42.0	27.5	62.0	17.4	148.9
Not graded	115.8	1.7	7.1	4.6	129.2
Total gross carrying amount	11,900.4	1,279.1	164.3	124.3	13,468.1
Impairment	(15.0)	(11.3)	(38.9)	(0.2)	(65.4)
Total loans to customers	11,885.4	1,267.8	125.4	124.1	13,402.7
30 September 2020					
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

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 lower risk cases in higher IFRS 9 stages include fully up-to-date receiver of rent cases; accounts where the customer is in arrears on their account with the Group but up to date on accounts with other lenders, creating an overall positive credit rating; 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 2021

27. CREDIT RISK (CONTINUED)

A small proportion of the loan book (2021: 1.0%, 2020: 2.9%) 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.

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 customer is entitled to settle the loan at any point and in most cases early settlement does take place. All customers on these accounts are required to make monthly payments.

An analysis of the indexed LTV ratio for those loan accounts secured on residential property by value at 30 September 2021 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**	
	2021	**2020**	**2021**	**2020**
	%	**%**	**%**	**%**
Loan to value ratio				
Less than 70%	83.8	59.9	88.4	74.5
70% to 80%	14.3	35.9	8.5	16.7
80% to 90%	0.5	2.3	1.5	5.2
90% to 100%	0.3	0.4	0.6	1.2
Over 100%	1.1	1.5	1.0	2.4
	100.0	100.0	100.0	100.0
Average LTV ratio	61.1	65.7	56.1	62.2
Of which:				
Buy-to-let	61.2	65.8		
Owner-occupied	42.0	49.2		

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 10.0% in the year ended 30 September 2021 (2020: 5.0%).

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the year ended 30 September 2021

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	
	2021	2020	2021	2020
	%	%	%	%
East Anglia	3.3	3.2	3.3	3.3
East Midlands	5.5	5.4	6.3	6.1
Greater London	18.5	18.7	7.8	8.2
North	3.1	3.2	4.0	3.9
North West	10.3	10.4	7.4	7.4
South East	31.8	31.6	39.3	39.5
South West	8.7	8.7	8.3	8.0
West Midlands	5.5	5.4	7.1	7.3
Yorkshire and Humberside	8.1	8.4	6.0	5.9
Total England	94.8	95.0	89.5	89.6
Northern Ireland	0.1	0.1	1.8	1.7
Scotland	2.0	1.7	5.2	5.2
Wales	3.1	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 (2020: 21 months). Settlement of principal and accrued interest takes place once the development is sold or refinanced following its completion and the customer is not normally required to make payments during the term of the loan. The loans are secured by a legal charge over the site and/or property together with other charges and warranties related to the build.

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 against the costs and progress in the agreed development programme 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.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the year ended 30 September 2021

27. CREDIT RISK (CONTINUED)

LTGDV	2021 By value %	2021 By number %	2020 By value %	2020 By number %
50% or less	2.9	5.3	7.6	4.8
50% to 60%	27.3	20.6	22.4	13.2
60% to 65%	44.3	49.4	34.0	41.0
65% to 70%	22.8	21.9	31.3	36.1
70% to 75%	1.4	1.6	2.8	4.0
Over 75%	1.3	1.2	1.9	0.9
	100.0	100.0	100.0	100.0

The average LTGDV cover at the year end was 61.7% (2020: 63.1%).

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 focus on residential property development within the portfolio means that asset values will generally move in line with the UK residential property market.

At 30 September 2021, the development finance portfolio comprised 247 accounts (2020: 229) with a total carrying value of £608.2m (2020: £609.0m). Of these accounts only 10 were included in Stage 2 at 30 September 2021 (2020: seven), with no accounts classified as Stage 3 (2020: one). In addition, account one acquired had been classified as POCI (2020: one). An allowance for this loss 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.

	2021 %	2020 %
East Anglia	3.6	5.1
East Midlands	6.3	5.5
Greater London	6.1	8.2
North	2.4	1.8
North West	1.1	0.4
South East	57.5	58.8
South West	13.5	14.0
West Midlands	4.8	4.0
Yorkshire and Humberside	3.5	1.1
Total England	98.8	98.9
Northern Ireland	-	-
Scotland	1.2	1.1
Wales	-	-
	100.0	100.0

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. The average contractual life of the asset finance loans was 51 months (2020: 52 months) while that of the motor finance loans was 64 months (2020: 60 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.

	2021	2020
	%	%
Commercial vehicles	33.4	32.0
Construction plant	34.2	33.7
Technology	7.0	6.9
Manufacturing	6.2	6.7
Print and paper	2.3	3.7
Refuse disposal vehicles	4.3	4.8
Other vehicles	4.3	3.6
Agriculture	3.1	2.9
Other	5.2	5.7
	100.0	100.0

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

Structured lending

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

Summary details of the structured lending portfolio are set out below.

	2021	2020
Number of active facilities	8	8
Total facilities (£m)	185.5	139.0
Carrying value (£m)	118.9	94.9

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 a 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 2021

27. CREDIT RISK (CONTINUED)

At 30 September 2021, one of these facilities was identified as Stage 2 (2020: four) with the remainder in Stage 1.

RLS, CBILS and BBLS

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

CBILS and BBLS were launched in 2020 and remained open for new applications until March 2021. RLS was launched in April 2021 as a successor scheme and is expected to be available until June 2022.

The Group offered 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 covers up to 80% of the lender's principal loss after the application of any proceeds from the asset financed (if applicable).

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 offers term loans and asset finance loans under the RLS. Interest and fees are payable by the customer from inception. The Government guarantee covers up to 80% of the lender's principal loss up, after the application of any proceeds from the asset financed (if applicable), although the Government has announced its intent to reduce this cover to 70% for applications received after 1 January 2022.

The Group's outstanding RLS, CBILS and BBLS loans at 30 September 2021 were:

	2021	**2020**
	£m	**£m**
RLS		
Term loans	0.1	-
Asset finance	20.7	-
Total RLS	20.8	-
CBILS		
Term loans	28.1	20.6
Asset finance	29.9	1.0
Total CBILS	58.0	21.6
BBLS	5.0	3.6
	83.8	25.2

At 30 September 2021, only £0.2m of this balance was considered to be non-performing (2020: £nil).

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the year ended 30 September 2021

27. CREDIT RISK (CONTINUED)

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.

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 2021 and 30 September 2020, compared to the industry averages at those dates published by UK Finance ('UKF') and the FLA, was:

	2021	2020
	%	%
First mortgages		
Accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	0.21	0.15
Buy-to-let accounts excluding receiver of rent cases	0.14	0.10
Owner-occupied accounts	4.48	3.72
UKF data for mortgage accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	0.45	0.52
Buy-to-let accounts excluding receiver of rent cases	0.43	0.50
Owner-occupied accounts	0.85	0.90
All mortgages	0.78	0.82
Second charge mortgage loans		
Accounts more than 2 months in arrears		
All accounts	19.08	14.77
Post-2010 originations	1.18	0.62
Legacy cases (Pre-2010 originations)	23.12	21.17
Purchased assets	24.76	17.85
FLA data for secured loans	8.60	8.40
Motor finance loans		
Accounts more than 2 months in arrears		
All accounts	4.15	4.58
Originated cases	2.30	1.76
Purchased assets	14.07	13.10
Asset finance loans		
Accounts more than 2 months in arrears	0.27	1.75
FLA data for business lease / hire purchase loans	0.60	1.70

No published industry data for asset classes comparable to the Group's other books has been identified. Where revised data at 30 September 2020 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 appropriate.

27. CREDIT RISK (CONTINUED)

It should be noted that, where customers were allowed to defer payments as part of Covid reliefs, these deferrals were not classified as arrears, in accordance with regulatory guidance.

Few of the arrangements remained in place at 30 September 2021, meaning that some of the increases shown above will relate to the suppression of arrears at the previous year end.

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 the Group's unsecured consumer loan assets are part of purchased debt portfolios where the consideration paid was 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 2021.

Collections on purchased accounts have been comfortably in excess of those implicit in the purchase prices.

In the debt purchase industry, 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 2021

27. CREDIT RISK (CONTINUED)

However, to aid comparability, the 84 and 120 month ERCs value 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.

	2021	**2020**	**2019**
	£m	**£m**	**£m**
All purchased consumer assets			
Carrying value	185.2	235.3	291.1
84 month ERCs	221.2	277.8	342.3
120 month ERCs	245.2	313.7	387.5
POCI assets only			
Carrying value	113.2	139.8	168.3
84 month ERCs	143.9	176.9	214.1
120 month ERCs	163.4	203.7	246.0

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 2021

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 preliminary financial information has been prepared on the basis of the accounting policies used in the production of the financial statements for the year. Therefore, they have been prepared on the basis of accounting policies set out in the Annual Report and Accounts of the Group for the year ended 30 September 2020, except for the adoption of the amendments to IFRS 9 and IAS 39 described in note 29 below.

The Group is required to prepare its financial statements for the year ending 30 September 2021 in accordance with International Financial Reporting Standards ('IFRS') in conformity with the requirements of the Companies Act 2006. They must also be prepared in accordance with IFRS adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union ('EU'). In the financial years reported on this will also mean that, in the Group's circumstances, the financial statements also accord with IFRS as approved by the International Accounting Standards Board.

The "requirements of the Companies Act 2006" here means accounts being prepared in accordance with "international accounting standards" as defined in section 474(1) of that Act, as it applied immediately before IP Completion Day (the end of the UK's transition period following its departure from the EU) ('IPCD'), including where the Company also makes use of standards which have been adopted for use within the United Kingdom in accordance with regulation 1(5) of the International Accounting Standards and European Public Limited Liability Company (Amendment etc.) (EU Exit) Regulations 2019, subsequent to the IPCD.

Under the Listing Rules of the FCA, despite the UK's exit from the EU on 31 January 2020, the EU endorsed IFRS regime remains applicable to the Group until its first financial year commencing after the IPCD on 31 December 2020.

Therefore, while EU endorsed IFRS applies to these financial statements, those for the year ending 30 September 2022 will instead be prepared under 'UK-adopted international accounting standards'.

The changes in the way that the basis of preparation is described, which result from the UK's exit from the EU, including the move to UK-adopted international accounting standards from the Group's financial year commencing 1 October 2021, do not represent a change in the basis of accounting which would necessitate a prior year restatement.

Going concern basis

The going concern basis has been adopted in the preparation of this preliminary financial information. The reasons for the adoption of this basis are set out in note 31.

NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION
For the year ended 30 September 2021

28. ACCOUNTING POLICIES (CONTINUED)

Comparability of information

The balance sheet information at 30 September 2019, was not required to be restated on the adoption of IFRS 16 on 1 October 2020. The information presented is derived in accordance with IAS 17 – 'Leases' ('IAS 17'), and therefore may not be directly comparable with the balance sheets at 30 September 2021 and 30 September 2020 which are prepared under IFRS 16.

New and revised reporting standards

Other Standards and interpretations in issue but not effective do not address matters relevant to the Group's accounting and reporting.

No new or revised reporting standards significantly affecting the Group's accounting have been issued since the approval of the Group's financial statements for the year ended 30 September 2020.

29. CHANGES IN ACCOUNTING STANDARDS

IAS 39 amendments 'Interest Rate Benchmark Reform'

In August 2020 the IASB issued a further amendment to IAS 39 'Interest Rate Benchmark Reform – Phase 2'. This amendment sets out accounting requirements for the treatment of IBOR-linked financial assets and liabilities under the amortised cost method and IBOR related hedge accounting when a firm replaces the IBOR linkage in the underlying instruments with a replacement benchmark. It is therefore potentially applicable to the Group's LIBOR-linked loan assets and those FRN liabilities where interest is charged on the basis of LIBOR or other IBOR rates. It also affects the Group's LIBOR (and other IBOR) referenced derivative assets and liabilities and the hedging relationships which they form part of.

The intention of the standard is that, where the transition is effectively a like for like replacement, no windfall gain or loss should occur on transition, and hedging relationships should be able to continue.

This amendment is effective from the Group's financial year ending 30 September 2022 but has been endorsed by both the EU and the UK and has been early adopted by the Group as permitted. The Group has utilised, and will continue to utilise, the provisions of the amendment as it transitions its IBOR-linked assets and liabilities. The impact of the amendment will depend upon the IBOR related assets, liabilities and hedging relationships at the point at which transition occurs.

30. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

The most significant judgements which the directors have made in the application of the accounting policies set out in note 28 relate to:

(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 PD, 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.

In determining whether an account has an SICR in the Covid environment the granting of Covid 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-related 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) Definition of default

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

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

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

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

NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION
For the year ended 30 September 2021

30. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (CONTINUED)

(c) Classification of financial assets

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

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

Financial assets are classified as held at amortised cost, at fair value through OCI, or at fair value through profit and loss.

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

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

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

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

Certain of the balances reported in the financial statements are based wholly or in part on estimates or assumptions made by the directors. There is, therefore, a potential risk that they may be subject to change in future periods. The most significant of these are:

(d) 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.

30. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (CONTINUED)

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 the ongoing effects of the Covid pandemic, 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.

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 2021 have been derived in light of the current economic situation, modelling a variety of possible outcomes as described in note 11. It should be noted, however, that there remains a significant range of different opinions amongst economists about the longer-term prospects for the UK and, while these positions are converging, this is likely to remain the case for some time to come.

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.

30. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (CONTINUED)

As a result of this exercise additional requirements for provision were identified, to compensate for potential model weakness and to allow for economic pressures in the wider economy which cannot be identified by a modelled approach. By their nature such adjustments are less systematic and therefore subject to a wider range of outturns. The nature and amounts of these PMA's are set out in note 11.

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 economic scenarios described above and their impact on the overall provision are also set out in that note.

(e) **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. For each portfolio a model is in place to ensure that income is appropriately spread.

The underlying 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.

To illustrate the potential variability of the estimate, the amortised cost values were recalculated by changing one factor in the EIR calculation and keeping all others at their current levels. This exercise indicated that:

- A reduction of the assumed average lives of loans secured on residential property by three months would reduce balance sheet assets by £12.0m (2020: £11.2m), while an increase of the assumed asset lives of such assets by three months would increase balance sheet assets by £12.1m (2020: £10.3m)
- An increase of 50% in the number of five year fixed rate buy-to-let loan assets assumed to redeem before the end of the fixed rate period, generating additional early redemption charges would increase balance sheet assets by £11.2m (2020: £7.3m)
- A reduction (or increase) in estimated cash flows from purchased loan assets of 5% would reduce (or increase) balance sheet assets by £7.1m (2020: £9.4m)

As any of these changes would, in reality, be accompanied by movements in other factors, actual outcomes may differ from these estimates.

NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION
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30. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (CONTINUED)

(f) 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. As the Group forecasts are based on the Group's central economic scenario, any variance from this will potentially impact on the valuation. 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.

(g) Retirement benefits

The present value of the retirement benefit obligation is derived from an actuarial calculation which rests on a number of assumptions relating to inflation, long-term return on investments and mortality. Where actual conditions differ from those assumed the ultimate value of the obligation would be different.

31. GOING CONCERN

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. The guidance requires that this assessment covers a period of at least twelve months from the date of approval of these financial statements.

The Group makes extensive use of stress testing in compiling and reviewing its forecasts. This stress testing approach was reviewed in detail during the year as part of the annual ICAAP cycle, where testing considered the impact of a number of severe but plausible scenarios. During the planning process, sensitivity analysis was carried out on a number of key assumptions that underpin the forecast to evaluate the impact of the Group's principal risks.

NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION
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31. GOING CONCERN (CONTINUED)

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

- Increased business volumes – An increase of 20% in buy-to-let application 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 – 25bps higher cost on all new savings deposits throughout. This scenario illustrated the impact of a significant prolonged margin squeeze on profitability and whether this would cause significant impacts on any capital, liquidity or encumbrance ratios
- Lower development finance growth – 50% lower loan book growth across the plan horizon coupled with a 50bp margin reduction. This scenario replicated a significant increase in competition within the sector, illustrating the impact of a lower proportion of the high-yielding development finance product in the Group's long-term asset mix on contribution to costs and other key ratios for the Group
- Higher buy-to-let redemptions – double redemption rates on all cohorts for the first three months post-reversion. With a significant volume of five-year fixes coming to an end in 2022, this scenario highlighted the potential risk that is inherent in the accounting difference between current and amortised cost balances on such loans, and invited discussion as to what mitigating action could be taken to avoid such an impact
- High impairment – a stress that modelled the IFRS 9 year end severe scenario across the plan horizon, simulating a significant short-term capital and profitability shock with prolonged house price deflation, but maintaining the same lending levels as the base case. This scenario is described in more detail in Note 11 and is derived from, but more severe than the stress testing scenario published by the Bank of England in January 2021. 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

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.

As part of the ICAAP process the Group also assessed the potential operational risks it could face. This was done through the analysis of the impact and cost of a series of severe but plausible scenarios. This analysis did not highlight any factors which cast doubt on the Group's ability to continue as a going concern.

The Group begins the forecast period with a strong capital and liquidity position, enabling the management of any significant outflows of deposits and / or reduced inflows from customer receipts. 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.

NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION
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31. GOING CONCERN (CONTINUED)

The Group's retail deposits of £9,300.4m (note 14), raised through Paragon Bank, are repayable within five years, with 77.6% of this balance (£7,212.9m) 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 2021 Paragon Bank held £942.7m 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 £1,092.7m.

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, updated annually. The Bank maintains a liquidity framework that includes a short to medium term cash flow requirement analysis, a longer-term funding plan and access to the Bank of England's liquidity insurance facilities, where pre-positioned assets would support drawings of £1,424.2m. 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 2021 the Group had £529.2m of such notes available for use, of which £287.0m were rated AAA. The available AAA notes would give access to £149.3m if used to support drawings on Bank of England facilities.

The Group's securitisation funding structures provide match funding for part of the asset base. 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 remains active with strong levels of demand and the Group maintains the infrastructure required to access it.

The earliest maturity of any of the Group's bond debt is the £125.0m retail bond, due January 2022. £69.0m of TFS debt was paid down after the year end and all other central bank debt was refinanced and is not payable until 2025.

The Group's access to debt is enhanced by its corporate BBB rating, affirmed by Fitch Ratings in March 2021, and its status as an issuer is evidenced by the BB+ rating of its £150.0 million Tier 2 bond issued in the year. 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 has access to the short-term repo market for liquidity purposes which it uses from time to time, including during the financial year ended 30 September 2021.

The Group's cash analysis, which includes the impact of all scheduled debt and deposit repayments, continues to show a strong position, even after allowing scope for significant discretionary payments and capital distributions.

As described in note 26 the Group's capital base is subject to consolidated supervision by the PRA the most recent review of the Group's capital position and management systems resulted in a reduction of the minimum capital level. Its capital at 30 September 2021 was in excess of regulatory requirements and its forecasts indicate this will continue to be the case.

NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION
For the year ended 30 September 2021

31. GOING CONCERN (CONTINUED)

After performing this assessment, the directors concluded that there was no material uncertainty as to whether the Group would be able to maintain adequate capital and liquidity for at least twelve months following the date of approval of these financial statements and consequently that it was appropriate for them to continue to adopt the going concern basis in preparing the financial statements of the Group.

32. 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 2021 or the year ended 30 September 2020 carried at fair value and valued using level 3 measurements, other than contingent consideration amounts (note 16).

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

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

NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION
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32. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

(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	2021 £m	2020 £m
Financial assets			
Derivative financial assets	12	44.2	463.3
		44.2	463.3
Financial liabilities			
Derivative financial liabilities	12	43.9	132.4
Contingent consideration	16	7.5	13.5
		51.4	145.9

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

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 market interest rate, adjusted for risk as appropriate.

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, EUR 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.

NOTES TO THE PRELIMINARY FINANCIAL INFORMATION – BASIS OF PREPARATION
For the year ended 30 September 2021

32. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

Contingent consideration

The value of the contingent consideration balances shown in note 16 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.

(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	2021 Carrying amount £m	2021 Fair value £m	2020 Carrying amount £m	2020 Fair value £m
The Group					
Financial assets					
Cash	9	1,360.1	1,360.1	1,925.0	1,925.0
Loans to customers	10	13,402.7	13,470.6	12,631.4	12,856.1
Sundry financial assets		65.7	65.7	125.3	125.3
		14,828.5	14,896.4	14,681.7	14,906.4
Financial liabilities					
Short term bank borrowings		0.3	0.3	0.4	0.4
Asset backed loan notes		516.0	516.0	3,270.5	3,270.5
Secured bank borrowings		730.0	730.0	657.8	657.8
Retail deposits	14	9,300.4	9,308.5	7,856.6	7,900.6
Corporate and retail bonds		386.1	411.9	446.6	455.7
Other financial liabilities	16	66.3	66.3	74.6	74.6
		10,999.1	11,033.0	12,306.5	12,359.6

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

32. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

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.

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 2021

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.

	2021 £m	2020 £m
Profit on ordinary activities before tax	213.7	118.4
Add back: Fair value adjustments	(19.5)	1.6
Underlying profit	194.2	120.0

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

	2021 £m	2020 £m
Underlying profit	194.2	120.0
Tax at effective rate (note 7)	(44.7)	(27.5)
Underlying earnings	149.5	92.5
Basic weighted average number of shares (note 8)	252.3	253.6
Underlying earnings per share	59.3p	36.5p

APPENDICES TO THE PRELIMINARY ANNOUNCEMENT
For the year ended 30 September 2021

A. UNDERLYING RESULTS (CONTINUED)

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

	2021 £m	2020 £m
Underlying earnings	149.5	92.5
Amortisation of intangible assets	2.0	2.0
Adjusted underlying earnings	151.5	94.5
Average tangible equity (note 26(b))	1,028.5	961.6
Underlying RoTE	14.7%	9.8%

APPENDICES TO THE PRELIMINARY ANNOUNCEMENT
For the year ended 30 September 2021

B. INCOME STATEMENT RATIOS

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 2021

	Note	Mortgage Lending £m	Commercial Lending £m	Idem Capital £m	Total £m
Opening loans to customers	10	10,819.5	1,514.8	297.1	12,631.4
Closing loans to customers	10	11,608.7	1,568.8	225.2	13,402.7
Average loans to customers		11,214.1	1,541.8	261.1	13,017.0
Net interest		219.2	94.5	20.2	310.5
NIM		1.95%	6.13%	7.74%	2.39%
Impairment provision (release) / charge	11	(5.9)	2.9	(1.7)	(4.7)
Cost of risk		(0.05)%	0.19%	(0.65)%	(0.04)%

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		190.0	82.1	26.1	278.1
NIM		1.80%	5.53%	7.60%	2.24%
Impairment provision charge	11	25.8	21.7	0.8	48.3
Cost of risk		0.24%	1.46%	0.23%	0.39%

Not all interest is allocated to segments (note 2).

APPENDICES TO THE PRELIMINARY ANNOUNCEMENT
For the year ended 30 September 2021

C. COST:INCOME RATIO

Cost: income ratio is derived as follows:

	Note	2021 £m	2020 £m
Cost – operating expenses		135.4	126.8
Total operating income		324.9	295.1
Cost / Income		41.7%	43.0%

D. NET ASSET VALUE

	Note	2021	2020
Total equity (£m)		1,241.9	1,156.0
Outstanding issued shares (m)	18	262.5	261.8
Treasury shares (m)	20	(12.1)	(5.2)
Shares held by ESOP schemes (m)	20	(3.7)	(3.6)
		246.7	253.0
Net asset value per £1 ordinary share		£5.03	£4.57
Tangible equity (£m)	26	1,071.4	985.9
Tangible net asset value per £1 ordinary share		£4.34	£3.90

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 but are not the exclusive means of identifying such statements. These have been made by the directors in good faith using information available up to the date on which they approved this report, and the Group undertakes no obligation to update or revise these forward-looking statements for any reason other than in accordance with its legal or regulatory obligations (including under the UK Market Abuse Regulation, UK Listing Rules and the Disclosure Guidance and Transparency Rules of the Financial Conduct Authority (‘FCA’)).

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 also 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 pandemic and ongoing challenges and uncertainties posed by the Covid pandemic for businesses and governments around the world, including the duration, spread and any recurrence of the Covid pandemic and the extent of the impact of the Covid pandemic on overall demand for the Group’s services and products; potential changes in 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 pandemic); actions by the Group’s competitors or counterparties; third party, fraud and reputational risks inherent in its operations; the UK’s exit from the EU; unstable economic conditions and market volatility, including currency fluctuations; the risk of a global economic downturn; technological changes and risks to the security of IT and operational infrastructure, systems, data and information resulting from increased threat of cyber and other attacks; general changes in government policy that may significantly influence investor decisions (including, without limitation, actions taken in support of managing and mitigating climate change and in supporting the global transition to net zero carbon emissions); societal shifts in customer financing and investment needs; and other risks inherent to the industries in which the Group operates.

Nothing in this preliminary announcement should be construed as a profit forecast.