Paragon Banking Group PLC

Preliminary announcement

For the year ended 30 September 2022

RNS Announcement
Paragon Banking Group PLC
6 December 2022

Strong delivery and well positioned in volatile markets

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 2022

Nigel Terrington, Chief Executive of Paragon said:

"These results reflect an outstanding financial and operational performance, delivering good growth, enhanced margins and improved cost efficiency, all combining to deliver strong returns to shareholders.

As a leading specialist banking group we are increasingly using technology to strengthen our franchises. New digital platforms introduced in the last year are already seeing tangible evidence of an enhanced customer proposition and service delivery, as well as improved cost efficiencies.

Our cautious risk appetite, high quality loan book and extensive through-the-cycle experience ensure we are well positioned as we head into 2023 and are fully prepared to support our customers' needs."

Financial highlights

- Operating profit before fair value items increased by 16.4% to £226.0 million (2021: £194.2 million)
- Statutory profit before tax increased by 95.6% to £417.9 million (2021: £213.7 million) reflecting non-cash accounting fair value gains which will reverse over time, providing high levels of protection to pipeline margins
- Underlying cost to income ratio improved to 39.4% (2021: 41.7%)
- Economic scenarios in impairment calculations updated to reflect more cautious outlook with weighting increased on severe scenario
- Underlying EPS up 17.9% to 69.9p (2021: 59.3p), reported EPS up 98.2% to 129.2p (2021: 65.2p)
- Total dividend up 9.6% to 28.6p (2021: 26.1p) reflecting smoothing of pandemic catch-ups in 2021
- Capital ratios further enhanced: CET1 ratio at 16.3% (2021: 15.4%)
- Net interest margin increased by 30 basis points year-on-year to 269 basis points, reflecting the Group's diversification strategy
- Underlying Return on Tangible Equity increased to 16.0% (2021: 14.7%)
- 30 September 2022 Tangible Net Asset Value per share £5.33 (2021:£4.34) up 22.8%
- Share buy-back of up to £50.0 million announced for 2023 financial year

Operational highlights

- Total new lending up 23.6% to £3.21 billion:
  - Mortgage Lending advances increased by 17.2% to £1.91 billion (2021: £1.63 billion)
  - Commercial Lending advances increased by 34.3% to £1.30 billion (2021: £0.97 billion)
  - Robust and high quality pipelines into 2023 provide an encouraging platform in the more uncertain new lending environment
- Over 70% of maturing complex buy-to-let customers retained at product maturity demonstrating the value of the proposition to landlords
- Arrears on the buy-to-let book reduced to 0.15% (2021: 0.21%) reflecting the quality of the portfolio
- Buy-to-let loan to value ratio at 57.9% (2021: 61.2%), representing significant asset backing
- Retail deposits up 14.7% to £10.7 billion (2021: £9.3 billion), exceeding £10 billion for the first time and providing a reliable, scalable and cost-effective source of funding
- Digitalisation process continuing at pace, with development finance successfully re-platformed and a new asset finance origination platform delivered during the year
- Phase 2 of IRB application ongoing, initial PRA feedback received
- Basel 3.1 consultation proposals broadly as anticipated, but Strong and Simple threshold increase and IRB proposals will be beneficial if retained in the eventual supervisory statement

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The Group will be holding a presentation for sell-side analysts on 6 December 2022 at 9:30am, a recording of which will be available on the Group's corporate 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 announcement.

Introduction

The Group has maintained the progress seen in 2021 into 2022, delivering strong results which reflect its strategic positioning, strong operational performance, robust operating platform and the commitment and professionalism of its people.

Our business model has been designed, using extensive through-the-cycle experience, to be resilient in challenging environments. Further, our diversification strategy and balance sheet structuring are designed to deliver stable funding, generate improved returns over time and also benefit in periods of higher interest rates.

The 2022 outturns demonstrate the effectiveness of this strategy, with the net loan book growing by 6.0%, margins widening by 30 basis points, cost efficiency improving and the underlying return on tangible equity rising to 16.0%. Statutory tangible net asset value per share increased by 22.8% to £5.33 per share (2021: £4.34).

The Group maintains close relationships with its customers, intermediaries and other business partners which have been particularly important with both the increase in the cost of living, and then interest rates rising sharply during the year.

Alongside this strong financial and operational delivery, we have continued to implement our digitalisation plans, with a number of front and back-office developments being delivered during the year, making immediate tangible improvements to customer journeys and operational efficiency.

Financial performance

Trading has been strong across the Group in the year. A combination of strong loan growth, widening net interest margins and tight cost control have resulted in profit before fair value items increasing by 16.4% to £226.0 million (2021: £194.2 million).

We have updated the Multiple Economic Scenarios ('MES') used for our impairment assessments, particularly in light of recent instability arising from the end of the pandemic, the war in Ukraine, rising inflation and interest rates and the policy responses to this backdrop. The scenario changes are illustrated below by comparing the weighted average forecast levels of key variables for the quarter ending 30 September 2023 in the current forecast to those for the same period in the forecast used at the previous year end.

Forecast for the quarter ended 30 September 2023	2022 MES	2021 MES
GDP	(1.1)%	2.9%
CPI	11.9%	1.9%
Unemployment	5.3%	5.9%
House prices	(8.2)%	(0.7)%

In addition to a harsher suite of assumptions, given the extreme volatility seen, particularly in the final quarter of the year, the Group has adjusted its downside / severe weighting mix from 35% / 15% in 2021 to a 30% / 20% in the current year. We have also released the remaining Covid overlays, but have added £15.0 million of judgmental adjustments to reflect the lack of observed data (notably in respect of inflation data) in the model build.

The Group has always operated a cautious hedging strategy, designed to minimise interest rate risk. This hedging takes place for both completed loans and the pipeline, and the Group has strategically increased its level of pipeline hedging in the year to enhance the protection of future margins. Derivatives hedging the pipeline only qualify for hedge accounting when the loan actually completes and are measured on a fair value basis until that point. Taking swaps out early in the process has, in a rapidly rising rate environment, created a material (£191.9 million) fair value gain for 2022. Whilst this will reverse over the coming years, it evidences the value that would have been lost to the Group had the pipeline loans only been hedged when they actually converted.

Basic earnings per share rose 17.9% to 69.9 pence on an underlying basis (removing the after tax impact of the fair value gains). Including the gains, reported basic EPS rose by 98.2% to 129.2p per share.

The total dividend for the year of 28.6 pence per share represents around 40% of the underlying earnings per share, with the effects of fair value movements removed.

Trading performance

Aggregate new business levels rose by 23.6% from 2021's level to £3.2 billion in 2022. As well as new front-end systems in the Commercial Lending division, the Group also benefitted from system and processing enhancements in its buy-to-let business, most notably in its product maturity management.

Mortgage Lending new advances increased by 17.2% to £1.91 billion (2021: £1.63 billion). The focus continues to be on complex properties and professional landlords, with simple business comprising just 2.1% of completions (2021: 3.2%). Five-year fixed rate loans, which increased in popularity in 2017, started to reach product maturity in 2022. The Group has been particularly successful in retaining these customers, having developed an online portal to facilitate the maturity process, and over 70% of our maturing specialist landlord customers chose to refinance with the Group at product maturity. The credit performance of the buy-to-let mortgage portfolio remains strong, with indexed loan to values falling to 57.9% at September 2022 (2021: 61.2%) and with only 1.4% of the book having an indexed LTV above 80%. Three month plus arrears on the portfolio were 15 basis points at 30 September 2022 (2021: 21 basis points).

Commercial Lending also had a strong year, with our new advances increasing by 34.3% to £1.30 billion, with each of the four sub-divisions seeing year-on-year growth. A complete end-to-end replatforming was delivered in development finance and a new digital broker portal launched in SME Lending during the year, the latter having an immediate impact on our processing times and business flows, which saw a rise of 40.9% in the final quarter of the year compared to the third quarter. Further digital enhancements will be delivered in the next financial year.

Capital and funding

Savings deposits remain the prime funding source for the Group, with balances increasing by 14.7% in the year, to £10.7 billion. The pricing profile of these deposits also changed during the period. Whilst comparing very favourably to the rates paid by the larger banks, the price of the administered rate portfolio moved from a premium of 37 basis points above SONIA at September 2021 to a discount of 64 basis points at September 2022. Further, for much of the second half of the year, equivalent swap rates exceeded the price of the Group's fixed rate bonds, also generating post-hedging funding below SONIA on this portion of the deposit book.

The move to a retail, rather than wholesale funded basis, has benefitted the Group greatly during the year and is the main driver in the outperformance of its net interest margin against both initial guidance and expectations. This optionality provides significant benefit and is a reflection of the Group's diversification strategy.

The Group completed £64.2 million of its £75.0 million share buy-back in the year. However having given an irrevocable instruction to Peel Hunt to complete the buy-back, the full value has been deducted from equity. The buy-back was subsequently completed on 7 November 2022. At 30 September 2022, our CET1 and TCR ratios stood at 16.3% and 18.3% respectively (2021: 15.4% and 17.6% respectively).

The level of capital resources substantially exceeds the regulatory minimum, which stands at 8.8% at the CET1 level, recognising the Group has no AT1 issuance.

Following the year end the Bank of England published their Consultation Paper regarding the process for the implementation of the Basel 3.1 standards in the UK. These largely followed the core Basel proposals and, as such, were materially in line with expectations. The Consultation Paper also highlighted enhancements to the IRB accreditation process and an increase in the Bank's threshold for Strong and Simple treatment to £20 billion of assets, each of which would have a favourable impact on the Group if retained in the ultimate supervisory statement.

The Group's IRB accreditation process continues. Although this has taken longer than initially anticipated, we now have good engagement with the PRA team. Non-binding feedback has been received in respect of the modelling aspects covered in Phase 2 of the process, with subsequent analysis and model remediation underway to meet the PRA's expectations.

Business model developments

The Group's multi-business line digitalisation programme continued at pace during the year. In addition to the development finance and SME systems noted above there were further notable developments, including the maturity management portal in buy-to-let and the movement of our general ledger to a cloud-based solution. An extensive change programme remains in place, with further developments scheduled to go live across the current and subsequent years. The general approach to accounting for these developments is to expense the bulk of expenditure, with the value of capitalised computer software standing at only £3.9 million at the year end.

People

The strong results for the year would not have been possible without the continued hard work, dedication and performance of our people. During the year we were awarded Platinum status by Investors in People ('IiP'), reflecting the Group's strong training and development approach and importantly the demonstration of behaviours that clearly reflect our values and culture. This status has only been attained by 5% of firms accredited by IiP.

We are committed to demonstrating a diverse and inclusive workplace, with the activities of our Equality, Diversity and Inclusion ('EDI') network materially expanding during the year, together with regular board engagement. Our initial HM Treasury Women in Finance targets, set in 2017, have been substantially met.

We have been particularly aware of the challenges our people were facing given the rapid increase in living costs in the year, and we gave each employee below senior management level a £500 one-off payment in the summer, together with a £500 advance on the 2022 profit related pay ('PRP') payment. Given the record level of profit reported in 2022, the final element of the 2022 PRP award will also be strong – further supporting our people.

Sustainability

In its first full year of operation the Group's Sustainability Committee has made much progress in fostering a holistic approach to a range of environmental and social issues and their related risks and opportunities. A particular area of focus has been climate change, where we are aware of the level of interest from stakeholders and regulators.

Policies have continued to develop in this area, while the year also saw the first offsetting of operational emissions, the continued greening of the Group's office estate and significant developments in lending on battery electric vehicles and energy efficient properties. The Group has also joined Bankers for Net Zero.

More widely the Group was pleased to publish its first Code of Conduct, outlining for all stakeholders the principles which guide its relationships with employees, customers, business introducers, suppliers and the wider community.

Outlook

The recent economic backdrop has created a volatile operating environment, with cost of living increases and rising interest rates creating uncertainties which impact demand, affordability and will potentially increase impairment levels. The Group's funding structure allows for a swift reaction to the changing environment and close contact with our customers allows us to help those who face difficulties as a result of changing rates and inflationary pressures.

We recognise that this environment will present challenges for the UK, its consumers and its businesses and, as an organisation built on relationships, we stand ready to support our customers through this difficult period.

We enter 2023 with strong margins, high quality loan books, robust pipelines, strong capital, cautious provisioning and well-developed franchises in each of our operating divisions. Our digitalisation process is expected to deliver further efficiencies and improvements for our customers and supporting intermediaries, and together with our agile and dedicated people, the Group is well placed to respond to the challenges in the year ahead. The strength of our business ensures we are well positioned to react positively to the opportunities which will inevitably emerge.

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 two segments, Mortgage Lending and Commercial Lending, based on types of customers, products and the internal management structure. This analysis was adopted in the year, following a review of segmental reporting. The former Idem Capital segment is no longer presented, and the remaining assets reanalysed. Comparative information has been restated in line with the new reporting structure.

New business advances in the year and year end loan balances are summarised below, analysed by segment:

	Advances in the year		Net loan balances at the year end	
	2022 £m	2021 £m	2022 £m	2021 £m
Mortgage Lending	1,910.0	1,630.0	12,328.7	11,829.6
Commercial Lending	1,304.7	971.5	1,881.6	1,573.1
	3,214.7	2,601.5	14,210.3	13,402.7

The Group's total loan balance increased by 6.0% in the year following a 6.1% increase in the preceding twelve months. The Group continued to pursue its strategy of focussed growth as its markets continued to recover from the impacts of the Covid pandemic. This growth was despite the sale of £78.9 million of unsecured loan balances as the Group exited that market in the year.

Total advances increased 23.6% year-on-year, although the pattern varied across the Group's specialist markets, as a result of the differing impacts of the complex movements in the UK economic situation as it developed through 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 Group has been active in this market for over a quarter of a century, through a wide range of economic environments. This gives the Group deep data and an unparalleled understanding of this form of mortgage and the landlord customer base it targets.

During the period the Group also offered a limited volume of loans to non-specialist landlords and owner-occupied first charge mortgages secured on residential property. Owner-occupied lending is carefully managed to ensure that only lending with appropriate risks which provides an acceptable return on capital is undertaken. The segment also includes legacy assets from discontinued product lines, including second charge mortgage loans formerly included in the Idem Capital segment.

In all its offerings, the Group targets niche markets where its focus on detailed case-by-case underwriting and its unique approach to property risk differentiate it from both mass market and other specialist lenders.

Housing and mortgage market

Activity in the UK housing market reduced year-on-year, although this is partly attributable to the artificially high volume of transactions in 2021, which included transactions delayed from the previous year due to Covid restrictions, and was stimulated by stamp duty reliefs. Transactions for the year reported by HMRC, at 1,223,000, were 21.3% lower than the 1,554,000 in the previous year. In their September 2022 Residential Market Survey, RICS noted a further slowing in market activity, attributable to the outlook on interest rates and more general economic uncertainty.

House prices saw strong growth in the year, contrary to some expert projections, with the Nationwide House Price Index recording a year-on-year increase of 9.5% to September 2022 (2021: 10.0%), although the rate of increase had slowed considerably towards the end of the period. Nationwide predict further slowing into the new financial year, due to the impact of affordability pressures, with RICS forecasting house price falls over a twelve month horizon.

New mortgage lending in the market remained strong in the year, with the Bank of England reporting new approvals of £304.3 billion in the year ended 30 September 2022. This was a decrease of only 3.6% on the record £315.9 billion reported for the previous financial year, which had been driven by the stamp duty holiday which ended on 30 September 2021. However, this total included an 18.0% fall in loans for house purchase, generally in line with the fall in transactions and greater re-mortgage activity.

At 30 September 2022 the UK Finance ('UKF') survey of mortgage market arrears and possessions reported a largely benign position with arrears levels holding steady or slightly falling and possessions rising, but remaining far below the pre-Covid levels of early 2020.

1 BUSINESS REVIEW (Continued)

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

The Group's target customers in the buy-to-let sector are specialist landlords. Such landlords will typically let out four or more properties, or operate with more complex properties, and will generally run their portfolio as a business and have both a strong understanding of their local lettings market and a high level of personal day-to-day involvement. The Group is amongst a small number of specialist lenders addressing this sector, which is underserved by many of the larger lenders.

The Group's experience over the past year is that some smaller amateur landlords are leaving the market in the face of economic pressures and regulatory changes, while its specialist customers remain committed to the sector.

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.

The PRS continues to provide homes for around 19% of UK households. With supply and pricing issues impacting first-time buyers and the potential for incomes to become more constrained, the sector will continue to be crucial in national housing provision.

The Group has commissioned research on the future of the sector with the Social Market Foundation. This exercise found that, contrary to some widely held beliefs, most people renting their home in the private rented sector are happy with both their property and their landlord, and value the flexibility renting offers to them.

The research also concluded that the attention of policy makers, the media and society more generally, focuses on the minority of PRS tenants who have had particularly bad experiences with renting. However, 81% of private renters expressed their contentment with their current property, and 85% said they were satisfied with their landlord.

The full report on this research – "*Where Next for the Private Rented Sector?*" – is available on the Group's website at www.paragonbankinggroup.co.uk.

In contrast to the wider mortgage market, new buy-to-let advances reported by UKF, at £53.3 billion for the year ended 30 September 2022, were 14.6% higher than for the previous year (2021: £46.5 billion). However, this was mostly driven by remortgage activity, which increased by 23.4% while the value of new buy-to-let mortgages for house purchase fell by 10.6%.

In the lettings market RICS' September 2022 UK Residential Market Survey reported continuing strong tenant demand coupled with a dearth of supply, which was pushing rents upwards, with an expectation of a strong growth in rental prices in the short term. Research published by Zoopla supported these conclusions.

This is borne out by the Group's own independently commissioned research for the quarter ended 30 September 2022 which showed 65% of landlords were experiencing increased tenant demand, with 39% reporting significant increases. Upward movements in rents were also reported. This continuing demand will benefit affordability and cash flows for the Group's landlord customers. Despite their positive view of the current situation, however, landlord confidence had declined significantly in the last quarter of the financial year across all metrics measured, covering their own business, the sector and the UK economy more generally.

1 BUSINESS REVIEW (Continued)

The UKF analysis of arrears and possessions also provided analysis of buy-to-let cases, showing a similar position to the wider mortgage market, with arrears levels largely stable.

These factors indicate that the buy-to-let mortgage market remains strong, even in the face of economic pressures, and underpins the strength of the Group's proposition.

Mortgage Lending activity

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

	2022 £m	2021 £m
Originated assets		
Specialist buy-to-let	1,869.5	1,562.2
Non-specialist buy-to-let	39.5	52.2
Total buy-to-let	1,909.0	1,614.4
Owner-occupied	1.0	1.5
Second charge	-	14.1
	1,910.0	1,630.0

Total mortgage originations in the Group increased by 17.2%, as the housing market continued to recover from the Covid pandemic. The Group's focus within the mortgage sector remained tightly on the specialist buy-to-let product, lending to larger landlords, those operating through corporate structures and those with complex properties, with other products ancillary to this activity.

New lending on specialist buy-to-let mortgages increased by 19.7% as this part of the PRS remained strong. These specialist completions, at £1,869.5 million formed 97.9% of the Group's new mortgage business. Restrictions in lending imposed during the pandemic were all reversed in the first half of the year, with further developments introduced, helping to drive volumes. Non-specialist buy-to-let lending remains modest in comparison, with advances continuing to decline.

The majority of the Group's mortgage lending products offer fixed rates for an initial period, with many customers choosing a new product, either with the Group or elsewhere, at the end of this fixed period. A market shift in 2017 saw five-year fixes become the dominant product and the initial tranche of that lending reached the end of the five-year period in the latter part of the year. The Group has well-established retention procedures to address accounts as their fixed rates expire and over 70% of the specialist landlord customers whose products matured in the year chose to refinance with the Group. This contact programme has also helped expand the pipeline of prospective new business.

The new business pipeline, being the loans passing through the underwriting process, stood at a record £1,256.0 million at the year-end, 24.6% higher than a year earlier (2021: £1,008.1 million), providing a strong platform for growth into the 2023 financial year. While the majority of this pipeline comprises fixed rate loans, with rates set by reference to market expectations at the time of offer, the Group's policy of pipeline hedging means that loans may be completed in a rising rate environment with limited impact on margins.

1 BUSINESS REVIEW (Continued)

The Group sources the majority of its new buy-to-let lending through specialist intermediaries, and it continues to invest to ensure the service offered to them is excellent. During the year the Group's regular surveys of its intermediaries showed 89% were satisfied with the ease of obtaining a response from the Group (2021: 91%), delivering an NPS at offer stage of +40 (2021: +43). Two thirds (67%) of intermediaries dealing with the Group rated its service as good or better than that provided by other lenders (2021: 66%). Paragon Mortgages was also named as Best Professional Buy-to-let Lender at the 2022 Your Mortgage awards.

The Group's long-term programme of reengineering its mortgage business continued through the year. All systems and operational processes are being thoroughly reviewed and refined to align them with the Group's strategy for the division and the overarching plan of digitalising the business. As part of this reengineering, the capacity of the underwriting function has been significantly increased, ensuring that service standards and turnaround times remain excellent.

Initially, particular focus has been on those areas which can deliver immediate impact, such as customer retention, and on enhancing service to mortgage brokers. Improvements which went live in the period are already playing an important role in managing retention risk as five-year fixed rate mortgages start to mature and have made the process of requesting a further advance much more streamlined for the Group's customers.

Environmental impacts

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.

As part of its response to climate change the Group offers a range of green buy-to-let mortgages on all properties within the Group's lending criteria. These products offer lower interest rates for energy efficient properties with EPC ratings of C or higher.

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 also announced a target of upgrading as many homes as possible in the PRS to an EPC rating of C or higher.

The Group, together with other UK banking entities, has been working with the UK Government to develop a more consistent approach to the definition of green activities in the housing market and the housing finance sectors and is hopeful of progressing these discussions further in the forthcoming year.

1 BUSINESS REVIEW (Continued)

The Group's new lending volumes on green buy-to-let products, which have increased by 44.1% in the year, are set out below.

	2022	2021
	£m	**£m**
EPC rated A or B	169.0	134.3
EPC rated C	663.2	443.4
Total rated A to C	832.2	577.7
Percentage with available data (England and Wales)	*99.6%*	*92.6%*

The increasing proportion of new accounts relating to energy-efficient properties is important in achieving the Group's downstream emissions aspirations and is generating a gradual improvement for the buy-to-let loan book as a whole.

The Group's latest analysis identified EPC grades for 92.8% by value of its mortgage book in England and Wales at 30 September 2022 (2021: 88.3%). Of these 98.9% were graded E or higher (2021: 98.4%) with 39.3% rated A, B or C (2021: 37.6%). The year-on-year movements are principally a result of the balance of new business, with 45.1% of advances in the year (2021: 39.7%) having one of the top three grades.

While the Group monitors EPC performance it is also conscious of the need to avoid unintended consequences by focussing lending on this. Although 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 2022, approximately 2.6% by number of properties securing the Group's buy-to-let mortgages in England and Wales for which information was available were considered to be at medium or high risk of flooding from the sea or rivers, based on data from the Environment Agency (2021: 2.5%).

In addition, a more detailed analysis was carried out in the period, using data which was more location specific, and also included risk of flooding from surface water. This showed 3.0% of properties securing buy-to-let mortgages, where data was available, were at 'higher' risk.

The Group's mortgage business is currently working to develop products to support its existing customers in making their properties more energy efficient. Given that the majority of properties in the PRS require some form of upgrade to meet the Government targets, this kind of support will be vital to achieving the UK's net zero target.

1 BUSINESS REVIEW (Continued)

Performance

The outstanding loan balances in the segment are set out below, analysed by business line. Legacy second charge mortgage assets and other consumer loans were previously disclosed within the Idem Capital segment.

	2022 £m	2021 £m
Post-2010 assets		
First charge buy-to-let	8,536.4	7,379.0
First charge owner-occupied	28.0	35.6
Second charge	104.4	148.1
	8,668.8	7,562.7
Legacy and acquired assets		
First charge buy-to-let	3,549.6	4,034.2
First charge owner-occupied	8.4	11.8
Second charge	101.9	133.6
Other consumer lending	-	87.3
	12,328.7	11,829.6

At 30 September 2022, the total net mortgage portfolio was 4.2% higher than at the start of the financial year, reflecting strong lending and retention performance. The balance of post-2010 buy-to-let lending grew by 15.7% and it now represents 69.2% of the division's total loan assets (2021: 62.4%).

The Group's residual unsecured consumer lending book, shown as 'other consumer lending' in the above table was disposed of in the year, realising a gain of £4.6 million, as part of the Group's exit strategy for this part of the lending market.

The annualised redemption rate on buy-to-let mortgage assets, at 9.8% (2021: 6.9%), has continued at a relatively low level, with the increase representing a reversion closer to pre-Covid levels. This is despite increasing numbers of five-year fixed rate loans reaching the end of their fixed period. As described above, the Group has adopted a number of strategic initiatives to retain customers whose mortgage accounts reach the end of their fixed rate period.

Arrears on the buy-to-let book reduced in the year to 0.15% (2021: 0.21%), with the payment performance of the Group's customers remaining strong, despite the growing economic pressures in the UK. Arrears on post-2010 lending were at 0.09% (2021: 0.09%). These arrears remain very low compared to the national buy-to-let market, with UKF reporting arrears of 0.41% across the buy-to-let sector at 30 September 2022 (2021: 0.45%). However, as noted above, landlord's expectations for their businesses appear more pessimistic than this performance data would suggest.

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. Relying on a detailed and thorough assessment of the value and suitability of the property as security, 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.

1 BUSINESS REVIEW (Continued)

The loan-to-value coverage in the Group's buy-to-let loan book, at 57.9% (2021: 61.2%) 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, indeed, on a simple weighted average basis, the Group's landlord customers now have over £10.0 billion of equity in their mortgaged properties.

Second charge arrears from post-2010 lending increased to 1.88% from 1.18% in the year, reflecting the increased seasoning and size of the portfolio. For legacy assets arrears rose to 26.7% (2021: 24.3%). 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 which had missed payments at some point in the past, inflating the arrears rate. Average arrears for secured lending of 7.5% at 30 September 2022 were reported by the Finance and Leasing Association ('FLA') (2021: 8.6%). The Group enjoys substantial security on its second charge mortgage assets, with an average loan-to-value ratio on such cases of 50.6% (2021: 56.1%) providing a significant mitigant to credit risk.

In terms of the Group's impairments procedures, 16.4% of the segment's gross balances were considered as having a significant increase in credit risk ('SICR') (2021: 12.4%) including 1.1% which were credit impaired (2021: 2.2%). This was a result of the impact of the worsening economic outlook on probabilities of default. However, the impact of security values meant that provision coverage was stable, at 31 basis points (2021: 32 basis points), although coverage on fully performing accounts had increased from 2 basis points at 30 September 2021 to 6 basis points 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. At the year end, 475 properties were managed by a receiver on the customer's behalf, a reduction of 14.1% over the year (2021: 553 properties), as cases were resolved, with generally successful results, considerably mitigating the original potential loss. Almost all these cases currently relate to pre-2010 lending, with cases being addressed on a long-term basis. There were relatively low numbers of new receivership cases in the year.

Outlook

While the increase in market interest rates has dampened the demand for new product, the Group's mortgage lending business is well placed as it enters the new financial year. Its investment in systems, which will continue going forward, enables it to provide an effective and responsive service to brokers and customers, whichever direction the UK economy takes, while its underwriting standards, the strong current performance and low loan-to-value ratio of the portfolio, and the hedging of the fixed rate pipeline bring strong defensive qualities to the balance sheet.

1 BUSINESS REVIEW (Continued)

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:

- Development finance, funding smaller, mostly residential, property development projects
- SME lending, providing leasing for business assets and unsecured cash flow lending for professional services firms, amongst other products
- 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 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.

Commercial Lending activity

The Commercial Lending segment saw a 34.3% increase in new business during the year as UK economic activity continued to recover from the effects of Covid, with each sub-segment showing year-on-year growth

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.

	2022 £m	2021 £m
Development finance	632.2	510.4
SME lending	446.4	336.9
Structured lending	59.9	24.0
Motor finance	166.2	100.2
	1,304.7	971.5

The impact of this new lending has been to increase the Group's overall Commercial Lending exposure by 19.6% in the year to £1,881.6 million (2021: £1,573.1 million).

1 BUSINESS REVIEW (Continued)

Development finance

The Group's development finance business performed strongly in the year with new lending increasing by 23.9% to £632.2 million (2021: £510.4 million). While the volume of projects funded increased as the UK emerged from Covid, some developers continued to experience supply chain issues, although not to the extent where ultimate project viability was threatened, and some project timescales were extended. Towards the end of the year the volume of enquiries reduced somewhat, with developers reacting to the uncertain economic outlook by taking a cautious approach to initiating new projects. This resulted in undrawn amounts on live facilities at 30 September 2022, at £556.0 million, being 11.1% higher than at the previous year end (2021: £500.4 million), while the post-offer pipeline fell to £136.8 million (2021: £298.6 million).

During the year the business launched its first major green finance option. Projects to develop energy-efficient properties, those with an EPC A grade, can receive beneficial funding terms. By 30 September 2022, £64.5 million of new lending facilities had been agreed under the green initiative, with drawings reaching £11.9 million by the year end. This type of project will be an area of focus for the Group going forward, as developers increasingly factor these discounts into their project planning.

The regional spread of the Group's lending has broadened, with the proportion of the portfolio located in London and the South-East of England falling to 56.8% from 63.6% at 30 September 2021. Activity increased particularly in both the East Midlands and West Midlands, with funding provided for a number of flagship projects. The business has also increased the range of specialist developments it has funded, including a heightened focus on the later living sector. However, the vast majority of lending relates to standard residential property.

The Group's investment in systems for this business has continued through this period, with a major upgrade to loan servicing capabilities delivered in the year as well as a stream of enhancements being delivered on a regular basis through the year to improve process efficiency and customer service. This drive towards digitalisation will continue, providing a solid platform for the growth of the business and supporting the transition to an IRB approach to capital management.

The business also saw a leadership change, with Robert Orr, who had led the operation since the Group's acquisition of the Titlestone development finance business in 2018 stepping back, to be succeeded as Managing Director by Neal Moy, who joined the Group with wide experience in the property finance sector. Other appointments were also made to enhance the relationship team.

Despite an uncertain economic outlook and potential supply chain disruptions the underlying business proposition for developers remains fundamentally unchanged. The UK is still failing to meet its targets for the development of new housing and demand continues to increase. The current state of the UK house building market gives a significant opportunity for smaller developers to expand, if they can access reliable sources of funding for projects. The Group's proposition is strong and attractive and continues to provide healthy returns for the capital invested and opportunities for growth as it moves forward with new systems and leadership to face the challenges ahead.

1 BUSINESS REVIEW (Continued)

SME lending

The Group's SME lending business is primarily focussed on financing core business assets for SMEs. The core assets financed included wheeled construction plant, such as excavators, and other commercial vehicles. These customers are therefore sensitive to sentiment around capital investment in the UK, which has become more negative towards the latter part of the year, resulting in a slowing of growth in the SME asset finance market reported for the FLA, where in the early part of the year a stronger post-pandemic recovery was seen.

Against this background the Group's SME asset leasing business saw volumes increase by 39.7% year-on-year to £276.9 million, excluding government-backed balances (2021: £198.2 million), far higher than the average of 9% reported by the FLA for the SME sector. Investment in operating leases has also continued with £14.5 million of assets acquired in the period (2021: £13.0 million).

Much of this success is attributable to investment made in system and processes, including the introduction of a new broker portal at the start of the year. This has increased efficiency and responsiveness in the underwriting process, as well as enhancing the Group's ability to handle smaller value propositions cost-effectively. This has also enabled record numbers of applications to be handled and improved conversion rates. Advances in the second half were over 45% higher than those in the first six months of the year, reflecting the roll out of the new portal. The reduced average loan size is also beneficial in spreading credit risk.

These service enhancements have improved the standing of the business in the finance broker community. 88% of brokers surveyed by the Group in the year said that they considered that their experience with the Group was as good or better than with other lenders and 81% stated that they were likely to provide further business.

Following the major upgrade, the programme of investment in system improvements to create efficiency gains has continued throughout the year. Agile and modular delivery enables individual improvements to go into the live system as they are completed, providing incremental enhancements.

The Group continued to advance loans under the UK Government-sponsored Recovery Loan Scheme, ('RLS') until the second phase of that scheme closed for new applications in June 2022. The Group's application to take part in the third phase of that scheme is being processed. RLS loans have the benefit of an 80% government guarantee (after the proceeds of any business assets are applied for leasing balances) for pre-January 2022 advances and a 70% guarantee for applications received between January and June 2022. The Group's lending on these products primarily focussed on its existing customers, and the majority of RLS lending has been on asset-secured products.

During the year £32.2 million was advanced under schemes backed by a government guarantee (2021: £64.2 million), of which £31.5 million was asset leasing business. This reduction was in line with expectations, given that these loans were initially introduced as a response to the Covid pandemic. The Group continues to closely monitor the portfolio for any adverse indications.

1 BUSINESS REVIEW (Continued)

Short-term lending to professional services firms outside government supported schemes more than doubled to £125.8 million (2021: £62.0 million). These loans are often used to spread the impact of tax payments, and the availability of tax deferrals, together with the availability of loans under the Coronavirus Business Interruption Loan Scheme ('CBILS') and similar arrangements amongst this customer group had seriously depressed demand. However, the underlying requirement for this form of finance remains for the longer-term, and performance has continued to move back towards pre-Covid levels.

The division has seen an increased level of green lending propositions over recent months, with many SME businesses in the transportation field and beyond seeking to reduce their carbon footprints. The division also has a strong presence in waste management, supporting local authorities as they transition to greener refuse collection activities, including funding new all-electric refuse collection vehicles for the City of Exeter, and providing funding for the development of recycling plants. It is a strategic priority of the Group to support UK SMEs, whose journey towards net zero may require significant capital investment over time, and these types of initiatives are expected to increase going forward.

UK SMEs are potentially facing a difficult period as interest rates and inflation rise and the labour market remains tight. The FLA outlook survey for September reports significantly negative expectations across the leasing market for business investment and the economy more generally. In the Group's own independently conducted research of over 1,000 SMEs, the majority acknowledged the seriousness of the economic situation, particularly the potential impact of inflation and costs, but were cautiously optimistic of managing their way successfully through it. In this environment opportunities for the Group's SME business are likely to be restricted, but it will leverage its customer relationships and account management experience to protects its franchise and optimise customer outcomes, whichever direction the UK economy moves in.

Structured lending

The Group's structured lending exposure has seen an increased level of activity in the year, with several new facilities agreed and older balances repaid, diversifying the business' exposures and increasing the overall balance outstanding by 50.3%. Total facilities also increased by 18.9% to £220.5 million (2021: £185.5 million)

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 client's ultimate customer population. The Group's experienced account managers receive regular reporting on the performance of the security assets, and maintain a high level of contact with clients 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 not addressed by mass-market lenders, including specialist makes and vehicle types, such as light commercial vehicles, motorhomes and caravans.

During the year the Group also began funding static caravans, which provide good yields and fit comfortably with the Group's focus on specialist products

Lending in the year grew 65.9% to £166.2 million (2021: £100.2 million), although the business was significantly affected by the Covid pandemic in the first part of the 2021 financial year and the current year's business represents a return to a more normal level.

The Group also launched its first products for financing battery-powered electric vehicles ('BEVs'). £6.0 million of new loans were made, reflecting the recent growth in the availability of these vehicles, with BEVs representing 11.8% of new vehicle registrations in the year, as reported by the Society of Motor Manufacturers and Traders. The offering was extended in the second half of the year to cover light commercial BEVs. The Group is well placed to support the green aspirations of its customers, as electric vehicles become a more widely viable and popular option.

Performance

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

	2022 £m	2021 £m
Asset leasing	532.5	468.7
Professions finance	60.9	33.1
CBILS, BBLS and RLS	88.0	83.8
Invoice finance	25.7	20.9
Unsecured business lending	14.6	10.3
Total SME lending	721.7	616.8
Development finance	719.9	608.2
Structured lending	178.7	118.9
Motor finance	261.3	229.2
	1,881.6	1,573.1

Despite the building pressures in the UK economy credit performance in the development finance book has been good, and the overall performance of the projects has been generally in line with expectations. Accounts are regularly monitored and graded on a case-by-case basis by the Credit Risk function. At 30 September 2022 only one account had been identified as being at risk of loss, a long-standing legacy case.

The average loan to gross development value for the portfolio at the year end, a measure of security cover, was 62.1% (2021: 61.7%), which gives the Group a substantial buffer if any project encounters problems. No new serious credit issues arose during the financial year.

1 BUSINESS REVIEW (Continued)

Credit performance in the division's originated finance leasing portfolios has been generally good, with improving arrears measures in both asset leasing at 0.08% and motor finance at 1.58% (2021: 0.27% and 2.30% 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.

For UK Government guaranteed loans credit performance remained strong. Despite widespread coverage of fraudulent loan applications across the sector the Group's total claims made up to 30 September 2022 were £2.4 million, with £2.2 million of this balance already recovered from the Government.

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 all accounts classified in IFRS 9 Stage 1 at the year end.

In terms of the Group's impairments procedures, 4.7% of the segment's gross balances were considered as having an SICR (2021: 6.0%) including 1.1% which were credit impaired (2021: 0.7%). Provision coverage had reduced in line with the shift towards performing accounts, at 134 basis points (2021: 174 basis points) although coverage on fully performing accounts had increased from 86 basis points at 30 September 2021 to 108 basis points at the year end as a result of management's evaluation of the probability of potential problem cases not registering through the normal SICR identification procedures in the current economic environment.

Outlook

The evident headwinds in the UK economy are likely to reduce the scope for near-term new business volume growth across the division's markets. However, the franchise remains strong and the efficient and effective processes which have been rolled out through the Group's digitalisation programme, coupled with strong customer relationship management and the high standards of credit management applied over time, will both protect the value in the businesses and allow them to gain market share, should their broader markets see a slowdown.

2 FUNDING

The Group is principally funded by retail deposits, but also accesses a variety of other funding sources. This creates an adaptable and sustainable funding position which can flex with developments in the business, its operating environment and the economic landscape. The Group is therefore able to access cost-effective funding, as well as raising funding for strategic initiatives on a timely basis.

During the year the Group's requirements for additional funding were satisfied through the retail deposit market. Demand for deposit products remained strong, with nervousness amongst consumers over impending cost of living issues motivating customers to save, at least in the short term.

The Group's funding at 30 September 2022 is summarised as follows:

	2022 £m	2021 £m	2020 £m
Retail deposit balances	10,669.2	9,300.4	7,856.6
Securitised and warehouse funding	995.3	1,246.0	3,928.3
Central bank facilities	2,750.0	2,819.0	1,854.4
Tier-2 and retail bonds	261.5	386.1	446.6
Total on balance sheet funding	14,676.0	13,751.5	14,085.9
Off balance sheet liquidity facilities	150.0	150.0	150.0
	14,826.0	13,901.5	14,235.9

The Group's retail deposit balance grew by 14.7% in the year to £10,669.2 million (2021: £9,300.4 million), exceeding £10 billion for the first time and representing 72.7% of balance sheet funding (2021: 67.6%), with wholesale borrowings continuing to reduce over the year.

At 30 September 2022 the proportion of easy access deposits, which are repayable on demand, was 27.0% of total on-balance sheet funding (2021: 24.1%). This increase is partly a result of market sentiment, with savers reluctant to commit funds to term deposits in the anticipation of future interest rate rises, 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 £1,689.1 million of cash available for liquidity and other purposes (2021: £1,236.5 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.

The Group's programme to transition away from the use of the London Interbank Offered Rate ('LIBOR') as a reference rate was completed during the year, in time for the withdrawal of that rate in December 2021. This formed the culmination of a multi-year programme to transition to other benchmarks, notably the Sterling Overnight Index Average ('SONIA') for both wholesale funding and retail lending and saving products.

2 FUNDING (Continued)

The Group engages in fixed rate lending and accepts fixed term deposits. It is therefore exposed to interest rate risk, and it manages this position through hedging with interest rate derivatives. Where interest rates are moving this can lead to substantial fair value movements, but the Group has established policies and procedures to ensure that only economically appropriate transactions which hedge normal trading activities are entered into.

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 stresses including 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.

The Group offers a variety of savings products, including term deposits, ISAs and easy access accounts and the business 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, savings balances of UK individuals reported by the Bank of England continued to increase, despite increasing pressures on living costs, with balances at 30 September 2022 reaching £1,402.3 billion (2021: £1,351.6 billion), an increase of 3.8% in the year. Some of this increase may be reversed as the cost of living increases, 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 performed well in the year and was able to deliver the required funding base at attractive cost compared to wholesale alternatives

Savings accounts at the financial year end are analysed below.

	Average interest rate		Proportion of deposits	
	2022	**2021**	**2022**	**2021**
	%	**%**	**%**	**%**
Fixed rate deposits	1.74%	1.25%	58.1%	58.8%
Variable rate deposits	1.55%	0.42%	41.9%	41.2%
All balances	1.66%	0.91%	100.0%	100.0%

The average initial term of fixed rate deposits was 22 months (2021: 26 months). Market savings rates in the year have begun to increase from their historically low levels as the UK bank base rate has moved upwards, particularly towards the end of the year. The Bank of England has reported average interest rates at 30 September 2022 for new 2-year fixed rate deposits at 2.67% (2021: 0.46%), at 0.6% for instant access balances (2021: 0.10%) and similar rises across product types. This rising rate environment has impacted on the Group's absolute funding cost, as shown above.

2 FUNDING (Continued)

It is notable that the SONIA market interest benchmark had increased from 0.05% at the start of the year to 2.19% by its close, meaning that the average variable rate paid by the Group represented a 64 basis point discount to SONIA whereas the opening position had been a 37 basis point premium.

The Group has continued to increase volumes through its direct channel and through an expansion of the number and volume of accounts opened through third party digital banking and wealth management platforms. The use of these third parties increases options to manage inflows and allows the Group to access a wider base of customers. The Group now operates through eight channels, including new relationships which commenced in the year. These channels now represent around 13% of the total deposit base and the Group's infrastructure offer opportunities to expand this further.

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 (2021: 88%). The NPS in the same survey was +59, similar to that in the previous year (2021: +58).

When customers with maturing savings balances in the year were surveyed, 87% stated that they would 'probably' or 'definitely' consider taking out a replacement product with the Group (2021: 89%) with an NPS at maturity of +52, the same level as in the 2021 financial year (2021: +52).

This level of customer satisfaction is also demonstrated by the Group's continuing success in industry awards. During the year awards won included 'Best Fixed Term Savings Account Provider' at the 2022 YourMoney awards, 'Best Fixed Rate Cash ISA Provider' at the 2022 Moneynet awards and 'Most Consistent Best Buy Savings Provider' in the MoneyComms 2022 Top Performers list.

The Group's direct and third party channels are both supported by reliable and scalable infrastructure, and it continues to invest in systems and processes to enable the business to develop. This delivers a retail deposit stream where volumes and rates can be effectively managed to support the Group's requirements.

The operation will continue to develop, expanding offerings, addressing wider customer groups and accessing new channels while monitoring the emerging impact of the cost of living and rising interest rates on the consumer savings market. The Group's profiling of its target customers suggests they may be more resilient than average in the event of future economic stresses, but the developing situation will remain under close review.

2 FUNDING (Continued)

2.2 CENTRAL BANK FACILITIES

The Bank of England Term Funding scheme for SMEs ('TFSME') continued to be available through the early part of the year to support lenders in providing credit to SME customers through the Covid pandemic. The Group refinanced its borrowings under the scheme before it closed to manage its maturity dates.

During the year the amount drawn under TFSME was £2,750.0 million (2021: £2,750.0 million). As TFSME provides funding at or very close to base rate, in a low base rate environment it forms a particularly cost-effective form of borrowing for lenders which, like the Group, wished to support their SME customers through the economic uncertainties of the pandemic. The relative cost-effectiveness of these borrowings as base rates begin to rise is being kept under review.

The Group's remaining drawings under the Bank of England's original Term Funding Scheme ('TFS') were repaid in the year. The Group retains access to other Bank of England funding channels and utilised these to make drawings under the Indexed Long-Term Repo Scheme ('ILTR') during the period. None of these drawings remained outstanding at the year end.

The Group expects to continue to make use of these central bank 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 at 30 September 2022 of up to £1,776.0 million (2021: £1,424.2 million).

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 increased to BBB+ by Fitch in March 2022, with a stable outlook, enhancing the Group's funding capacity.

For much of the year the capital markets remained active, with activity in most areas of funding. The securitisation markets remained open, but with very few transactions coming to market. Towards the end of the year the levels of uncertainty in the markets effectively prevented any new deals being launched.

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 renegotiated its £400.0 million warehouse funding facility during the period, increasing the facility size to £450.0 million and transitioning the interest rate from 0.60% above LIBOR to 0.50% over SONIA. 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.

2 FUNDING (Continued)

The Group's retail bond issued in January 2015 was repaid at maturity in January 2022. The Group also entered into sale and repurchase transactions from time to time, to ensure it retains access to this channel for liquidity purposes.

The Group's wholesale funding position is stable, mostly long-dated and cost effective. It retains the infrastructure to access all appropriate wholesale funding sources whenever appropriate. This wholesale funding strategy is effective and adaptable, 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 ended 30 September 2022 saw the continuing growth of the Group's savings proposition, with total balances exceeding £10 billion for the first time. The wholesale part of the funding base continued to reduce while remaining stable, with little requiring refinancing in the short term, providing some protection against any developing issues in the UK economy.

This has been consistent with the Group's funding strategy, making strategic use of wholesale 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 23.

3 CAPITAL REVIEW

The Group manages its capital to maintain the strength of its balance sheet, ensure that its regulatory capital and liquidity positions are sufficient to safeguard depositors and provide capacity to meet its strategic objectives and other opportunities going forward.

With the increasing levels of uncertainty in the UK economy over the year and the upward movement in interest rates and inflation towards the end of the year, the Group focussed on ensuring that its capital strength remains sufficient to withstand the potential pressures.

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 2022 Annual General Meeting ('AGM'), which will be proposed for renewal at the 2023 meeting.

3.1 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 a Total Capital Requirement ('TCR') setting an amount of regulatory capital, defined under the international Basel 3 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. The TCR is specific to the Group and is set on the basis of periodic supervisory reviews carried out by the regulator, most recently in 2021.

The Group's TCR at 30 September 2022 was 8.8% (2021: 8.8%), compared to the minimum TCR allowed under the Basel 3 framework of 8.0%. This low level gives the Group advantages in capital management and reflects the regulator's view of the maturity of the Group's systems for the management of capital and risk.

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. This relief is being phased out, year-by-year, while any reversal of Covid-related provisions will generate a corresponding reduction in relief.

3 CAPITAL REVIEW (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. As the value of reliefs will taper over time, the difference between measures on the regulatory and fully loaded bases will narrow and eventually converge. The Group's principal capital measures, CET1 and Total Regulatory Capital ('TRC') are set out below on both bases.

	Regulatory basis		Fully loaded basis	
	2022	2021	2022	2021
	£m	£m	£m	£m
Capital				
CET1 capital	1,221.8	1,055.8	1,196.0	1,026.1
Total Regulatory Capital ('TRC')	1,371.8	1,205.8	1,346.0	1,176.1
Requirement				
TCR	660.6	604.2	658.4	601.8

The Group's CET1 capital comprises its equity shareholders' funds, adjusted as required by Regulatory Capital Rules of the PRA and can be used for all capital purposes. TRC, in addition, includes tier-2 capital in the form of the Group's green bond. This tier-2 capital can be used to meet up to 25% of the Group's TCR.

The increase in capital over the year has been generated by the profits earned in the year, offset, to some extent, by the impact of dividends and buy-backs. The capital positions set out above include gains made on fair value accounting, which will reverse over time. The increase in TCR on both the regulatory and fully loaded bases shown above has arisen principally as a result of balance sheet growth in the year.

CET1 capital must also cover the buffers required by the 'Capital Buffers' part of the PRA Rulebook, 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 (2021: 2.5%), while the UK CCyB remained at 0.0% (2021: 0.0%), having been reduced from 1.0% during 2020 as a regulatory response to the pandemic. However, it has been announced by the Financial Policy Committee of the Bank of England that the CCyB will increase to 1.0% from December 2022 and 2.0%, its expected long-term standard level, in July 2023 and this requirement for additional capital in the future has been factored into the Group's capital planning.

CET1 capital required to cover CCoB and CCyB buffers increased to £187.9 million at the year end on the regulatory basis (2021: £170.9 million), mostly as a result of balance sheet growth.

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

The Group's capital ratios, after allowing for the proposed dividend for the year and its irrevocable buy-back commitments, are set out below.

	Basic		Fully loaded	
	2022	2021	2022	2021
CET1 ratio	16.3%	15.4%	16.0%	15.1%
Total capital ratio	18.3%	17.6%	18.0%	17.3%
UK leverage ratio	7.9%	7.5%	7.8%	7.3%

3 CAPITAL REVIEW (Continued)

All the Group's capital ratios show strong improvement over the period. This reflects the trading profits, including those relating to fair values and the extinguishing of the pension scheme liability. As the IFRS 9 reliefs are phased out the fully loaded and regulatory bases will automatically converge.

The Basel Committee on Banking Supervision ('BCBS') had set the implementation date for its revisions to the Basel 3 framework, sometimes referred to as Basel 3.1, as 1 January 2023. This is, however, subject to those revisions being enacted in the relevant jurisdiction, which was delayed by the Covid pandemic. In the UK these rules will be enacted through the PRA Rulebook and the PRA has announced that it intends that these changes will become effective in the UK from 1 January 2025, following a consultation on the detailed requirements which was published in November 2022.

The PRA has also launched a more extensive consultation on a 'strong and simple' approach to regulating non-systemically important banks without international activities. While its initial proposals address the smallest banks, it has indicated that this is a first step and that all non-systematic banks will be considered. 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 and is currently responding to PRA feedback on various elements of this phase, ahead of a formal PRA panel assessment. The project continues to progress to plan, and work continues into the new financial year on both the buy-to-let portfolio and 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 146.2% compared to 165.6% during the 2021 financial year. These figures, however, reflect the reduction of liquidity being held as Covid receded in the early part of the year followed by a tightening in the latter part of the year as the economic situation deteriorated.

The NSFR is a longer-term measure of liquidity with a one year horizon, supporting the management of balance sheet maturities. At 30 September 2022 the Bank's NSFR stood at 122.3% (30 September 2021: 119.6%), reflecting the strengthening of the overall funding and capital position over the year.

3 CAPITAL REVIEW (Continued)

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 and excess capital is available, balancing the expectations and requirements of different investor groups.

An interim dividend for the year of 9.4 pence per share (2021: 7.2 pence per share) was paid in July 2022 and the Board is proposing, subject to approval at the AGM on 1 March 2023, a final dividend for the year of 19.2 pence per share (2021: 18.9 pence per share). This would give a total dividend of 28.6 pence per share (2021: 26.1 pence per share). Given the magnitude of the fair value gains recorded in the year, the Board considered whether they should be included in the calculation of the distribution. As these gains are considered to be essentially timing differences it was decided to exclude them. The dividend proposed therefore represents approximately 40% of the adjusted profit, giving a dividend cover on the adjusted basis of 2.50 times (2021: 2.50 times) (Appendix D).

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

During the year the Board authorised the completion of the remainder of the buy-back programme which had been suspended at the 2021 year end. It also authorised a buy-back programme for the year of £50.0 million, which was subsequently extended to £75.0 million. £66.9 million, including costs, was expended during the year (Note 27). An irrevocable instruction for the completion of the remaining £10.8 million was given to the Group's brokers before the year end This was accrued for at the year end and was completed on 7 November 2022.

As part of the review of capital management described above the Board decided that it was appropriate to authorise a further buy-back programme of up to £50.0 million for the 2023 financial year. This will commence shortly after the announcement of the Group's 2022 year end results.

The Group has the general authority to make such purchases, granted at the AGM on 2 March 2022. Any purchases made under these programmes will be announced through the Regulatory News Service ('RNS') of the London Stock Exchange and the shares will be initially held in treasury.

The Board has affirmed the existing dividend policy going forward, subject to an assessment of prevailing conditions at the time, including future capital requirements, business strategy and external economic risks.

3 CAPITAL REVIEW (Continued)

3.4 CAPITAL OUTLOOK

The Group keeps its current and forecast capital position under review in the light of economic, strategic and business requirements and proposed or forecast changes in the capital regime. The capital position strengthened in the year, although part of this increase relates to fair value gains which do not form part of underlying results.

The Group is well capitalised as it enters 2023, even after providing for an appropriate level of dividends and share buy-backs, the planned increases in the CCyB and the phasing out of IFRS 9 relief. Even in light of potential worsening in the UK's economic position this capital strength is prudent and sustainable and supports the overall viability of the business for the benefit of all stakeholders.

4 FINANCIAL RESULTS

The delivery of the Group's strategy through a year of economic turbulence in the UK saw underlying profit (Appendix A), which excludes fair value gains and the profit arising on the sale of a loan book, continuing to grow in the year, reaching £221.4 million, an increase of 14.0% (2021: £194.2 million). This drove growth in underlying earnings per share, which rose by 17.9%, reaching 69.9 pence per share (2021: 59.3 pence per share).

The Group's statutory results for the year were significantly inflated by the accounting treatment required for pipeline hedging. It is the Group's policy to hedge a substantial part of its lending pipeline with interest rate derivatives and these can lead to substantial fair value gains being recorded in a rapidly changing interest rate environment before the relevant loans complete. The actual cash flows from hedging will impact on net margin through the subsequent life of the loan and the fair value gains will unwind. The level of such gains recorded in the period increased profit before tax on the statutory basis to £417.9 million (2021: £213.7 million), with earnings per share at 129.2 pence per share (2021: 65.2p).

The Group has consistently excluded these fair value items from underlying results as the timing of their recognition does not reflect that of their economic impact on the business.

4.1 CONSOLIDATED RESULTS

CONSOLIDATED RESULTS
For the year ended 30 September 2022

	2022	**2021**
	£m	**£m**
Interest receivable	545.7	443.5
Interest payable and similar charges	(174.5)	(133.0)
Net interest income	**371.2**	**310.5**
Net leasing income	4.6	3.5
Gain on disposal of loan assets	4.6	-
Other income	12.6	10.9
Total operating income	**393.0**	**324.9**
Operating expenses	(153.0)	(135.4)
Provisions for losses	(14.0)	4.7
	226.0	194.2
Fair value net gains / (losses)	191.9	19.5
Operating profit being profit on ordinary activities before taxation	**417.9**	**213.7**
Tax charge on profit on ordinary activities	(104.3)	(49.2)
Profit on ordinary activities after taxation	**313.6**	**164.5**

4 FINANCIAL RESULTS (Continued)

	2022	2021
Dividend – rate per share for the year	28.6p	26.1p
Basic earnings per share	129.2p	65.2p
Diluted earnings per share	125.9p	63.0p

Income

The Group's total operating income increased by 21.0% in the year, reaching £393.0 million. This included a one-off gain of £4.6 million on the disposal of the residual unsecured consumer lending book, which is excluded from underlying metrics.

The principal component of operating income continues to be net interest on the Group's lending assets. This increased from £310.5 million in 2021 to £371.2 million in 2022, a growth rate of 19.5%. This arises both from net growth in the loan book, with average balances increasing by 6.1% to £13,806.5 million (2021: £13,017.0 million) (Appendix B), and from an improvement in net interest margin ('NIM'), in both of its divisions. This is despite the sale of higher yielding unsecured consumer assets in the year.

The progression of the Group's NIM over the past five years is set out below.

	Total Basis points
Year ended 30 September	
2022	**269**
2021	239
2020	224
2019	229
2018	219

The Group's other operating income (excluding the one-off gain) increased by 19.4% to £17.2 million from £14.4 million in the previous year, representing generally higher activity across all elements of the business.

Costs

The Group's cost base for the year increased by 13.0% in the year to £153.0 million (2021: £135.4 million). The largest item within costs continues to be employment costs, forming 67.7% of the total at £103.6 million (2021: £87.9 million). The increase of 17.9% in the year is partly attributable to an increase in staff numbers, with average headcount increasing by 5.0% to 1,498, but also the increase in the number of higher skilled, and therefore higher paid positions as the business develops. The Group has also been impacted by the level of UK wage inflation, which has been particularly severe in professional and technology positions.

4 FINANCIAL RESULTS (Continued)

Costs not related to employment, at £49.4 million were only marginally increased from those in the previous year (2021: £47.5 million), despite the impact of Covid restrictions on expenditure in 2021. The Group continues to channel significant resources into its digitalisation programme, with systems and enhancements delivered across the business in the period. These developments are fundamental to the Group's strategy going forward.

Costs continue to be incurred on the Group's IRB programme, which is expected to deliver significant benefits to the Group's capital position in the longer term.

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

	Underlying	Statutory
	%	%
Year ended 30 September		
2022	**39.4**	**38.9**
2021	41.7	41.7
2020	43.0	43.0
2019	42.1	40.7
2018	40.6	37.8

Cost:income continued to reduce slowly in the year with margins on income widening. Cost control is a strategic priority of the Group, but it recognises that the cost base must also adapt to deliver its strategic priorities and to meet regulatory expectations. Therefore the aim of a sustainably lower cost:income ratio is a long-term aspiration, rather than a short term priority.

Impairment provisions

The Group's recognition of credit losses is governed by the accounting standard IFRS 9, which requires the directors to take a view on the future performance of the Group's loan assets and to base provisioning on expected credit losses ('ECL'). It is unfortunate that since the standard was introduced in 2018 the UK has encountered a series of unprecedented economic, political and social disruptions, which have made the prediction of future asset behaviour, and therefore the operation of the standard very complex.

Based on the evaluation of ECL in the year end the Group has made a charge for impairment of £14.0 million (2021: release of £4.7 million). This mostly results from a balancing of the reduced likelihood of Covid impacts on the Group's portfolios against emerging economic and political issues such as the cost of living and doing business in the UK, the potential impacts on the global economy of the conflict in Ukraine and uncertainties over the future direction of UK Government policy, both generally and on issues which may affect the Group and its customers directly. None of these issues have direct precedents and therefore a significant exercise of judgment is required to evaluate how these should be reflected in ECL.

4 FINANCIAL RESULTS (Continued)

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

	Write offs	Charge / (release)	Cost of risk
		£m	%
Year ended 30 September			
2022	**16.5**	**14.0**	**0.10**
2021	13.3	(4.7)	(0.04)
2020	9.9	48.3	0.39
2019	17.0	8.0	0.07

The fluctuations shown above show the impact of these uncertainties over time as they appear and then resolve. The high charge in 2020 represented the initial onset of the Covid pandemic, in 2021 the position appeared to have become a little more stable, while 2022 has seen new challenges arising, which have significantly reduced the level of clarity on the overall direction of the UK economy heading into the 2023 financial year.

The application of provisions in writing off accounts has remained more stable across the period, although the 2022 result was inflated by a large one-off case in asset finance. This highlights both the Group's careful approach to provisioning and the resilient nature of its assets.

Multiple economic scenarios and impacts

In order to support management's estimation of ECLs the Group has developed models to project losses in its largest books based on customer performance to the reporting date and anticipated future economic conditions. The use of these models therefore requires the use of a range of forward-looking economic scenarios which are each evaluated and then weighted to form an overall projection.

For portfolios where detailed models cannot be used the Group will also consider the potential impact of these economic scenarios where this might be significant.

Economic forecasting at the reporting date has become more difficult than at the half year, with the levels of uncertainty in the UK political environment significantly heightened at September 2022, increasing the risk of inaccurate forecasts.

Generally the consensus of forecasters is for a worse outlook overall than at the previous year end and the March half year, with the magnitude of change in key economic metrics likely to be larger than seen in some considerable time. The levels of uncertainty also mean that the range of opinions amongst reputable forecasters is considerable.

In the face of these uncertainties the Group has constructed the scenarios for its ECL modelling based on a number of forecasts from public and private bodies, synthesised to produce internally coherent sets of data. The central scenario is that used for the Group's planning process, while upside and downside scenarios have been derived from these. To allow for the wider range of economic possibilities to be covered, the downside scenario has been set further below the base case than has previously been the case.

4 FINANCIAL RESULTS (Continued)

As in previous years, the severe downside scenario is based on the Bank of England stress testing scenario published in 2022, adjusted to allow a harsher impact on house prices. This scenario is included to represent the range of highly stressed outcomes for the UK and the Group's customers.

Overall the forecasts represent an environment of increased interest rate expectations, a more subdued housing market, especially in the short term and inflation at very high levels compared to recent history.

Given the increased range of potential outcomes, the Group has reviewed the weightings attributable to each scenario in its modelling. It has determined that it is appropriate to increase the weighting applied to the severe scenario by 5% to 20% and make a corresponding reduction in the weighting of the downside scenario, representing the growth in the number of plausible severe outturns for the UK.

The forecast economic assumptions within each scenario, and the weightings applied, are set out in more detail in note 17.

The impairment provision levels generated by the Group's provisioning procedures and the scenarios described above are set out below. In order to demonstrate the impact of the scenarios used, the provisions have also been calculated on a single scenario basis for the central and severe scenarios.

	2022		2021	
	Unadjusted provision £m	**Cover ratio**	**Unadjusted provision £m**	**Cover ratio**
Weighted average	48.5	0.37%	46.0	0.34%
Central scenario	38.3	0.27%	33.3	0.25%
Severe scenario	85.3	0.60%	86.7	0.64%

The increase in the provisions calculated represents a more normal economic environment, with a reversion to longer term relationships between customer behaviour and eventual loss, reducing the need for other judgements to some extent. However, observation does not suggest that this linkage is fully re-established as yet.

The distribution of gross balances by IFRS 9 stage produced by the Group's impairment methodology at the two most recent year ends is set out below.

	2022	2021
Stage 1	85.2%	88.4%
Stage 2	13.7%	9.5%
Stage 3	0.9%	1.2%
POCI	0.2%	0.9%
Total	**100.0%**	**100.0%**

This demonstrates the resolution of non-performing cases, the disposal of the POCI cases in the unsecured loan business and the increased identification of Stage 2 cases by provision models in response to a more normal economic framework.

4 FINANCIAL RESULTS (Continued)

Judgemental adjustments

The fundamental requirement of any provisioning methodology is that the accounts present fairly the assets of the business. Therefore it is a vital part of the process that all mechanical outputs are challenged based on management's understanding of the business to ensure that the provision is consistent with all available information at the year end, qualitative or quantitative and whether it can be input into the modelling process or not. While the Group would ideally like its mechanical provisioning procedures to allow for as much of this information as possible, it acknowledges that this can never entirely be the case.

This is particularly true where predicted economic conditions are not represented in the data used to develop the model, where the inherent modelling uncertainty will increase. There is also information which may only be relevant in certain situations, or more qualitative data, such as internal and external feedback, which it would be difficult to incorporate into a statistical modelling framework.

Management use their understanding of any model limitations, coupled with the wider ongoing and ad hoc management information about the Group's portfolios to determine whether any judgemental adjustments to provisioning are required.

At 30 September 2022, the absolute magnitude of economic indicators such as bank base rates and inflation lay significantly outside recent historical levels, as did their rate of change, which may decrease model reliability. The Group's loan books were generally performing well, with historically low arrears figures in the principal portfolios. However, customer and market feedback suggests that the overall effect of these may be masking a higher ECL than that predicted.

This is particularly so in the Group's SME lending operations where SME businesses are known to be holding excess cash balances, partly resulting from government support lending schemes, which may be being used to delay the impact of potential business issues.

It is also clear that some customer groups in the SME business, such as those related to the construction industry, might be impacted more specifically by the economic situation and any potential governmental response to it, which might also have an impact on the recoverable value of security assets.

To allow for these additional uncertainties the Group has applied judgemental overlays to its SME leasing portfolio and to its buy-to-let mortgage book.

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

	2022 £m	2021 £m
Mortgage Lending	5.0	9.2
Commercial Lending	10.0	10.2
	15.0	19.4

4 FINANCIAL RESULTS (Continued)

The reduction in the overlay in Mortgage Lending reflects the receding threat of Covid generated losses, compared to 2022. There is also some transfer from overlays to the modelled provision as a more normal linkage between customer metrics and future performance returns. However, it is clear that there are new concerns in the UK economy, including those arising from living costs which are not being fully recognised in the modelling.

In the SME lending book, it is unclear whether the long-term damage to customer businesses from Covid shutdowns has yet fully manifested itself. Bureau data shows that the cash balances which had built up in the SME sector as Covid-related funds were drawn down has still not normalised and this may be delaying these impacts. There is also likely to be an extent to which businesses weakened by Covid impacts are less able to withstand the forecast economic headwinds than might ordinarily be expected. For these reasons management determined that the level of overlay in this part of the portfolio should be broadly maintained in response to these new concerns.

Management then considered whether there were any customer groups (such as industries or geographies) where the risk was particularly greater than others. No such significant groups have yet been identified so the judgemental uplifts were applied across all performing cases.

The application of these judgemental adjustments is considered to align the accounting provision levels with current loss expectations in the business, taking into accounts all relevant internal information and allowing for inherent economic uncertainties. The Group will continue to monitor the appropriateness and scale of these overlays going forward and consider the extent to which any of the elements giving rise to them can or should be incorporated into models and standard processes.

Ratios and trends

The impact of the economic scenarios adopted, together with the judgemental adjustments 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.

	2022 **£m**	**2021** **£m**	**2020** **£m**
Calculated provision	48.5	46.0	62.0
Judgemental adjustments	15.0	19.4	19.8
Total	63.5	65.4	81.8
Cover ratio			
Mortgage Lending	0.31%	0.32%	0.48%
Commercial Lending	1.34%	1.74%	1.83%
Total	**0.44%**	**0.49%**	**0.64%**

4 FINANCIAL RESULTS (Continued)

The trend of the ratios above is back towards a more normal measure of coverage, as the UK economic situation continues to evolve, although without returning to the 0.34% coverage ratio seen pre-pandemic at 30 September 2019. The downward trend was also influenced by the resolution of some significant legacy positions, and by the increasing levels of security coverage generated by house price inflation in the period, with the average loan to value in the buy-to-let mortgage portfolio falling to 57.9% (2021: 61.2%). The future levels of coverage will be dependent on the performance of the UK economy and its impact on the Group's customers and their markets, where applicable.

Fair value movements

The fair value line in the Group's profit and loss account primarily reports fair value movements arising from the Group's interest rate hedging arrangements. These are put in place to protect the Group's margins when offering fixed interest rate products in either its savings or lending markets while continuing to honour offers to customers in the event of significant interest rate movements. The Group maintains a cautious approach to interest rate risk and considers its exposures to be appropriately economically hedged. The Group does not engage in any form of speculative derivative trading and all fair value movements relate to banking book exposures.

The accounting entries included in this balance are primarily non-cash items and will reverse over the life of the hedging arrangement, although period to period movements are mostly influenced by volatility in market interest rates.

Where derivatives are hedging active loan or savings balances the accounting entries should broadly cancel each other out, although this effect can be distorted in periods of greater interest rate volatility, such as the financial year just ended.

Where derivatives are hedging the lending pipeline such offsets are not available, and the full fair value movement will be shown on this line. Where future interest rate expectations increase significantly between the point at which the pipeline loans were hedged and the point at which the loans complete, then a substantial fair value movement will have been posted to the balance sheet by this time. However, through the life of the loan product the derivative will provide inflows of cash to support the income from the loan, compensating for the difference between the fixed rate already agreed and the fixed rates available in the market at the time of completion.

For this reason the Group regards these movements as essentially the anticipation of gains belonging economically to later accounting periods and excludes them from underlying results.

The particularly high levels of these movements in the 2022 financial year, where a gain of £191.9 million was recorded (2021: £19.5 million) result primarily from the levels of volatility in UK benchmark interest rate expectations in the year, the Group's approach to pipeline hedging and the retention strategy applying to maturing five-year fixed loans, which meant that the pipeline was larger and of longer duration (and hence more exposed to movements in rates) them in earlier periods.

4 FINANCIAL RESULTS (Continued)

The Group has a net derivative position of £1,201.0 million at 30 September 2022, which is unmatched for hedge accounting, although forming part of the economic hedging position. These derivatives must be carried at a fair value based on expected cash flows over their contractual lives. As a substantial proportion of this balance has a lifetime of two to five years, volatility in the interest rate markets can generate substantial month to month fluctuations in this valuation which have to be included in the Group's profit.

The table below shows the movements in unmatched exposures over the last three years alongside the maximum and minimum five year swap rates in the year as a measure of volatility.

		2022	2021	2020
		£m	£m	£m
Opening	Loan	681.6	567.7	315.4
	Deposit	683.5	935.0	562.0
	Net	(1.9)	(367.3)	(246.6)
Closing	Loan	1,578.1	681.6	567.7
	Deposit	377.1	683.5	935.0
	Net	1,201.0	(1.9)	(367.3)
Average		599.6	(184.6)	(307.0)
Swap rate	High	5.39%	1.09%	0.66%
	Low	1.11%	(0.05)%	(0.08)%
	Range	4.28%	1.14%	0.74%

This clearly shows a quadrupling of the interest rate range, the doubling of the loan pipeline hedge and a reduction in the deposit pipeline hedge which would have provided an offset. These factors have driven the gain from pipeline hedging recorded in the year.

As a result of these accounting transactions the Group is carrying a net fair value hedging asset on its balance sheet of £216.6 million (2021: £8.8 million) which will revert to zero over the lives of the related instruments.

Tax

Accounting standards require that a company should account for tax in its year end accounts at the rates of tax enshrined in legislation at the reporting date, regardless of any indications of future tax policy given by governments. This means that these accounts are prepared on the assumption that the UK Government increases the rate of corporation tax from 19% to 25% from April 2023 and reduces the bank surcharge from 8% to 3%, from the same date. Any deviation from this position will be accounted for in future periods.

4 FINANCIAL RESULTS (Continued)

The effective tax rate applied to the Group's profits has increased from 23.0% in 2021 to 25.0% during 2022. The main cause of this has been the recognition of the deferred tax liability on fair value gains which are calculated on the basis of the higher tax rates legislated for in future years. The bank surcharge represented 313 basis points of the effective rate in the year (2021: 496 basis points), meaning that it represented over half of the difference between the basic and effective rates.

As the bulk of the fair value gain arose in Paragon Bank it is subject to a higher rate of tax than the overall effective rate for the Group. This meant that the effective tax rate on underlying profit was 23.4%. In previous periods the effective tax rate on underlying profit had been materially similar to the overall effective tax rate.

Results

The year's profit before tax was 95.6% higher than in 2021 at £417.9 million (2021: £213.7 million), with much of the increase related to fair value items. Profit after tax increased 90.6% to £313.6 million (2021: £164.5 million).

Basic earnings per share increased to 129.2 pence (2021: 65.2 pence) and the diluted measure was 125.6 pence per share (2021: 63.0 pence), both inflated by the fair value accounting adjustments.

This result increased consolidated equity to £1,417.3 million (2021: £1,241.9 million), representing a tangible net asset value of £5.33 per share (2021: £4.34 per share) and a net asset value on the statutory basis of £6.06 per share (2021: £5.03 per share) (Appendix E).

4 FINANCIAL RESULTS (Continued)

4.2 ASSETS AND LIABILITIES

SUMMARY BALANCE SHEET
30 September 2022

	2022 £m	2021 £m	2020 £m
Investment in customer loans			
Mortgage Lending	12,328.7	11,829.6	11,101.1
Commercial Lending	1,881.6	1,573.1	1,530.3
	14,210.3	13,402.7	12,631.4
Hedging adjustments	(559.9)	5.5	109.7
Derivative financial assets	779.0	44.2	463.3
Cash	1,930.9	1,360.1	1,925.0
Intangible assets	170.2	170.5	170.1
Pension surplus	7.1	-	-
Other assets	116.0	154.0	206.0
Total assets	16,653.6	15,137.0	15,505.5
Equity	1,417.3	1,241.9	1,156.0
Retail deposits	10,669.2	9,300.4	7,856.6
Hedging adjustments	(99.7)	(3.0)	10.4
Other borrowings	4,007.2	4,451.4	6,229.7
Derivative financial liabilities	102.1	43.9	132.4
Pension deficit	-	10.3	20.4
Other liabilities	557.5	92.1	100.0
Total equity and liabilities	16,653.6	15,137.0	15,505.5

The Group's loan portfolio grew by 6.0% during 2022, with growth in both Mortgage Lending and Commercial Lending, despite the disposal of its unsecured consumer lending book. 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 balance increased by 6.7% during the year, marginally faster than the growth in the loan book as cash balances increased. The proportion represented by retail deposits increased to 72.7% in accordance with the Group's long-term funding strategy (2021: 67.6%), with wholesale borrowings paid down. Movements in funding balances are discussed in more detail in Section 2.

4 FINANCIAL RESULTS (Continued)

Derivatives and hedging

The Group's derivative assets shown in the table above relate almost entirely to the hedging of interest rate risk in the lending and deposit portfolios. Driven by interest rate volatility the balances of both the derivative assets and liabilities, and the related hedging adjustments on loans and deposits, have risen sharply as the volume of the Group's fixed rate products where the rate significantly differs from market fixed rate positions has grown, as market rates have increased during the year. All these items will ultimately effectively flow to the profit and loss account as fair value movements.

Pension obligations

The valuation of the Group's defined benefit pension scheme under International Accounting Standard ('IAS') 19 moved from a deficit of £10.3 million at the start of the year to a surplus of £7.1 million at 30 September 2022. This valuation is driven by inputs based on market-derived interest rates and the volatility in the period produced significant fluctuations. These inputs must be based on point-in-time observations at the year end, and market disruption around the end of September 2022 has therefore impacted the valuation.

The principal change in inputs was the increase in the discount rate used in evaluating scheme liabilities, which is based on long-term corporate bond yields, from 2.00% to 5.00%, while the assumed rate of RPI inflation, which is based on gilt yields and would normally counteract the impact of rising discount rates only increased from 3.40% to 3.55%. These movements led to a pre-tax valuation gain of £15.3 million being booked in other comprehensive income.

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 2022 was estimated at £1.4 million, an increase of £0.4 million in the period (2021: deficit of £1.0 million), representing a 98.7% funding level (2021: 99.4%). However, the position was subject to significant fluctuation around the year end date due to market conditions.

Other assets and liabilities

Sundry assets fell from £154.0 million to £116.0 million in the year, largely a result of movements in collateral balances generated by the movements in derivatives described above, which reduced by £36.6 million.

Sundry liabilities grew from £92.1 million to £557.5 million, also principally driven by derivative movements, with collateral liabilities increasing by £388.4 million and a deferred tax balance of £44.4 million being recognised, largely due to fair value accounting adjustments. The increasing interest rate environment also generated increases in accrued interest payable of £23.5 million.

4 FINANCIAL RESULTS (Continued)

4.3 SEGMENTAL RESULTS

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

	2022 £m	2021 £m
Segmental profit		
Mortgage Lending	239.9	230.2
Commercial Lending	88.6	76.4
	328.5	306.6
Unallocated central costs and other one-off items	(102.5)	(112.4)
	226.0	194.2

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 Group's Mortgage Lending division, which now includes second mortgage assets formerly reported in the Idem Capital segment continued to perform strongly and grow its NIM. Net interest grew by 9.6% in the year to £261.5 million (2021: £238.7 million) with average net assets growing by 5.4% to £12,079.2 million (2021: £11,465.3 million) as NIM increased to 216 basis points (2021: 208 basis points).

Credit performance in the period was good with a provision of £4.6 million in the year (2021: release of £7.6 million) and a cost of risk of 4 basis points. IFRS 9 Stage 3 cases reduced from £145.3 million to £119.3 million as the Group continued to resolve legacy cases which had been managed on a long-term basis.

Commercial Lending

In the Commercial Lending division average balances grew by 11.3% to £1,727.3 million (2021: £1,551.7), leading to an increase of 18.8% in net interest to £113.1 million (2021: £95.2 million). NIM grew from 614 basis points to 655 basis points, due to the continuing focus on higher margin business, and with lower-margin government backed lending forming a smaller part of new business than in the previous year.

While credit performance in the period remained largely stable, with low arrears and relatively few defaulted cases in the portfolio, potential adverse headwinds evolved in their nature but remained a threat. Stage 3 gross balance comprised only 0.3% of the segment's total gross portfolio at 30 September 2022 (2021: 1.2%). However, the uncertain outlook for the UK economy meant that the provision charge in the segment increased from £2.9 million in 2021 to £9.4 million in 2022, to ensure these risks are adequately provided against.

5 OPERATIONS REVIEW

At the heart of the Group's strategy is its vision to become a leading technology-enabled specialist bank. This relies on the strength of its people, systems and controls and the continuing development of these alongside the evolution of its business is an ongoing focus at senior management levels. The Covid pandemic demonstrated the Group's agility and flexibility in resource deployment, which are fundamental to the execution of this strategy and the Group's ability to demonstrate its resilience to its regulators also confirms the strength of this position.

It was very pleasing that the Group's commitment to its people was recognised by the award of Platinum Investors in People ('IiP') status, the highest level available, achieved by only 5% of employers assessed.

During the year the Group's operational journey away from Covid restrictions continued and a permanent commitment to hybrid working was made. The evolution of these hybrid models in different business areas continues to be a major area of focus. At the same time IT and process developments continued to progress, supporting the Group's digitalised vision of its future operating model, while the enterprise risk management framework has further evolved to ensure that the business remains robust.

All these activities combine to give the Group an evolving operational structure on which it can rely to deliver its business strategy in the future.

5.1 OPERATIONS

The Group workforce has now exceeded 1,500 people, and they have seen a major shift in working patterns over recent years, which has continued through the most recent year. A hybrid working model was adopted on an ongoing basis, following trials and building on experience of the Covid pandemic. The majority of employees are attached to one of the Group's locations, with a proportion of their time spent working from home.

In order for the Group to provide the best possible service to customers and remain successful, individual business areas have taken different approaches to implementing the flexibility this offers their people. The optimisation of these arrangements has been an area of significant operational focus in the period and this process continues into the new financial year. The evaluation of the potential consequences of these changes on the Group's social, physical and IT infrastructure will remain a priority moving forward.

The Group's success in continuing to progress the development of new systems, processes and products during the Covid pandemic meant that it entered the year well positioned to deliver enhancements in the period, and a significant number of technological, operational and regulatory developments were completed or progressed.

Long-term projects to provide better technology for the development finance, SME lending and mortgage lending operations continued in the period, with enhancements becoming available to support customers and intermediaries. During the year major projects upgrading the Group's payment and treasury systems came on line, alongside additional cyber-security capabilities. Shorter-term projects provided enhancements to accounting systems, surveyors' administration, video conferencing and interactions with customers in vulnerable circumstances.

5 OPERATIONS (Continued)

These developments are already contributing to the success of the Group's operations, delivering benefits to brokers and applicants for new SME lending products and to buy-to-let mortgage customers reaching the end of a fixed term on their products, as already described in Section 1 above.

The Group considers that its office locations remain valuable as part of its hybrid working model. Physical proximity can play a significant role in fostering collaboration, collegiality, creativity and the growth of the Group's culture and identity. The Group continues to review its locations to ensure they are optimised for new working methods and to manage their energy efficiency. As part of that process the Group's SME lending hub was relocated within the Southampton area, to a more suitable building with a better environmental impact. The Group's premises in Cardiff and Poole were also replaced with more appropriate facilities.

The Group has maintained its focus on high quality customer service throughout the period and is currently working to embed the new FCA Consumer Duty requirements in its systems and processes. This is a significant transformation in the way that the regulator approaches firm's responsibilities and a major project is taking place to ensure that the business will be able to comply within the deadlines set by the FCA.

On the Group's termination of its unsecured lending activities and the sale of its residual loan assets it was a particular focus to ensure that customers, especially those with vulnerabilities or potential vulnerabilities, were not adversely impacted by the process. The Group focusses on complaints data as a high level satisfaction metric, and incident levels remained low throughout the period.

The operational resilience of the business remains an important area of focus for the Group. During the period the formal self-assessment required by regulators was successfully completed, endorsing the Group's investment of time and resources in this area over recent periods.

5.2 GOVERNANCE

Throughout the year ended 30 September 2022, 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 tenure of Fiona Clutterbuck as Chair past nine years for succession planning purposes and to ensure the appointment of a suitable replacement Chair. Fiona stepped down from the Board on 1 September 2022 on the appointment of the new Chair, Robert East.

The appointment of the new Chair of the Board in September 2022 has also resulted in the Company adopting a 'comply and explain' approach to Provision 21 of the Code, which requires a Board to undertake a formal and rigorous annual evaluation of the performance of the Board, its committees, the Chair and individual directors. Given the appointment of a new Chair, the decision was taken to defer the 2022 evaluation until 2023 to allow the new Chair sufficient time in post to make the evaluation more relevant, meaningful and useful. The board evaluation in 2023 will be externally facilitated.

5 OPERATIONS (Continued)

Board of Directors

On 1 September Robert East was appointed as Chair of the Board in place of Fiona Clutterbuck who stepped down from the Board on that day. Robert has over 40 years' experience in UK financial services, including at board level, as CEO and Chair. During his executive career he held senior roles at Barclays. He was also CEO of Cattles, where he led the restructuring and wind down of its operations from 2010 to 2016. He has held positions as Chair of Vanquis Bank, Skipton Building Society and Hampshire Trust Bank. He has previously served as a non-executive director on the boards of Provident Financial Group, Skipton and Hampshire Trust Bank, where he was also Chair of the Risk Committee.

On the same day Tanvi Davda was appointed as an additional independent non-executive director of the Group. She brings a diverse range of skills and knowledge to the Board following an executive career of more than 25 years. Her career began at Credit Suisse as a derivatives trader. She then went on to work with IBM as a management consultant before joining ABN AMRO and then Barclays Wealth, where she was Managing Director of Global Research and Investments. In 2015, Tanvi co-founded Saranac Partners, a boutique wealth manager, where she was Managing Partner until 2021. She continued to sit on the Saranac Partners board as a non-executive director until the end of November 2022. She has also held non-executive roles on the boards of Ofqual, the qualifications and examinations regulator, and the Student Loans Company.

Following these changes the Board consists of nine directors, three of whom are female (33.3%).

Remuneration policy

The PRA remuneration rules applicable to the Group were changed with effect from the current financial year as it qualified as a Proportionality Level 2 (‘Level 2’) bank, bringing it within the scope of more onerous rules. This is a result of both 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. Affected employees have been determined and the changes required identified. All variable pay awards in respect of the current period have been made in accordance with relevant regulatory remuneration rules. The principal changes relate to the delivery mechanisms for the provision of variable remuneration to such people and the duration of deferral, for parts of that variable remuneration, which they are now subject to.

The Group’s triennial review of its Directors’ Remuneration policy commenced in the second half of the year, with consultations taking place with shareholders, investor bodies and other stakeholder groups. The proposed policy developed in this process will be presented to the 2023 AGM for approval by shareholders. We would like to thank all stakeholders who took part in the process for their input.

5 OPERATIONS (Continued)

5.3 MANAGEMENT AND PEOPLE

The Group employs just over 1,500 people and during the year headcount has grown by 4.3% (2021: 3.6%), largely driven by the creation of new roles in mortgage underwriting and customer support functions.

People and development

During the period the Group's priority has continued to be the wellbeing of employees, ensuring they were provided with the necessary support to return to the office environment safely as the restrictions from the pandemic came to an end. This included a number of trials, managed across the Group's different business areas, to identify the optimum way of working in a hybrid way, providing flexibility for employees whilst maintaining the high standards of delivering good outcomes for the Group's customers. In March 2022, an announcement was made to all employees to confirm hybrid working was being adopted on a permanent basis following the success of the trials.

The Group's Wellbeing team continues to play an important role in helping employees with their mental, physical, financial and emotional wellbeing. The Group's introduction of The Vitality Health programme during the year gave all employees access allowing them to obtain personalised health reviews, discounts and rewards through Vitality's partner brands and Vitality Wellbeing Coaches.

In May 2022 the Group was proud to announce the re-accreditation of its IiP status, being recognised for the first time as a Platinum employer. This recognition is the first for a Solihull based employer and it means the Group is one of just 5% of assessed organisations who have achieved this recognition.

The attrition rate of employees has increased during the period due to an increase in the number of retirees and a buoyant marketplace. The overall shortage of labour in the UK economy has put pressure on attracting trained and effective resource and the Group has experienced some of the effects of this. Whilst the voluntary attrition rate has increased to 12.2% from 8.6% in 2021, this level is not significantly above pre-Covid levels, and the Group continues to track below the national average of 18.6% for the banking and finance sector in 2022, published by Reward Gateway. Strong levels of retention remain a key feature of the Group's employee base with 55% of employees achieving over 5 years' service, 12% achieving over 20 years and 4% achieving over 30 years' service.

Employees continued to show flexibility during the year with many undertaking secondments and transfers to different areas of the business to ensure the Group continued to meet the needs of its customers. Although the decision was made to exit the unsecured consumer loans market in the year, of the 43 employees affected, over 50% were offered similar or alternate roles within the Group, with a number deciding to take voluntary redundancy in August.

The Group maintains its UK Living Wage Foundation accreditation and minimum pay exceeds the levels set by the Foundation. In July 2022, the Group made an exceptional payment of £1,000 to all employees below senior leader level, including a £500 advance of profit related pay for the current year, to assist with the cost-of-living pressures.

5 OPERATIONS (Continued)

Holiday entitlement was enhanced during the year, with an additional day's leave given for an employee's birthday and, following a proposal from the Group's People Forum, it was agreed to extend the half day for Christmas Eve and New Year's Eve to a full day's leave for each date. All full time employees now enjoy at least 28 days paid leave, rising to 33 days after five years. This is in addition to public holidays.

Learning and development

The Group continues to provide employees with a range of training and development opportunities. During the period this has included a range of technology focused training to support the delivery of the IT roadmap and permanent move to hybrid working, alongside extensive leadership and management training. Additionally, a new development programme for high performing employees working in specialist, non-managerial roles was launched to support the career progression of technical experts. This training is complemented by other development opportunities such as apprenticeships, coaching and mentoring.

Equality and diversity

The Group made significant progress on its equality, diversity and inclusion ('EDI') strategy during the year. Richard Rowntree, Managing Director – Mortgages, continues in the role of Executive Sponsor for EDI and sponsors the Group's EDI Network which continued to develop through the year. The Network has had a positive impact on the development of the business and has been involved in several initiatives, including promoting the importance of diversity data collection (as at 30 September 2022 the Group had achieved 73% disclosure rate (2021: 63%)) and arranging Listening Circles where members of the Executive Committee meet with employees from minority groups to discuss their experiences of working at Paragon, often resulting in a reverse mentoring experience.

In May 2022 the Group became a founding member of 'Progress Together' the City of London's Socio-Economic Diversity Membership Body. The Group is committed to improving socio-economic diversity across the financial services sector and is working on several initiatives to widen the talent pools it is accessing.

The Group is pleased to report that it continues to achieve 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 has committed to achieve 40% female representation in senior management by 31 December 2025, compared to the current 38.1%.

To support its efforts to improve gender equality the Group has continued to participate in Mission Gender Equity, a cross-company mentoring programme run by Moving Ahead. This opportunity has proven popular with both mentors and mentees, with 97% of mentees being retained, 30% securing a new role within the Group and 17% being promoted. Nicki Breen, Learning and Development Business Partner, was also recognised as a runner-up in Moving Ahead's 'Most Dedicated Programme Partner of the year' award. The Group is pleased to be participating in a similar scheme, Mission INCLUDE, for employees from ethnic minorities over the coming year.

5 OPERATIONS (Continued)

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.

5.4 SUSTAINABILITY

Sustainability, including resilience in the face of climate change risks, is core to the Group's strategy: to focus on specialist customers, 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 and savings through the design of products offered and the choices of sectors in which to operate

The Group has a Sustainability Committee which coordinates its overall response to climate change and other sustainability issues and reports directly to the Executive Committee. This provides a forum for sharing information on initiatives within business areas and helps to develop the Group's proactive approach. Since its formation in 2021 it has increased the profile of sustainability-related risks and opportunities within the Group and driven improved reporting and understanding of these matters.

The Group published its first sustainability report, Responsible Business Report, in December 2021 and has used feedback from that exercise in the development of its 2022 report. This reporting provides more detailed information on its sustainability initiatives and demonstrates how sustainability is embedded throughout the Group. It is available on the Group's corporate website at www.paragonbankinggroup.co.uk.

Climate change

Climate change is designated as a principal risk within the Group's Enterprise Risk Management Framework. As a result 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)

5 OPERATIONS (Continued)

The Group recognises the importance of reducing the impact that its own operations have on the environment. As a financial services provider the Group's overall environmental footprint across its principal operations is low. The Group is, however, committed to identifying, measuring and managing the impact of its operations on the environment and to find ways to mitigate any negative impacts. During the year key initiatives included:

- Inclusion of conditions related to climate targets in the Group's long-term variable pay arrangements
- Establishing a target to reduce operational footprint to net zero by 2030 and purchasing carbon credits to offset operational emissions in the year
- Relocating the Group's Southampton, Cardiff and Poole operations to more energy efficient premises
- Installing electric vehicle charging points at the several of the Group's buildings for use by employees
- Updating the company car policy so that only hybrid or electric vehicles will be provided on new leases, eliminating diesel and petrol vehicles from the company fleet by 2025. The Group's target is for a completely electric-only fleet by 2031
- Continuing the rollout of LED lighting across the Group's principal sites

The Group has also joined Bankers for Net Zero.

Green product initiatives have been developed across all the Group's main sectors and continue to evolve. These are discussed in the relevant business reviews in Section 1.

The Group continues to develop its reporting to manage both its risk management processes and its reporting under the principles set out by the Taskforce on Climate-Related Financial Disclosure ('TCFD'). As required by the UK Listing Rules the Group has reported on climate change risk and exposures under the TCFD framework in its 2022 year end accounts, building on the disclosures introduced in 2021.

The Group takes climate change very seriously and will only make commitments which it objectively believes are achievable and will deliver real benefits on climate change.

Social engagement

The Group's Charity Committee raised almost £43,000 for the Alzheimer's Society, the employee's chosen charity for 2021, an outstanding result, given the restrictions imposed on normal fundraising activities by the pandemic. For the nine months ended 30 September 2022 £31,000 was raised for MIND and employees have now selected Newlife, a disabled children's charity, as the beneficiary of fund raising efforts for the 2023 financial year.

Employees are also using their entitlement to an annual paid volunteering day, particularly as more opportunities become available with the loosening of Covid restrictions, with days used increasing from 49 in 2021 to 286. Employees took part in projects in the fields of homelessness, education and the environment, with the Group promoting a wider take-up for the coming year.

5 OPERATIONS (Continued)

5.5 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.

Risk environment

Whilst two previous reporting years have largely been dominated by the response to the Covid pandemic the Group now faces new economic and geopolitical challenges which require it to remain agile and resilient in its risk management capability. It is recognised that the wider pandemic is still a global challenge, and the possibility of further waves may pose additional issues. The Group's ability in successfully navigating the unprecedented situation posed by Covid in 2020 and 2021, means that it is well-placed to address any future operational challenges this may bring.

It is clear that the risk environment has significantly changed due to Covid and wider global issues which have, and will require the Group to ensure it continues to closely monitor impacts on its operations and risk profile. The Group's risk management framework will continue to provide a robust mechanism to ensure that new risks are promptly identified, assessed, managed, and appropriately overseen from a risk governance perspective.

There are a number of strategic issues that have been prominent in the risk landscape during the year and are expected to continue to pose challenges for the foreseeable future:

- The "cost of living" crisis has escalated over recent months and remains a dominant theme in the political and economic agenda. The implications of increasing inflationary pressures are far-reaching and the Group continues to monitor how this may impact its customers and employees
  - In an environment of rising interest rates and cost pressures for both new and existing borrowers, the Group continues to ensure that high standards of prudent lending are maintained. The Group takes a forward-looking, as well as current view of affordability, and has adjusted credit policy to ensure loan repayments are sustainable for customers and will continue to do so. The Group takes its responsibilities in respect of customers in vulnerable circumstances extremely seriously and continues to ensure where appropriate forbearance solutions are necessary these are tailored to individual customer circumstances and aligned to regulatory guidance and expectation
  - The Group remains committed to supporting its employees in the face of economic challenges. Various financial and wellbeing initiatives have been instigated to ensure that employees have access to information and resources to assist in navigating cost of living challenges. The welfare of its employees is a key priority of the Group, and it will continue to look at innovative ways of ensuring that individuals feel fully supported during the current uncertainty

  The Group continues to closely monitor how changes in political leadership and associated priorities, policies or interventions may influence the broader economic landscape

5 OPERATIONS (Continued)

- Following the outbreak of conflict between Russia and Ukraine the Group identified and ringfenced any potential exposures to Russian, Belorussian or Ukrainian customers and suppliers. Close oversight continues to be maintained through ongoing customer due diligence and risk assessment processes. In addition, the Group is committed to ongoing investment in its cyber controls, given heightened threat assessments posed by the geopolitical situation
- The continued embedding of the Group's operational resilience capability, given its proven criticality in the handling of the pandemic, and the incorporation of lessons learned into the overarching framework. The Group continues to build out its resilience capability having identified ongoing enhancements as a result of its initial self-assessment undertaken in March 2022. As regulatory and industry practice evolve following this sector-wide exercise, the Group is well-positioned to respond accordingly. Robust operational resilience capability is deemed to be critical as the Group undertakes its programme of strategic transformation across a number of legacy platforms and processes
- Prioritising focus on climate change given the associated risks, remains an ever-present challenge. The UK Government has confirmed its goal of net zero carbon by 2050 and the Group, and the rest of the financial services industry, have a vital role to play in that commitment. The Group considers the impacts of climate change risk through both its operations, and its lending activities and continues to evolve its approach to measure and mitigate the transition and physical risks potentially caused by climate change

These issues are expected to continue to dominate the risk landscape moving into 2023, particularly with the overall levels of economic uncertainty in the UK and the prospect of levels of inflation and interest rates not seen for many years. The Group will carefully monitor the emerging impacts on both credit risk and the wider risk landscape as the situation develops.

Risk management

Given the spectrum of risks the Group has faced, and continues to face, the maintenance of a robust risk management framework, allowing it to promptly identify and assess risk exposures and develop appropriate mitigants, remains imperative. It therefore remains committed to further evolution and embedding of its risk practices with significant progress having been made in the year in further enhancing its ability to manage all categories of risk through the ERMF.

The recruitment of experienced resource in 2021 within the second line of defence has enabled considerable enhancement of core risk processes during the year. This ensures that the risk framework continues to support the strategic aspirations of the Group in an effective and proportionate way. Good progress has been made in refining the suite of policies that underpin the management of each of the Group's identified principal risks. This, in turn, has resulted in refinement of associated risk appetites and better articulation of the control environment for each risk type. These activities have been accompanied by a comprehensive programme of education aimed at bolstering the Group's risk culture, and ensuring that individual accountabilities and responsibilities in respect of risk are fully understood.

5 OPERATIONS (Continued)

A detailed roadmap supports the development of the framework, with regular reporting against these commitments provided to the Risk and Compliance Committee. Strong progress was made through the year with the focus for 2023 onwards directed to ongoing embedding and validating the success of this through a programme of risk maturity assessments.

Despite the wider strategic challenges, the Group has identified, focussed and delivered on a number of risk issues including:

- **LIBOR transition** – Successfully transitioning all customers with LIBOR-linked products to alternative rates prior to the withdrawal of LIBOR in December 2021, while ensuring that all strategic, operational and conduct-related risk implications of the changes in product design, funding and operation were fully met

- **Financial crime** – Enhancing further the Group's financial crime systems and controls. Such systems have been an area of regulatory focus across the sector and the Group has made significant investment in both technology and resources to support its comprehensive anti-money laundering programme

- **FCA Consumer Duty** – Mobilising a comprehensive programme of work to assess the impact of the new FCA Consumer Duty on the products and services offered across the Group, ensuring that its culture is driving good outcomes for its customers

- **IRB** – Continuing to develop IRB model methodologies for the buy-to-let and development finance portfolios, while embedding the overarching model risk framework to enhance credit risk management and support the Group's IRB application process. Following submission to the PRA of Phase 2 of the buy-to-let application in March 2021, initial agreed refinement points are in the process of being addressed. Phase 3 documentation for buy-to-let, and Phase 2 documentation for development finance, are nearing completion and waiting for PRA submission invitation prior to concluding final internal governance steps

The Group has also continued to develop its management of third-party outsourcing risks, climate change risk, cyber security and data risk and stress testing, while embedding the results of the resilience self-assessment referred to above.

The long-term impact of the UK's exit from the EU continues to emerge. 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 or those of its customers.

The Group also continues to monitor the wider challenges around energy supplies given the potential threats of power shortages and energy rationing. This is subject to ongoing analysis and stress testing and the Group has undertaken detailed contingency planning in the event that such a scenario occurs. Currently the Group is comfortable that it has access to adequate alternative energy sources, however, this continues to be assessed as the implications and likelihood of energy shortages becomes clearer.

5 OPERATIONS (Continued)

Risk outlook

The principal challenges in the risk environment faced by the Group as it moves forward into its 2023 financial year and beyond include:

- Risks associated with the wider economic landscape and the impact this will inevitably have on individual living standards, particularly expected increases in energy costs. Whilst the level and duration of government intervention is yet unclear given the changing political leadership 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 addressing the regulatory requirements in respect of the new FCA Consumer Duty rules and ensuring that it continues to meet regulatory expectations in respect of its anti-money laundering and wider financial crime control frameworks
- Risks associated with climate change , where the UK Government has confirmed its goal of net zero carbon by 2050 in November 2020 giving 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 will ensure that both its operational footprint and the impact of its lending activities, explicitly consider climate change risks 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 continues to pose a particular challenge 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.

During the year all relevant regulatory publications have been considered by the Group, any implications identified and required changes implemented within an appropriate timeframe. The volume of requests for information from the FCA has increased during the year and this trend is anticipated to continue, focussing on exercising forbearance for customers as the cost of living crisis develops. The Group responds to such requests in a timely fashion, and maintains robust controls to support the delivery of fair customer outcomes.

5 OPERATIONS (Continued)

The following developments currently in progress have the greatest potential impact on the Group:

- **Consumer Duty** – In July 2022, the FCA issued its final rules and guidance on "A new Consumer Duty", which seeks to set higher expectations for the standard of support provided to customers, and challenges firms to evidence the customer outcomes that they are delivering. As implementation of the new rules is staged (with the requirement for existing products to be in compliance by July 2023, and closed products by July 2024), previous project plans have been revised to ensure appropriate focus and prioritisation. This activity is being championed by the Board, with a non-executive director having specifically been assigned responsibility for oversight of the programme

- **MREL** – 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. On 3 December 2021 the Bank of England published a Statement of Policy based upon this consultation, which took effect from 1 January 2022. Although the Group is not subject to MREL requirements currently, given its potential for growth it may be required to issue MREL eligible instruments at some point in the future and therefore continues to closely monitor developments and potential impacts

- **Basel 3.1** – The PRA published a Consultation Paper on Basel 3.1 implementation in November 2022. This follows delays driven by a need to respond to the Covid pandemic. The PRA's current intention is to consult on the proposals then implement on 1 January 2025. The Group actively monitors and manages its capital, assessing the implications of a range of different impacts including the implementation of any new requirements

- **Regulatory framework** – In 2021 the PRA published Discussion Paper 1/21, which explored options for developing a 'strong and simple' prudential framework for banks and building societies that are considered by the PRA to be neither systemically important nor internationally active, such as the Group. The PRA published a Consultation Paper 5/22 in April 2022 that focused on a proposed approach for the smallest firms, which would not impact on the Group based on the total asset's threshold (£15bn). However, the regulator has indicated that larger institutions will be addressed in the future. The Group continues to monitor developments and potential implications for its operations

- **Customers in vulnerable circumstances** – The treatment of customers in vulnerable circumstances continues to be a strong focus for the FCA, demonstrated in its business plan and three-year strategy released in April 2022. The Group continues to take its responsibilities in this regard very seriously. Significant work continues to be undertaken to revise existing procedures, controls and training provisions to meet regulatory and industry expectations

5 OPERATIONS (Continued)

- **Operational resilience** – Following the publication of the final rules and guidance on 'building operational resilience in financial services' in 2021 by the FCA, PRA and Bank of England, the Group successfully met the March 2022 policy implementation deadline. This included setting of impact tolerances for important business services, embedding a scenario testing approach and undertaking a self-assessment against the regulatory framework. The 2022 self-assessment set clear objectives for further refining the Group's approach to resilience.

  The Group is committed to a programme of continuous improvement in its resilience capability. Important business services are mapped and tested using severe but plausible scenarios to push the boundaries on the ability of the infrastructure, key dependencies and third parties to recover from disruption. This approach should ensure the Group can meet the regulatory deadline of 2025 where it will need to demonstrate the ability to stay consistently within impact tolerances

- **Climate change** – The Group continues to embed its approach to managing climate-related financial risks. The Sustainability Committee, alongside the existing executive level risk committees, ensures comprehensive consideration across all aspects of the business and ensures the Group is well-positioned to address the emerging challenges.

  Managing the impacts of climate change is seen as a key strategic priority for the Group and a detailed plan of work has been developed which reflects regulatory and wider requirements. This will continue to be refined as new thinking emerges.

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 Financial Services and Markets Bill, which sets out how the UK financial sector will be regulated post-Brexit, was published in July 2022 with the aim that it will obtain royal assent by May 2023. The Bill will implement the outcomes of the Future Regulatory Framework ('FRF') Review, revoking retained EU law relating to financial services and enabling HM Treasury and the financial services regulators to replace it with legislation designed specifically for UK markets, in a way that builds on the UK's existing approach to financial services regulation. The Bill covers a wide range of areas, but key elements include the introduction of a new secondary objective for both the PRA and the FCA for medium to long-term growth and international competitiveness in the financial services sector, an enhancement to regulatory powers over critical third parties and increased powers for HM Treasury over the Bank of England and PRA on existing and new rules. The Group continues its close monitoring of developments in this area and the emerging implications of Brexit more widely, and how these may ultimately impact the specific regulatory frameworks under which the Group operates.

The governance and risk management framework within the Group continues to be developed to ensure that the impacts of all new regulatory requirements are clearly understood and mitigated as far as possible. Regular reports on key regulatory developments are received at both executive and board risk committees.

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

PRINCIPAL RISKS

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

Capital

Insufficient capital to operate effectively and meet minimum requirements

Liquidity and funding

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

Market

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

Credit

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

Model

Making incorrect decisions based on the output of internal models

Reputational

Failing to meet the expectations and standards of our stakeholders

Strategic

The corporate plan does not fully align to and support strategic priorities or is not executed effectively

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 or to act with integrity

Operational

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

We have an 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 2022.

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, including the Companies Act 2006 ('the Companies Act'), 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 2022, that law requires the directors to prepare the consolidated financial statements in accordance with UK-adopted international accounting standards in conformity with the requirements of the Companies Act and they have also elected to prepare the separate financial statements of the Company on the same basis.

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 UK-adopted international accounting standards
- 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.

In accordance with DTR 4.1.14R of the FCA Disclosure Guidance and Transparency Rules, the financial statements will form part of the annual financial report published in the single electronic reporting format specified in the TD ESEF Regulation (the UK version of the EU Commission Delegated Regulation (EU) 2019/815). The independent auditor's report on these financial statements provides no assurance over the ESEF format.

Confirmation by the Board of Directors

The Board of Directors currently comprises:

R D East (Chair of the Board)

N S Terrington (CEO)

R J Woodman (CFO)

H R Tudor (Senior Independent Director)

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)

T P Davda (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

CIARA MURPHY

Company Secretary

6 December 2022

PRELIMINARY FINANCIAL INFORMATION

CONSOLIDATED STATEMENT OF PROFIT OR LOSS
For the year ended 30 September 2022

	Note	2022 £m	2022 £m	2021 (Restated*) £m	2021 (Restated*) £m
Interest receivable	3		545.7		443.5
Interest payable and similar charges	4		(174.5)		(133.0)
Net interest income			371.2		310.5
Other leasing income		24.6		20.4	
Related costs		(20.0)		(16.9)	
Net operating lease income		4.6		3.5	
Gain on disposal of financial assets	5	4.6		-	
Other income	6	12.6		10.9	
Other operating income			21.8		14.4
Total operating income			393.0		324.9
Operating expenses			(153.0)		(135.4)
Provisions for losses	7		(14.0)		4.7
Operating profit before fair value items			226.0		194.2
Fair value net gains / (losses)	8		191.9		19.5
Operating profit being profit on ordinary activities before taxation			417.9		213.7
Tax charge on profit on ordinary activities	9		(104.3)		(49.2)
Profit on ordinary activities after taxation for the financial year			313.6		164.5

	Note	2022	2021
Earnings per share			
- basic	10	129.2p	65.2p
- diluted	10	125.9p	63.0p

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

* See Note 3

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended 30 September 2022

	Note	2022 £m	2022 £m	2021 £m	2021 £m
Profit for the year			313.6		164.5
Other comprehensive income					
Items that will not be reclassified subsequently to profit or loss					
Actuarial gain / (loss) on pension scheme	20	15.3		8.2	
Tax thereon		(3.7)		(0.9)	
			11.6		7.3
Items that may be reclassified subsequently to profit or loss					
Cash flow hedge (losses) taken to equity		-		(3.0)	
Tax thereon		-		0.5	
			-		(2.5)
Other comprehensive income / (expenditure) for the year net of tax			11.6		4.8
Total comprehensive income for the year			325.2		169.3

CONSOLIDATED BALANCE SHEET
30 September 2022

	Note	2022 £m	2021 £m	2020 £m
Assets				
Cash – central banks	11	1,612.5	1,142.0	1,637.1
Cash – retail banks	11	318.4	218.1	287.9
Loans to customers	12	13,650.4	13,408.2	12,741.1
Derivative financial assets	19	779.0	44.2	463.3
Sundry assets		39.2	69.2	128.0
Current tax assets		5.4	-	5.7
Deferred tax assets		-	14.4	6.2
Retirement benefit obligations	20	7.1	-	-
Property, plant and equipment		71.4	70.4	66.1
Intangible assets	21	170.2	170.5	170.1
Total assets		16,653.6	15,137.0	15,505.5
Liabilities				
Short term bank borrowings		0.4	0.3	0.4
Retail deposits	22	10,569.5	9,297.4	7,867.0
Derivative financial liabilities	19	102.1	43.9	132.4
Asset backed loan notes	23	409.3	516.0	3,270.5
Secured bank borrowings	23	586.0	730.0	657.8
Retail bond issuance	23	112.3	237.1	296.8
Corporate bond issuance	23	149.2	149.0	149.8
Central bank facilities	23	2,750.0	2,819.0	1,854.4
Sundry liabilities	24	513.1	90.7	100.0
Current tax liabilities		-	1.4	-
Deferred tax liabilities		44.4	-	-
Retirement benefit obligations	20	-	10.3	20.4
Total liabilities		15,236.3	13,895.1	14,349.5
Called up share capital	25	241.4	262.5	261.8
Reserves	26	1,223.9	1,056.1	932.0
Own shares	27	(48.0)	(76.7)	(37.8)
Total equity		1,417.3	1,241.9	1,156.0
Total liabilities and equity		16,653.6	15,137.0	15,505.5

Approved by the Board of Directors on 6 December 2022.

Signed on behalf of the Board of Directors

N S Terrington
Chief Executive

R J Woodman
Chief Financial Officer

CONSOLIDATED CASH FLOW STATEMENT

For the year ended 30 September 2022

	Note	2022 £m	2021 £m
Net cash generated by operating activities	29	1,168.7	878.1
Net cash (utilised) by investing activities	30	(2.4)	(4.3)
Net cash (utilised) by financing activities	31	(595.6)	(1,438.6)
Net increase / (decrease) in cash and cash equivalents		570.7	(564.8)
Opening cash and cash equivalents		1,359.8	1,924.6
Closing cash and cash equivalents		1,930.5	1,359.8
Represented by balances within:			
Cash	11	1,930.9	1,360.1
Short term bank borrowings		(0.4)	(0.3)
		1,930.5	1,359.8

CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY
For the year ended 30 September 2022

	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	-	-	-	-	-	313.6	-	313.6
Other comprehensive income	-	-	-	-	-	11.6	-	11.6
Total comprehensive income	-	-	-	-	-	325.2	-	325.2
Transactions with owners								
Dividends paid (note 28)	-	-	-	-	-	(68.9)	-	(68.9)
Own shares purchased	-	-	-	-	-	-	(79.5)	(79.5)
Irrevocable instruction accrual	-	-	-	-	-	-	(10.8)	(10.8)
Exercise of share awards	0.4	1.0	-	-	-	(10.3)	9.6	0.7
Shares cancelled	(21.5)	-	21.5	-	-	(109.4)	109.4	-
Charge for share based remuneration	-	-	-	-	-	9.2	-	9.2
Tax on share based remuneration	-	-	-	-	-	(0.5)	-	(0.5)
Net movement in equity in the year	(21.1)	1.0	21.5	-	-	145.3	28.7	175.4
Opening equity	262.5	70.1	50.3	(70.2)	-	1,005.9	(76.7)	1,241.9
Closing equity	241.4	71.1	71.8	(70.2)	-	1,151.2	(48.0)	1,417.3

CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY
For the year ended 30 September 2022

Year ended 30 September 2021

	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	-	-	-	-	-	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 28)	-	-	-	-	-	(54.6)	-	(54.6)
Own shares purchased	-	-	-	-	-	-	(42.2)	(42.2)
Irrevocable instruction accrual	-	-	-	-	-	-	-	-
Exercise of share awards	0.7	1.4	-	-	-	(3.3)	3.3	2.1
Shares cancelled	-	-	-	-	-	-	-	-
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

NOTES TO THE FINANCIAL INFORMATION

For the year ended 30 September 2022

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 2020, 30 September 2021 or 30 September 2022, 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 2020 and 30 September 2021 have been delivered to the Registrar of Companies and those for the year ended 30 September 2022 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 2022 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
- 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 2022

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

2. SEGMENTAL INFORMATION

The Group analyses its operations, both for internal management reporting and external financial reporting, on the basis of the markets from which its assets are generated. The segments used internally were revised during the year, following the disposal of the unsecured consumer loan assets of the former Idem Capital segment (note 5). The segments used at 30 September 2022 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

Comparative disclosures have been restated to correspond to the new segments.

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

Gains on derecognition of financial assets have not been allocated to segment results.

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

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

Other assets and liabilities are not allocated between segments.

All 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 2022

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. The presentation of interest receivable and interest payable below has been revised as described in Note 3

Year ended 30 September 2022

	Mortgage Lending £m	Commercial Lending £m	Unallocated Items £m	Total Segments £m
Interest receivable	400.3	135.8	9.6	545.7
Interest payable	(138.8)	(22.7)	(13.0)	(174.5)
Net interest income	261.5	113.1	(3.4)	371.2
Other operating income	7.4	9.8	4.6	21.8
Total operating income	268.9	122.9	1.2	393.0
Operating expenses	(24.4)	(24.9)	(103.7)	(153.0)
Provisions for losses	(4.6)	(9.4)	-	(14.0)
	239.9	88.6	(102.5)	226.0

Year ended 30 September 2021 (restated)

	Mortgage Lending £m	Commercial Lending £m	Unallocated Items £m	Total Segments £m
Interest receivable	367.7	115.0	(39.2)	443.5
Interest payable	(129.0)	(19.8)	15.8	(133.0)
Net interest income	238.7	95.2	(23.4)	310.5
Other operating income	6.4	8.0	-	14.4
Total operating income	245.1	103.2	(23.4)	324.9
Operating expenses	(22.5)	(23.9)	(89.0)	(135.4)
Provisions for losses	7.6	(2.9)	-	4.7
	230.2	76.4	(112.4)	194.2

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

	2022 £m	2021 £m
Results shown above	226.0	194.2
Fair value items	191.9	19.5
Operating profit	417.9	213.7

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

2. SEGMENTAL INFORMATION (CONTINUED)

The assets of the segments listed above are:

	2022 £m	2021 (Restated) £m	2020 (Restated) £m
Mortgage Lending	12,569.2	11,952.9	11,769.8
Commercial Lending	1,923.2	1,612.4	1,569.8
Total segment assets	14,492.4	13,565.3	13,339.6
Unallocated assets	2,161.2	1,571.7	2,165.9
Total assets	16,653.6	15,137.0	15,505.5

An analysis of the Group's loan assets by type and segment is shown in note 12.

3. INTEREST RECEIVABLE

The Group has reconsidered the analysis it presents of net interest income in its accounts in light of the increasing magnitude of hedging impacts on these balances, with derivative income and expense attributed to the hedged transaction and shown separately. This will provide better information to users and is consistent with approaches currently used by comparable firms. Information in respect of the year ended 30 September 2021 has been restated on the same basis. While this change affects the total reported amounts of interest receivable and interest payable (note 4), by the amount reported as 'effect of fair value hedging of loan assets', total net interest is unaffected.

Interest receivable is analysed as follows.

	2022 £m	2021 (Restated) £m
Interest receivable in respect of		
Loans and receivables	486.7	440.0
Finance leases	45.0	40.4
Factoring income	3.4	2.3
Interest on loans to customers	535.1	482.7
Effect of fair value hedging of loan assets	(1.5)	(40.7)
Interest on loans to customers after hedging	533.6	442.0
Other interest receivable	12.1	1.5
Total interest on financial assets	545.7	443.5

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

3. INTEREST RECEIVABLE (CONTINUED)

The above amounts relate to:

	2022 £m	2021 (Restated) £m
Financial assets held at amortised cost	502.2	443.8
Finance leases	45.0	40.4
Derivative financial instruments held at fair value	(1.5)	(40.7)
	545.7	443.5

4. INTEREST PAYABLE AND SIMILAR CHARGES

The Group's interest payable disclosure has been reanalysed, and comparative amounts restated as described in note 3.

In the 2021 disclosures as originally presented, transactions relating to fair value hedging were included in 'interest payable on retail deposits' (£26.3) and 'interest payable on asset backed loan notes' (£8.4m). These amounts have been reanalysed between 'effect of fair value hedging of deposits' below and 'effect of fair value hedging of loan assets' in note 3.

	Note	2022 £m	2021 (Restated) £m
On financial liabilities			
Retail deposits		108.8	94.2
Effect of fair value hedging of deposits		4.2	(6.0)
Interest on retail deposits after hedging		113.0	88.2
Asset backed loan notes		9.1	9.5
Bank loans and overdrafts		13.3	6.6
Corporate bonds		6.6	9.3
Retail bonds		9.1	15.4
Central bank facilities		22.2	2.2
Repurchase agreements		-	0.1
Total interest on financial liabilities		173.3	131.3
Pension scheme deficit	20	0.2	0.3
Discounting on contingent consideration		0.1	0.3
Discounting on lease liabilities		0.2	0.2
Other finance costs		0.7	0.9
		174.5	133.0

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

4. INTEREST PAYABLE AND SIMILAR CHARGES (CONTINUED)

The above amounts relate to:

	2022 £m	2021 (Restated) £m
Financial liabilities held at amortised cost	169.1	137.3
Derivative financial instruments held at fair value	4.2	(6.0)
Other items	1.2	1.7
	174.5	133.0

5. GAIN ON DISPOSAL OF FINANCIAL ASSETS

On 8 June 2022 the Group disposed of almost all of its unsecured consumer loan balances, which had been held within the Idem Capital Segment. The Group has no continuing interest in these assets. The carrying value of the loans disposed of was £74.1m and cash consideration of £78.9m was received, resulting in a gain on disposal of £4.6m after allowing for costs arising from the transaction.

This disposal significantly reduced the size of the Idem Capital segment, and subsequently the Group reorganised its segmental reporting as described in note 2.

6. OTHER INCOME

	2022 £m	2021 £m
Loan account fee income	6.1	5.1
Broker commissions	2.3	1.9
Third party servicing	3.5	3.5
Other income	0.7	0.4
	12.6	10.9

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 2022

7. LOAN IMPAIRMENTS - PROVISIONS CHARGED / CREDITED TO INCOME

The amounts charged / (credited) to the profit and loss account in the year are analysed as follows.

	Mortgage Lending £m	Commercial Lending £m	Total £m
30 September 2022			
Provided in period	5.1	10.7	15.8
Recovery of written off amounts	(0.5)	(1.3)	(1.8)
	4.6	9.4	14.0
Of which			
Loan accounts	4.6	2.4	7.0
Finance leases	-	7.0	7.0
	4.6	9.4	14.0
30 September 2021 (Restated)			
(Released) / provided in period	(7.1)	4.0	(3.1)
Recovery of written off amounts	(0.5)	(1.1)	(1.6)
	(7.6)	2.9	(4.7)
Of which			
Loan accounts	(7.6)	(2.1)	(9.7)
Finance leases	-	5.0	5.0
	(7.6)	2.9	(4.7)

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

8. FAIR VALUE NET GAINS / (LOSSES)

	2022 £m	2021 £m
Ineffectiveness of fair value hedges		
Portfolio hedges of interest rate risk		
Deposit hedge	11.6	(0.3)
Loan hedge	15.1	6.6
	26.7	6.3
Ineffectiveness of cash flow hedges	-	-
Other hedging movements	4.7	9.9
Net gains / (losses) on other derivatives	160.5	3.3
	191.9	19.5

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.

The impact of hedging arrangements on the Group's balance sheet is summarised in note 19 which also provides a full description of the Group's use of derivative financial instruments for hedging purposes.

9. TAX CHARGE ON PROFIT ON ORDINARY ACTIVITIES

Income tax for the year ended 30 September 2022 is charged at an effective rate of 25.0% (2021: 23.0%).

The standard rate of corporation tax in the UK applicable to the Group in the year was 19.0% (2021 H1: 19.0%), based on legislation enacted at the year end. During the year ended 30 September 2021, the UK Government enacted legislation increasing the standard rate of corporation tax in the UK from 19.0% to 25.0% from April 2023. Therefore legislation currently in force will increase the standard rate of corporation tax applicable to the Group to 22.0% in the year ending 30 September 2023 and to 25.0% in the year ending 30 September 2024 and thereafter. The effect of these changes on deferred tax balances was accounted for in the year ended 30 September 2021.

The Bank Corporation Tax Surcharge subjects any taxable profits arising in the Group's banking subsidiary, Paragon Bank PLC (and no other Group entity), to an additional 8.0% of tax to the extent these profits exceed £25.0m.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

9. TAX CHARGE ON PROFIT ON ORDINARY ACTIVITIES (CONTINUED)

In the current financial year the UK Government enacted legislation which will reduce the rate of the Banking Surcharge from 8.0% to 3.0%, also from April 2023, while increasing the profit threshold at which the surcharge applies to £100.0m from £25.0m. This will result in the surcharge applicable to Paragon Bank reducing to 5.5% with a threshold of £62.5m in the financial year ending 30 September 2023 and 3.0%, with a threshold of £100.0m, thereafter. The impact of this change on deferred tax balances has been accounted for in the current period.

10. EARNINGS PER SHARE

Earnings per ordinary share is calculated as follows:

		2022	**2021**
Profit for the year (£m)		313.6	164.5
Basic weighted average number of ordinary shares ranking for dividend during the year (m)		242.7	252.3
Dilutive effect of the weighted average number of share options and incentive plans in issue during the year (m)		6.4	8.9
Diluted weighted average number of ordinary shares ranking for dividend during the year (m)		249.1	261.2
Earnings per ordinary share	- basic	129.2p	65.2p
	- diluted	125.9p	63.0p

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

11. 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.

	2022 £m	2021 £m	2020 £m
Deposits with the Bank of England	1,612.5	1,142.0	1,637.1
Balances with central banks	1,612.5	1,142.0	1,637.1
Deposits with other banks	318.4	218.1	287.9
Balances with other banks	318.4	218.1	287.9
Cash and cash equivalents	1,930.9	1,360.1	1,925.0

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. This cash is shown as 'securitisation cash' below.

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. This is shown as 'ESOP cash' below.

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

	2022 £m	2021 £m	2020 £m
Available cash	1,689.1	1,236.5	1,701.1
Securitisation cash	240.5	123.3	223.4
ESOP cash	1.3	0.3	0.5
	1,930.9	1,360.1	1,925.0

Cash and cash equivalents are classified as Stage 1 exposures (see note 14) for the purposes of impairment provisioning. The probabilities of default have been assessed to be so low as to require no significant impairment provision.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

12. LOANS TO CUSTOMERS

The Group's loans to customers at 30 September 2022, analysed between the segments described in note 2 are as follows:

	Note	2022 £m	2021 (Restated) £m	2020 (Restated) £m
First mortgages		12,122.4	11,460.6	10,636.9
Second charge mortgages		206.3	281.7	354.5
Unsecured consumer loans		-	87.3	109.7
Total Mortgage Lending		12,328.7	11,829.6	11,101.1
Finance lease receivables		825.2	720.3	724.4
Development finance		719.9	608.2	609.0
Other secured commercial lending		238.1	168.0	134.4
Other commercial loans		98.4	76.6	62.5
Total Commercial Lending		1,881.6	1,573.1	1,530.3
Loans to customers		14,210.3	13,402.7	12,631.4
Fair value adjustments from portfolio hedging	19	(559.9)	5.5	109.7
		13,650.4	13,408.2	12,741.1

The segmental analysis shown above has been restated in line with the revision of the Group's segments described in Note 2. Total balances of each class of lending are unaffected by this change.

Other secured commercial lending includes structured lending, aviation mortgages and invoice finance.

Other commercial loans includes principally professions finance, discounted receivables, term loans issued under the RLS, CBILS and BBLS scheme, and other short term commercial balances.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

13. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS

The following notes set out information on the Group's impairment provisioning under IFRS 9 for the loans to customers balances set out in note 16, 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 within the following notes:

- 14 Loan impairments – Basis of provision
- 15 Loan impairments by stage and division
- 16 Loan impairments – Provision movements in the year
- 17 Loan impairments – Economic inputs to calculations
- 18 Loan impairments – Sensitivity analysis

The impact on the Group's profit and loss account for the year is set out in note 7.

14. LOAN IMPAIRMENT - BASIS OF PROVISION

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

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 judgemental adjustments to ensure all elements of credit risk are fully addressed

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

14. LOAN IMPAIRMENT – BASIS OF PROVISION (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. In determining for which portfolios a statistically modelled approach is appropriate, the Group considers the volume of available data and the level of similarity of the credit characteristics of the underlying accounts.

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 extreme or unprecedented economic conditions, 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. This may be the case where economic indicators at the reporting date and future expectations for those indicators lie outside the range of the observations used to construct the models. In such circumstances, management carefully review all outputs to ensure provision is adequate.

At 30 September 2022 the UK economy was subject to levels of inflation and interest rates not seen for some considerable time and not represented sufficiently in the data sets used to create the Group's models. There was also a level of uncertainty as to the direction of government policy which was unusual for the UK. The situation was evolving rapidly at the year end, meaning that there was a risk that credit metrics and external credit bureau data might not fully reflect increasing risks, which would lead to a potential understatement of PDs.

These factors led management to conclude that current and forecast economic conditions were not ones under which the Group's models would necessarily perform well, and that judgemental adjustments might be required to compensate for these weaknesses.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

14. LOAN IMPAIRMENT – BASIS OF PROVISION (CONTINUED)

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.

As part of its determination of whether model outputs form a reliable basis for impairment provisioning, the Group considered whether it had any evidence of groups of accounts demonstrating factors indicating a higher level of credit risk than other accounts in the same portfolios. No such evidence was noted at 30 September 2022, and hence no additional accounts were identified as having an SICR.

At 30 September 2021 the Group had identified accounts where the customer had been granted a Covid-related payment holiday as being at increased credit risk and an additional £599.8m of balances were designated as having an SICR. The performance of such accounts was monitored through the period and management were able to conclude that, given the passage of a further 12 months, accounts would either have stabilised or be identified as defaulted or as at SICR through the Group's normal process. No similar adjustment was therefore required at 30 September 2022.

While no requirement to identify additional SICR cases has arisen in 2022, the approach is consistent with that adopted at 30 September 2021, and will be kept under review in future periods.

iii) Definitions of default

As the IFRS 9 definition of ECL is based on PD, default must be defined for this purpose. The analysis of these default cases provides the foundation for the Group's PD modelling. 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, combined with qualitative and quantitative factors specific to each portfolio.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

14. LOAN IMPAIRMENT – BASIS OF PROVISION (CONTINUED)

The most influential quantitative factor in the majority of portfolios is the arrears level, while the principal qualitative factors relate to internal account management statuses. In particular the decision to commence a process of enforcement will be considered as a default in all portfolios. In the Group's buy-to-let mortgage portfolio the appointment of a receiver of rent to manage the property on the customer's behalf is considered a default, while for portfolios assessed on a case-by-case basis, such as the Group's development finance loans, the movement of an account to the highest risk category is considered as a default.

This ensures that Group's definitions of default for its various portfolios are materially aligned to the regulatory definitions of default used internally, and are broadly aligned to its internal operational procedures, allowing for the arbitrary nature of the 90-day cut-off, which is a regulatory rather than an operational requirement. 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.

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 2022

14. LOAN IMPAIRMENT – BASIS OF PROVISION (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 asset 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.

The adoption of this model has enabled the reporting process in the year to be more streamlined and supported increased use of scenario analysis.

The Group's programme of model development continued during the year with a particular focus on analysing how default and loss data recorded over the period of the Covid pandemic should be reflected in forward-looking models, given the unprecedented nature of the pandemic and the national and international response to it.

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

The impacts of the adoption of the new PD model in the year ended 30 September 2021 on the calculated provision were not significant.

vii) Judgemental Adjustments

In order to ensure that its loan portfolios are adequately provisioned, the Group considers whether there are factors not fully captured by the modelling process, including economic conditions more generally, which indicate a need for judgemental adjustments. Information considered includes credit data, customer and broker feedback received, the results of insight surveys, industry intelligence and expert knowledge within the business lines.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

14. LOAN IMPAIRMENT – BASIS OF PROVISION (CONTINUED)

During the year, the dominance of Covid in these considerations reduced as the short-term impact of the pandemic receded and other economic factors such as the UK cost of living, rising interest rates and the conflict in the Ukraine became more significant.

Towards the end of the year the consensus view of the likely severity of these impacts became markedly more pessimistic, and together with political instability in the UK Government and emerging negative economic indicators this generated a situation where very careful assessment of credit prospects was required.

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, judgemental adjustments 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 judgemental adjustments required is minimal, but in economic conditions where previous relevant experience is limited or non-existent, some form of judgemental adjustment is always likely to be necessary. While high interest rate and inflation scenarios have occurred in the UK in the past, market conditions, products and regulatory expectations have moved on considerably in the meantime, and most such observations would pre-date the existence of buy-to-let mortgages as a distinct asset class. This means that the value of past history as a guide to future credit performance is reduced.

The current model behaviour and the potential for unobserved credit issues have meant that the requirement for such adjustments over recent periods has been 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 are combined to form a broad estimate of the level of provision required across the Group.

The requirement for judgemental adjustments is considered on a portfolio-by-portfolio basis, and the potential for the existence of significant groups of assets being particularly exposed to credit risk in the expected economic scenarios is also considered.

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

	2022	2021 (restated)
	£m	£m
Mortgage Lending	5.0	9.2
Commercial Lending	10.0	10.2
	15.0	19.4

The movements in the period represent a transition from Covid related overlays to ones which relate more to the responsiveness of the Group's provision models to current economic conditions.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

14. LOAN IMPAIRMENT – BASIS OF PROVISION (CONTINUED)

In the Mortgage Lending book it is considered that where Covid-related adjustments were made at 30 September 2021, this credit risk is now either reflected in credit metrics or has reduced. The adjustment at 30 September 2022 is principally a result of a disconnect between the credit metrics which drive the models and the economic expectations of management, brokers and customers at the year end date.

In the Commercial Lending segment the adjustment has remained of a similar size, but relates to more general economic exposures than it did at 2021, with outlook for the sector less positive than credit metrics might indicate. However, the potential long-term impacts of Covid in the forms of business weakness and the continuing government backed funding of SMEs, through CBILS and similar schemes. still play a part in this assessment.

The Group's analysis found no evidence of particular concentrations of credit risk below portfolio level. Given this, and the high level nature of the exercise undertaken, the judgemental adjustments have been apportioned across the Group's buy-to-let mortgage and SME leasing portfolios to individual cases. As such they are included in the credit risk disclosures required by IFRS 7.

The Group will continue to monitor the requirement for these adjustments as the economic situation develops and its impacts begin to be reflected in model outputs. It is anticipated that a more normal economic situation would require a lower value of adjustments, but the timescale in which such a scenario might be reached appears uncertain.

The Group has adopted the terminology for impairment adjustments proposed by the Taskforce on Disclosures about Expected Credit Loss ('DECL') which restricts the use of the term 'Post Model Adjustment' ('PMA') to those adjustments calculated on an account-by-account basis and therefore no longer uses that term for other judgemental adjustments.

15. LOAN 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 Mortgage Lending, 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 2022

15. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

An analysis of the Group's loan portfolios between the stages defined above is set out below. The segmental analysis included in this note for the year ended 30 September 2021 has been restated for the changes in the segments reported (Note 2).

	Stage 1 £m	Stage 2 * £m	Stage 3 * £m	POCI £m	Total £m
30 September 2022					
Gross loan book					
Mortgage Lending	10,339.6	1,886.4	119.3	21.4	12,366.7
Commercial Lending	1,817.4	77.2	5.1	7.4	1,907.1
Total	12,157.0	1,963.6	124.4	28.8	14,273.8
Impairment provision					
Mortgage Lending	(5.8)	(6.1)	(26.1)	-	(38.0)
Commercial Lending	(19.7)	(1.9)	(2.4)	(1.5)	(25.5)
Total	(25.5)	(8.0)	(28.5)	(1.5)	(63.5)
Net loan book					
Mortgage Lending	10,333.8	1,880.3	93.2	21.4	12,328.7
Commercial Lending	1,797.7	75.3	2.7	5.9	1,881.6
Total	12,131.5	1,955.6	95.9	27.3	14,210.3
Coverage ratio					
Mortgage Lending	0.06%	0.32%	21.88%	-	0.31%
Commercial Lending	1.08%	2.46%	47.06%	20.27%	1.34%
Total	0.21%	0.41%	22.91%	5.21%	0.44%

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

15. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

	Stage 1 £m	Stage 2 * £m	Stage 3 * £m	POCI £m	Total £m
30 September 2021 (Restated)					
Gross loan book					
Mortgage Lending	10,396.2	1,212.7	145.3	113.1	11,867.3
Commercial Lending	1,504.2	66.4	19.0	11.2	1,600.8
Total	11,900.4	1,279.1	164.3	124.3	13,468.1
Impairment provision					
Mortgage Lending	(2.1)	(10.3)	(25.3)	-	(37.7)
Commercial Lending	(12.9)	(1.0)	(13.6)	(0.2)	(27.7)
Total	(15.0)	(11.3)	(38.9)	(0.2)	(65.4)
Net loan book					
Mortgage Lending	10,394.1	1,202.4	120.0	113.1	11,829.6
Commercial Lending	1,491.3	65.4	5.4	11.0	1,573.1
Total	11,885.4	1,267.8	125.4	124.1	13,402.7
Coverage ratio					
Mortgage Lending	0.02%	0.85%	17.41%	-	0.32%
Commercial Lending	0.86%	1.51%	71.58%	1.79%	1.74%
Total	0.13%	0.88%	23.68%	0.16%	0.49%

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

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

POCI balances included in the Commercial Lending segment arise principally from acquired businesses, where those assets were identified as credit impaired at the point of acquisition when the acquired portfolios as a whole were evaluated. Additional provision arising on these assets post-acquisition is shown as 'Impairment Provision' above.

The Group's acquired consumer loans are included in the Mortgage Lending segment, together with legacy (originated pre-2010) second charge mortgage. Acquired loans which were performing on acquisition are included in the staging analysis above.

Acquired portfolios within the Mortgage Lending which were largely non-performing at acquisition, and which were purchased at a deep discount to face value are shown as POCI assets above. Although no provision is shown above for such assets, the effect of the discount on purchase is included in the gross value ensuring that the carrying value is substantially less than the current balances due from customers and the level of cover is considerable.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

15. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

Analysis of Stage 2 loans

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

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.

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

The value of accounts in stage 2 has increased across all categories as a result of the generally worsening economic outlook. The largest increase is in those cases in the buy-to-let book identified with an SICR through PD movements, a result of the updated economic scenarios and weightings (note 17)

Provision levels and coverage in the Mortgage Lending division have both reduced, however, due to the impact of the strong growth in house prices on security values. Coverage levels in the Commercial Lending division have increased, largely as a result of the nature of the items included in this stage at 30 September 2022 compared to a year earlier, and a more pessimistic outlook for security values.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

15. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

	< 1 month arrears	Recent arrears	> 1 <= 3 months arrears	Total
	£m	£m	£m	£m
30 September 2022				
Gross loan book				
Mortgage Lending	1,850.0	10.8	25.6	1,886.4
Commercial Lending	74.2	0.2	2.8	77.2
Total	1,924.2	11.0	28.4	1,963.6
Impairment provision				
Mortgage Lending	(5.4)	(0.1)	(0.6)	(6.1)
Commercial Lending	(1.6)	-	(0.3)	(1.9)
Total	(7.0)	(0.1)	(0.9)	(8.0)
Net loan book				
Mortgage Lending	1,844.6	10.7	25.0	1,880.3
Commercial Lending	72.6	0.2	2.5	75.3
Total	1,917.2	10.9	27.5	1,955.6
Coverage ratio				
Mortgage Lending	0.29%	0.93%	2.34%	0.32%
Commercial Lending	2.16%	-	10.71%	2.46%
Total	0.36%	0.91%	3.17%	0.41%

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

15. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

	< 1 month arrears	Recent arrears	> 1 <= 3 months arrears	Total
	£m	£m	£m	£m
30 September 2021 (Restated)				
Gross loan book				
Mortgage Lending	1,187.7	8.7	16.3	1,212.7
Commercial Lending	61.1	0.2	5.1	66.4
Total	1,248.8	8.9	21.4	1,279.1
Impairment provision				
Mortgage Lending	(9.9)	(0.1)	(0.3)	(10.3)
Commercial Lending	(0.9)	-	(0.1)	(1.0)
Total	(10.8)	(0.1)	(0.4)	(11.3)
Net loan book				
Mortgage Lending	1,177.8	8.6	16.0	1,202.4
Commercial Lending	60.2	0.2	5.0	65.4
Total	1,238.0	8.8	21.0	1,267.8
Coverage ratio				
Mortgage Lending	0.83%	1.15%	1.84%	0.85%
Commercial Lending	1.47%	-	1.96%	1.51%
Total	0.86%	1.12%	1.87%	0.88%

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.

RoR accounts in Stage 3 may be fully up-to-date with full recovery possible. These accounts are included in Stage 3 as they are classified as defaulted for regulatory purposes.

The gross values of Stage 3 accounts at 30 September 2022 are significantly reduced from these at 30 September 2021 as the number of new defaults in the year remained low and historic cases were resolved.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

15. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

Other than the impact of the Commercial Lending write-offs, coverage levels remained broadly similar to the previous year end position. Ratios in Stage 3 will naturally be subject to a wider range of fluctuation than those elsewhere, given the low number of accounts involved, the consequent potential for mix effects and the idiosyncratic nature of some of the cases.

	Probation	> 3 month arrears	RoR managed	Realisations	Total
	£m	£m	£m	£m	£m
30 September 2022					
Gross loan book					
Mortgage Lending	6.0	37.5	49.6	26.2	119.3
Commercial Lending	0.2	0.7	-	4.2	5.1
Total	6.2	38.2	49.6	30.4	124.4
Impairment provision					
Mortgage Lending	(0.4)	(1.0)	(17.2)	(7.5)	(26.1)
Commercial Lending	-	(0.2)	-	(2.2)	(2.4)
Total	(0.4)	(1.2)	(17.2)	(9.7)	(28.5)
Net loan book					
Mortgage Lending	5.6	36.5	32.4	18.7	93.2
Commercial Lending	0.2	0.5	-	2.0	2.7
Total	5.8	37.0	32.4	20.7	95.9
Coverage ratio					
Mortgage Lending	6.67%	2.67%	34.68%	28.63%	21.88%
Commercial Lending	-	28.57%	-	52.38%	47.06%
Total	6.45%	3.14%	34.68%	31.91%	22.91%

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

15. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

	Probation	> 3 month arrears	RoR managed	Realisations	Total
	£m	£m	£m	£m	£m
30 September 2021 (Restated)					
Gross loan book					
Mortgage Lending	8.0	42.0	80.9	14.4	145.3
Commercial Lending	0.6	11.4	-	7.0	19.0
Total	8.6	53.4	80.9	21.4	164.3
Impairment provision					
Mortgage Lending	(0.3)	(1.9)	(17.4)	(5.7)	(25.3)
Commercial Lending	(0.1)	(10.3)	-	(3.2)	(13.6)
Total	(0.4)	(12.2)	(17.4)	(8.9)	(38.9)
Net loan book					
Mortgage Lending	7.7	40.1	63.5	8.7	120.0
Commercial Lending	0.5	1.1	-	3.8	5.4
Total	8.2	41.2	63.5	12.5	125.4
Coverage ratio					
Mortgage Lending	3.75%	4.52%	21.51%	39.58%	17.41%
Commercial Lending	16.67%	90.35%	-	45.71%	71.58%
Total	4.65%	22.85%	21.51%	41.59%	23.68%

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.

	2022	2021
	£m	£m
First mortgages	66.2	74.7
Second mortgages	14.6	15.4
Asset finance	1.6	4.7
Motor finance	0.7	2.0
	83.1	96.8

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For the year ended 30 September 2022

15. LOAN IMPAIRMENTS BY STAGE AND DIVISION (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.

Mortgage Lending balances with over three months arrears include 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)

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

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

	30 September 2022		30 September 2021	
	No.	£m	No.	£m
Managed accounts				
Appointment date				
2010 and earlier	199	31.2	333	56.3
2011 to 2013	42	6.3	56	9.1
2014 to 2016	14	1.9	24	3.3
2016 and later	79	10.2	86	12.2
Total managed accounts	334	49.6	499	80.9
Accounts in the process of realisation	141	23.5	54	10.2
	475	73.1	553	91.1

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

16. LOAN IMPAIRMENTS – PROVISION MOVEMENTS 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	Total £m
At 30 September 2021	37.7	27.7	65.4
(Released) / provided in period (note 7)	5.1	10.7	15.8
Amounts written off	(3.6)	(12.9)	(16.5)
Assets derecognised	(1.2)	-	(1.2)
At 30 September 2022 (note 15)	38.0	25.5	63.5
At 30 September 2020	53.2	28.6	81.8
(Released) / Provided in period (note 7)	(7.1)	4.0	(3.1)
Amounts written off	(8.4)	(4.9)	(13.3)
Assets derecognised	-	-	-
At 30 September 2021 (note 15)	37.7	27.7	65.4

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.

At 30 September 2022, enforceable contractual balances of £4.9m (2021: £8.8m) were outstanding on non-POCI assets written off in the period. This excludes those accounts where a full and final settlement was agreed and those where the contractual terms do not permit any further action. Enforceable balances are kept under review for operational purposes, but no amounts are recognised in respect of such accounts unless further cash is received or there is a strong expectation that it will be.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

16. LOAN IMPAIRMENTS – PROVISION MOVEMENTS IN THE YEAR (CONTINUED)

A more detailed analysis of these movements by IFRS 9 stage on a consolidated basis for the year ended 30 September 2022 and 30 September 2021 is set out below.

These tables, and the matching tables analysing movements in gross balances, have been compiled by comparing opening and closing balances on each account and analysing the movements between them.

Changes due to credit risk includes all changes in model parameters whether related to account performance, external credit data or model assumptions, including economic scenarios and weightings.

There have been no changes in models creating significant movements in balances in the year.

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Loss allowance at 30 September 2021	15.0	11.3	38.9	0.2	65.4
New assets originated or purchased	7.2	-	-	-	7.2
Changes in loss allowance					
Transfer to Stage 1	2.6	(2.3)	(0.3)	-	-
Transfer to Stage 2	(1.6)	2.3	(0.7)	-	-
Transfer to Stage 3	(0.2)	(0.4)	0.6	-	-
Changes on stage transfer	(2.4)	1.8	4.3	-	3.7
Changes due to credit risk	4.9	(4.7)	3.4	1.3	4.9
Loans sold	-	-	(1.2)	-	(1.2)
Write offs	-	-	(16.5)	-	(16.5)
Loss allowance at 30 September 2022	25.5	8.0	28.5	1.5	63.5
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)
Loans sold	-	-	-	-	-
Write offs	-	-	(13.3)	-	(13.3)
Loss allowance at 30 September 2021	15.0	11.3	38.9	0.2	65.4

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

16. LOAN IMPAIRMENTS – PROVISION MOVEMENTS IN THE YEAR (CONTINUED)

During the year ended 30 September 2022 the impairment allowance remained relatively stable, due to the opposing effects of the easing of Covid-related pressures on the UK economy and mounting concerns about the nation's economic health more generally, with inflation and interest rates increasing and the potential for impacts from the conflict in Ukraine.

The increase in stage 1 provision came mostly from new lending, coupled with the need to make judgemental increases in the provision balance. Stage 2 provisions fell slightly as the impacts of additional Covid-related SICRs in 2021 fell away. Stage 3 provision reduced as bought forward cases were resolved, in both the Commercial Lending and Mortgage Lending divisions.

The principal movements in the impairment provision in the year ended 30 September 2021 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 remained 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 fewer accounts had been granted payment holiday extensions in that year than in the year ended 30 September 2020, this had driven further transfers from Stage 1 to Stage 2. Transfers to Stage 3 reflected principally a small number of realisation cases and other cases identified through credit review. Write offs largely related to the realisation of already provided losses on cases being worked out on a long-term basis.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

16. LOAN IMPAIRMENTS – PROVISION MOVEMENTS IN THE YEAR (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 2021	11,900.4	1,279.1	164.3	124.3	13,468.1
New assets originated or purchased	3,020.8	-	-	-	3,020.8
Changes in staging					
Transfer to Stage 1	519.4	(516.8)	(2.6)	-	-
Transfer to Stage 2	(1,365.2)	1,378.2	(13.0)	-	-
Transfer to Stage 3	(29.5)	(16.6)	46.1	-	-
Redemptions and repayments	(2,311.2)	(230.4)	(55.6)	(33.1)	(2,630.3)
Loans sold	-	-	(1.5)	(73.8)	(75.3)
Write offs	-	-	(16.5)	-	(16.5)
Other changes	422.3	70.1	3.2	11.4	507.0
Balance at 30 September 2022	12,157.0	1,963.6	124.4	28.8	14,273.8
Loss allowance	(25.5)	(8.0)	(28.5)	(1.5)	(63.5)
Carrying value	12,131.5	1,955.6	95.9	27.3	14,210.3
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)
Loans sold	-	-	-	-	-
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

Other changes includes interest and similar charges

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

17. LOAN IMPAIRMENTS – ECONOMIC INPUTS TO 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 consistent with the 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 2022 forecasting cycle (the 'October forecast'), the Group has adopted a central economic scenario derived using a broadly equivalent approach to that used in September 2021, with the starting point of the scenario updated to reflect the actual movements of economic variables and expectations in the year. The general trend of the Group's central forecast is broadly negative in the short term, with interest rates and inflation increasing sharply by historical terms in the early part of the five year forecast period before normalising. Short term falls in house prices are also anticipated.

Compared to the central scenario adopted at 30 September 2021, the new central forecast is based on a significantly higher interest rate environment throughout the period, reflecting increases already seen in the second half of the year and clear market expectations of higher rates to come. Inflation is much higher in the early years of the forecast than anticipated twelve months ago, with credit growth more constricted. GDP growth is slowed and house prices less positive in the short term, but recover later. These all reflect a worsening outlook for the UK than anticipated 12 months ago especially in the first two years of the period.

The upside and downside scenarios continue to be derived from the central scenario, as they have been in previous periods. The shapes of these three scenarios are broadly similar across the period, but the degree of divergence of the upside and downside scenarios from the central scenario has been reviewed to ensure that the asymmetrical nature of credit risk is properly accounted for and the full universe of possible outcomes adequately represented.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

17. LOAN IMPAIRMENTS – ECONOMIC INPUTS TO CALCULATIONS (CONTINUED)

The severe scenario has been derived from stress testing scenarios published by the Bank of England, as in previous periods, with the 2022 Annual Cyclical Scenario being used at 30 September 2022. This scenario is based on a deep recession, higher interest rates and falling asset prices. To ensure that the scenario is appropriately severe in the Group's circumstances a slightly higher unemployment level and a slightly worse outcome on house prices were assumed, otherwise the appreciation of security values in the later part of the forecast period would negate other impacts.

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 amend the scenario weightings used at 30 September 2021 for the current year

While the direct impacts of the Covid pandemic have begun to recede, fresh uncertainties, particularly around cost of living issues in the UK and the conflict in Ukraine, arose in the period and increased rapidly towards the year end, as the political climate in the UK became more unstable. This expanded the range of potential economic outcomes and the Group considered it was appropriate to increase the weighting of the severe scenario and reduce that of the downside scenario to allow for this. Sensitivities showing the impact of this change, and comparing the effect of these weightings with those which might be seen in a more normal economic environment are set out in Note 18.

The weightings attached to each scenario are set out below

	2022	2021
Central scenario	40%	40%
Upside scenario	10%	10%
Downside scenario	30%	35%
Severe scenario	20%	15%
	100%	100%

The Group's economic scenarios comprise seven 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

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For the year ended 30 September 2022

17. LOAN IMPAIRMENTS – ECONOMIC INPUTS TO CALCULATIONS (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 2022

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

	2023	**2024**	**2025**	**2026**	**2027**
Central scenario	0.4%	1.3%	1.3%	1.9%	1.2%
Upside scenario	1.9%	3.0%	2.2%	2.7%	1.7%
Downside scenario	(2.2)%	0.6%	1.4%	1.9%	1.2%
Severe scenario	(3.6)%	(0.2)%	1.2%	1.2%	1.2%

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

	2023	**2024**	**2025**	**2026**	**2027**
Central scenario	(0.6)%	0.8%	3.9%	4.2%	4.4%
Upside scenario	4.7%	4.7%	6.8%	6.8%	5.0%
Downside scenario	(6.5)%	(3.3)%	4.4%	4.0%	4.0%
Severe scenario	(7.2)%	(15.4)%	(14.4)%	2.7%	5.5%

Bank Base Rate ('BBR') (rate)

	2023	**2024**	**2025**	**2026**	**2027**
Central scenario	4.6%	4.3%	3.8%	3.3%	3.0%
Upside scenario	4.1%	4.3%	3.8%	3.4%	3.1%
Downside scenario	5.0%	4.4%	3.8%	3.3%	3.0%
Severe scenario	5.8%	5.8%	5.1%	4.3%	3.5%

Consumer Price Inflation ('CPI') (rate)

	2023	**2024**	**2025**	**2026**	**2027**
Central scenario	10.4%	3.9%	2.2%	1.6%	1.9%
Upside scenario	9.7%	2.9%	1.9%	2.0%	1.9%
Downside scenario	13.0%	8.8%	2.9%	2.0%	1.9%
Severe scenario	16.7%	10.0%	3.0%	2.3%	2.0%

Unemployment (rate)

	2023	**2024**	**2025**	**2026**	**2027**
Central scenario	4.2%	4.9%	4.8%	4.6%	4.3%
Upside scenario	3.5%	4.3%	4.3%	4.1%	3.8%
Downside scenario	4.6%	5.8%	6.3%	6.2%	5.7%
Severe scenario	6.4%	9.2%	8.8%	8.2%	7.5%

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17. LOAN IMPAIRMENTS – ECONOMIC INPUTS TO CALCULATIONS (CONTINUED)

Secured lending (annual change)

	2023	2024	2025	2026	2027
Central scenario	3.3%	2.6%	2.5%	3.5%	3.5%
Upside scenario	4.1%	3.3%	3.2%	4.2%	4.3%
Downside scenario	2.6%	1.8%	1.7%	2.7%	2.8%
Severe scenario	0.2%	(0.7)%	1.3%	3.0%	3.7%

Consumer credit (annual change)

	2023	2024	2025	2026	2027
Central scenario	3.6%	3.1%	3.6%	3.5%	3.5%
Upside scenario	4.4%	3.9%	4.4%	4.3%	4.3%
Downside scenario	2.9%	2.4%	2.9%	2.8%	2.8%
Severe scenario	(3.7)%	(4.4)%	0.1%	2.8%	4.7%

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%

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

17. LOAN IMPAIRMENTS – ECONOMIC INPUTS TO CALCULATIONS (CONTINUED)

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%

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%

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 2022

	Central scenario		Upside scenario		Downside scenario		Severe scenario	
	Max %	Min %	Max %	Min %	Max %	Min %	Max %	Min %
Economic driver								
GDP	2.2	(0.3)	3.5	1.2	2.2	(2.7)	1.2	(5.0)
HPI	4.8	(4.5)	7.5	3.3	4.9	(13.1)	5.7	(17.8)
BBR	5.0	3.0	4.5	3.0	5.5	3.0	6.0	3.3
CPI	10.8	1.4	10.3	1.7	14.0	1.8	17.0	1.8
Unemployment	5.0	3.9	4.5	3.4	6.3	4.1	9.2	4.5
Secured lending	4.0	2.3	4.8	3.1	3.3	1.6	3.7	(1.2)
Consumer credit	5.0	2.5	5.8	3.3	4.3	1.8	4.8	(5.2)

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

17. LOAN IMPAIRMENTS – ECONOMIC INPUTS TO CALCULATIONS (CONTINUED)

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)

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.

	2022 £m	2021 (Restated) £m
Provision using central scenario 100% weighted		
Mortgage Lending	29.1	26.7
Commercial Lending	24.2	26.0
	53.3	52.7
Calculated impairment provision	63.5	65.4
Effect of multiple economic scenarios	10.2	12.7

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

18. LOAN IMPAIRMENTS – SENSITIVITY ANALYSIS

The calculation of impairment provisions under IFRS 9 is subject to a variety of uncertainties arising from assumptions, forecasts and expectations about future events and conditions. To illustrate the impact of these uncertainties, sensitivity calculations have been performed for some of the most significant.

These sensitivities are intended as mathematical illustrations of the impacts of the various assumptions on the Group's modelling. They do not necessarily represent alternative potential impairment values as other factors might also need to be considered in arriving at a final provision figure if circumstances differed from those at the balance sheet date.

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:

	2022		2021	
Scenario	**Provision £m**	**Difference £m**	**Provision £m**	**Difference £m**
Central	53.3	(10.2)	52.7	(12.7)
Upside	46.8	(16.7)	47.1	(18.3)
Downside	62.5	(1.0)	68.1	2.7
Severe	100.3	36.8	106.1	40.7

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.

Scenario weightings

In order to illustrate the impact of scenario weightings on the outcomes, the impairment provision requirements were sensitised using alternative weightings. Sensitivity A is based on the weightings used at IFRS 9 transition on 1 October 2018. The use of the 2018 weighting is intended to represent a more settled outlook than has been evident at either of the two most recent year ends. Sensitivity B uses the weightings used at the previous year end and is included so that the impact of the change in weightings can be seen. Judgemental adjustments are assumed to remain constant in both cases.

The weightings used, and the results of applying these sensitivities to the 30 September 2022 scenarios are set out below.

	Weighting				Impairment	Difference
	Central	**Upside**	**Downside**	**Severe**	**£m**	**£m**
As reported	40%	10%	30%	20%	63.5	-
Sensitivity A	40%	30%	25%	5%	55.5	(8.0)
Sensitivity B	40%	10%	35%	15%	61.1	(2.4)

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

18. LOAN IMPAIRMENTS – SENSITIVITY ANALYSIS (CONTINUED)

Significant increase in credit risk

The most important driver of SICR is relative PD. If all PDs across the Group's principal buy-to-let mortgage book were increased by 10%, loans with a gross value of £136.8m would transfer from Stage 1 to Stage 2 (2021: £99.0m), and the total provision would increase by £0.9m from the combined effects of higher PDs on expected losses and the impact of providing for expected lifetime losses, rather than 12-month losses on the additional Stage 2 cases (2021: £1.1m).

Value of security

The principal assumptions impacting on LGD are the estimated security values. If the rate of growth in house prices assumed by the model after the forecast minimum were halved, ignoring any PD effects, then the provision for the Group's first and second mortgage assets under the central scenario would increase by £2.7m (2021: £3.3m).

Receiver of rent

The majority of receiver of rent cases, which are included in Stage 3, are managed long-term and therefore their assumed realisation date has an important impact on the provision calculation. If the assumed rate of realisations was increased by 20%, the impairment provision in the central scenario would increase by £0.4m (2021: £0.6m).

19. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING

The Group's hedging arrangements can be analysed for accounting purposes between:

- Fair value hedges of portfolio interest rate risk, which are used to manage the interest rate risk inherent in fixed rate lending and deposit taking
- Cash flow hedges, which were used in previous years to manage the foreign exchange and interest rate risk inherent in its currency borrowings. No such hedges were in place during the year

An economic hedge of the interest rate risk in fixed rate lending must also address pipeline exposures, where future lending at a given fixed rate is anticipated. However, such arrangements do not qualify as hedges for accounting purposes.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

19. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

The analysis below splits derivatives between those accounted for within portfolio fair value 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 2022 or the preceding year.

	2022 Assets £m	2022 Liabilities £m	2021 Assets £m	2021 Liabilities £m
Derivatives in hedge accounting relationships				
Fair value hedges				
Interest rate swaps				
Fixed to floating	652.7	-	35.9	(35.8)
Floating to fixed	0.3	(98.5)	2.8	(5.9)
Total derivatives in hedge accounting relationships	653.0	(98.5)	38.7	(41.7)
Other derivatives				
Interest rate swaps	125.5	(3.6)	5.5	(2.0)
Currency futures	0.5	-	-	(0.2)
Total recognised derivative assets / (liabilities)	779.0	(102.1)	44.2	(43.9)

The balances held on the Group's balance sheet relating to the hedging of interest rate risk on its fixed rate customer loan and deposit balances are summarised below.

	Note	2022 £m	2021 £m
Derivative financial instruments			
Assets		779.0	44.2
Liabilities		(102.1)	(43.9)
		676.9	0.3
Fair value hedging adjustments			
On loans to customers	12	(559.9)	5.5
On retail deposits	22	99.7	3.0
		(460.2)	8.5
Net balance sheet position		216.7	8.8
Collateral balances			
Posted (in sundry assets)		-	36.6
Received (in sundry liabilities)	24	(388.6)	(0.2)
		(388.6)	36.4

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

20. RETIREMENT BENEFIT OBLIGATIONS

Since the last IAS 19 actuarial valuation at 30 September 2021 there have been substantial movements in financial conditions, requiring an adjustment to the actuarial assumptions underlying the calculation of the defined benefit obligation at 30 September 2022. In particular, over the period since the 30 September 2021 actuarial valuation, the discount rate has increased by 300 basis points per annum, whereas expectations of long-term inflation have increased by only around 15 basis points. The performance of the Plan assets was severely impacted by market movements.

The preliminary results of the 2022 triennial valuation have been reflected in the IAS 19 valuation, resulting, including experience differences and updated mortality assumptions.

The Group has recognised the surplus as an asset at the balance sheet date as it anticipates being able to access economic benefits at least as great as the carrying value. However such assets are eliminated from capital for regulatory purposes (note 33).

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

	2022 £m	2021 £m
Opening pension deficit	(10.3)	(20.4)
Employer contributions	4.0	4.8
Amounts posted to profit and loss		
Service cost	(0.9)	(1.8)
Past service cost	-	
Net funding cost (note 4)	(0.2)	(0.3)
Administrative expenses	(0.8)	(0.8)
Amounts posted to other comprehensive income		
Return on plan assets not included in interest	(43.1)	11.0
Experience (loss) on liabilities	(1.3)	-
Actuarial loss from changes in financial assumptions	61.9	(1.7)
Actuarial loss from changes in demographic assumptions	(2.2)	(1.1)
Closing pension surplus / (deficit)	7.1	(10.3)

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 2022

21. INTANGIBLE ASSETS

Intangible assets at net book value comprise:

	2022 £m	2021 £m	2020 £m
Goodwill	164.4	164.4	164.4
Computer software	3.9	3.4	2.2
Other intangibles	1.9	2.7	3.5
Total assets	170.2	170.5	170.1

The balance for goodwill at 30 September 2022 shown above includes £113.0m in respect of the SME 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 2022 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 2022 covering a five-year period.

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 lending over the five-year period of 10.56%, compared with 13.9% used in the calculation at 30 September 2021. The new lending forecasts are the key driver for the profit and cash flow forecasts. Cash flows beyond the five-year budget are extrapolated using a constant growth rate of 1.54% (2021: 1.6%) 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 14.8% (2021: 13.4%)

As an illustration of the sensitivity of this impairment test to movements in key assumptions, the Group has calculated that a 0% growth rate combined with a 7.5% reduction in profit levels would eliminate the projected headroom of £43.5m. While such movements are not expected by management, they are considered 'reasonably possible' for the purposes of IAS 36. A 0% growth rate combined with a 11.2% reduction in profit levels would generate a write down of £10.0m.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

21. INTANGIBLE ASSETS (CONTINUED)

In the testing carried out at 30 September 2021, 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 , which were considered ‘reasonably possible’ movements, would have eliminated the projected headroom at that date of £98.3m. 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 have generated a write down of £10.0m.

(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 2022 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 2022 covering a five-year period.

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

- Level of business activity, based on management expectations. The forecast assumes a CAGR for drawdowns over the five-year period of 8.77%, compared with 13.2% used in the calculation at 30 September 2021. Cash flows beyond the five-year budget are extrapolated using a constant growth rate of 1.54% (2021: 1.6%) which does not exceed the long-term average growth rate for the UK economy

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

- Discount rate, which is based on third party estimates of the implied industry cost of capital. The pre-tax discount rate applied to the cash flow projection is 14.4% (2021: 13.2%)

Management believes any reasonably possible change in the key assumptions above would not cause the recoverable amount of the development finance CGU to fall below the balance sheet carrying value. This was also the case in the testing carried out at 30 September 2021.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

22. 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:

	2022 £m	2021 £m	2020 £m
Fixed rate	6,201.3	5,466.0	4,975.9
Variable rates	4,467.9	3,834.4	2,880.7
	10,669.2	9,300.4	7,856.6

The weighted average interest rate on retail deposits at 30 September 2022, analysed by charging method, was:

	2022 %	2021 %	2020 %
Fixed rate	1.74	1.25	1.69
Variable rates	1.55	0.42	0.72
All deposits	1.66	0.91	1.34

The contractual maturity of these deposits is analysed below.

	2022 £m	2021 £m	2020 £m
Amounts repayable			
In less than three months	929.0	789.0	565.0
In more than three months, but not more than one year	3,732.1	3,105.4	2,725.6
In more than one year, but not more than two years	1,627.3	1,580.1	1,541.6
In more than two years, but not more than five years	421.4	507.4	664.8
Total term deposits	6,709.8	5,981.9	5,497.0
Repayable on demand	3,959.4	3,318.5	2,359.6
	10,669.2	9,300.4	7,856.6
Fair value adjustments for portfolio hedging (note 19)	(99.7)	(3.0)	10.4
	10,569.5	9,297.4	7,867.0

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

23. BORROWINGS

On 4 March 2022 Fitch Ratings upgraded the Group's Long-Term Issuer Default Rating from BBB to BBB+, with a stable outlook. It also upgraded the senior unsecured debt rating to BBB from BBB- and the rating of the Group's Tier-2 bond from BB+ to BBB-, meaning that this security now enjoys an investment-grade rating.

All borrowings described in the Group Accounts for the year ended 30 September 2021 remained in place throughout the period, except as noted below.

On 21 October 2021 all of the Group's drawings under the Bank of England Term Funding Scheme for SMEs ('TFSME') were repaid and redrawn, extending the tenor of this borrowing to 21 October 2025. No further amounts were drawn in the period and the TFSME is no longer available for new drawings.

The Group's remaining drawings under the Bank of England Term Funding Scheme ('TFS') were repaid in the year. The Group retains access to the Bank of England Indexed Long-Term Repo scheme ('ILTR') for short term liquidity purposes, but there were no balances outstanding at the year end.

On 8 November 2021 revisions were agreed to the Group's warehouse facility, held in Paragon Seventh Funding Limited. This increased the maximum facility to £450.0m and amended the interest rate payable to 0.5% above SONIA. The commitment period was extended for an initial 13-month period with the ability to extend monthly. The facility will expire on 24 July 2023.

The Group's £125.0m retail bond was repaid in full at its due date in January 2022.

Repayments made in respect of the Group's borrowings are shown in note 31.

During the period all of the Group's remaining LIBOR linked borrowings were transitioned to SONIA based rates, as described in the 2021 Annual Report and Accounts.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

24. SUNDRY LIABILITIES

Sundry liabilities include:

	Note	2022 £m	2021 £m
Amounts falling due within one year			
Contingent consideration		2.2	4.6
Lease payables		2.2	1.5
CSA liabilities	19	388.6	0.2
Purchase of own shares	27	10.8	-
Other sundry liabilities		86.2	62.3
		490.0	68.6
Amounts falling due after more than one year			
Contingent consideration		-	2.9
Lease payables		6.8	8.0
Other sundry liabilities		16.3	11.2
		23.1	22.1
Total			
Contingent consideration		2.2	7.5
Lease payables		9.0	9.5
Other sundry liabilities		501.9	73.7
		513.1	90.7

25. 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:

	2022 Number	2021 Number
Ordinary shares		
At 1 October 2021	262,495,185	261,777,972
Shares issued	386,039	717,213
Shares cancelled	(21,471,600)	-
At 30 September 2022	241,409,624	262,495,185

During the year, the Company issued shares 386,039 (2021: 717,213) to satisfy options granted under Sharesave schemes for a consideration of £1,309,525 (2021: £2,196,934).

On 24 November 2021, 12,100,834 shares, held in treasury at 30 September 2021, were cancelled. On 8 September 2022 a further 9,370,766 shares, purchased into treasury during the year were also cancelled.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

26. RESERVES

	2022 £m	2021 £m	2020 £m
Share premium account	71.1	70.1	68.7
Capital redemption reserve	71.8	50.3	50.3
Merger reserve	(70.2)	(70.2)	(70.2)
Cash flow hedging reserve	-	-	2.5
Profit and loss account	1,151.2	1,005.9	880.7
	1,223.9	1,056.1	932.0

The share premium account and capital redemption reserve are non-distributable reserves which are required by, and operate under the provisions of, UK company law.

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 2022

27. OWN SHARES

	2022 £m	2021 £m
Treasury shares		
At 1 October 2021	60.7	23.0
Shares purchased	66.9	37.7
Shares cancelled	(109.4)	-
At 30 September 2022	18.2	60.7
ESOP shares		
At 1 October 2021	16.0	14.8
Shares purchased	12.6	4.5
Options exercised	(9.6)	(3.3)
At 30 September 2022	19.0	16.0
Irrevocable authority to purchase		
At 1 October 2021	-	-
Given in year	10.8	-
Expired or utilised in year	-	-
At 30 September 2022	10.8	-
Balance at 30 September 2022	48.0	76.7
Balance at 1 October 2021	76.7	37.8

At 30 September 2022 the number of the Company's own shares held in treasury was 3,640,519 (2021: 12,100,834). These shares had a nominal value of £3,640,519 (2021: £12,100,834). These shares do not qualify for dividends.

At 30 September 2022 an irrevocable instruction for the purchase of a further £10.8m to be held in treasury was in place. This instruction was completed on 7 November 2022, before the approval date of these financial statements.

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 2022, the trust held 3,879,160 ordinary shares (2021: 3,732,324) with a nominal value of £3,879,160 (2021: £3,732,324) and a market value of £15,314,924 (2021: £20,359,827). Options, or other share-based awards, were outstanding against all of these shares at 30 September 2022 (2021: all). The dividends on all these shares have been waived (2021: all).

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

28. EQUITY DIVIDEND

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

	2022 Per share	2021 Per share	2022 £m	2021 £m
Equity dividends on ordinary shares				
Final dividend for the previous year	18.9p	14.4p	46.6	36.5
Interim dividend for the current year	9.4p	7.2p	22.3	18.1
	28.3p	21.6p	68.9	54.6

Amounts paid and proposed in respect of the year:

	2022 Per share	2021 Per share	2022 £m	2021 £m
Interim dividend for the current year	9.4p	7.2p	22.3	18.1
Proposed final dividend for the current year	19.2p	18.9p	44.9	46.6
	28.6p	26.1p	67.2	64.7

The proposed final dividend for the year ended 30 September 2022 will be paid on 3 March 2023, subject to approval at the AGM, with a record date of 3 February 2023. The dividend will be recognised in the accounts when it is paid.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2022

29. NET CASH FLOW FROM OPERATING ACTIVITIES

	2022 £m	2021 £m
Profit before tax	417.9	213.7
Non-cash items included in profit and other adjustments:		
Depreciation of operating property, plant and equipment	3.5	4.3
Profit on disposal of operating property, plant and equipment	(0.1)	0.1
Amortisation of intangible assets	2.0	2.0
Movements related to asset backed loan notes denominated in currency	-	(442.3)
Other non-cash movements on borrowings	1.9	2.5
Impairment losses on loans to customers	14.0	(4.7)
Charge for share based remuneration	9.2	8.9
Net (increase) / decrease in operating assets:		
Assets held for leasing	(2.3)	0.2
Loans to customers	(821.6)	(766.6)
Derivative financial instruments	(734.8)	419.1
Fair value of portfolio hedges	565.4	104.2
Other receivables	22.9	58.8
Net increase / (decrease) in operating liabilities:		
Retail deposits	1,368.8	1,443.8
Derivative financial instruments	58.2	(88.5)
Fair value of portfolio hedges	(96.7)	(13.4)
Other liabilities	416.9	(15.7)
Cash generated by operations	1,225.2	926.4
Income taxes (paid)	(56.5)	(48.3)
	1,168.7	878.1

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

30. NET CASH FLOW FROM INVESTING ACTIVITIES

	2022 £m	2021 £m
Proceeds from sales of operating property, plant and equipment	0.6	-
Purchases of operating property, plant and equipment	(1.3)	(1.9)
Purchases of intangible assets	(1.7)	(2.4)
Net cash (utilised) by investing activities	(2.4)	(4.3)

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For the year ended 30 September 2022

31. NET CASH FLOW FROM FINANCING ACTIVITIES

	2022 £m	2021 £m
Shares issued (note 25)	1.4	2.1
Dividends paid (note 28)	(68.9)	(54.6)
Issue of Tier-2 bond	-	148.9
Repayment of asset backed floating rate notes	(107.6)	(2,313.1)
Repayment of Tier-2 bond	-	(153.7)
Repayment of retail bond	(125.0)	(60.0)
Movement on central bank facilities	(69.0)	964.6
Movement on other bank facilities	(144.6)	71.9
Capital element of lease payments	(1.7)	(2.5)
Purchase of shares (note 27)	(79.5)	(42.2)
Exercise of share awards	(0.7)	-
Net cash (utilised) by financing activities	(595.6)	(1,438.6)

32. 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 £779,000 were outstanding at the year-end (2021: £16,000), and the maximum amounts outstanding during the year totalled £793,000 (2021: £301,000).

The Paragon Pension Plan (the ‘Plan’) is a related party of the Group. Transactions with the Plan are described in note 20.

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

NOTES TO THE FINANCIAL INFORMATION – CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

The notes below describe the processes and measurements which the Group uses to manage its capital position and 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.

33. 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 protection of the Group's capital base and its long-term viability are key strategic priorities.

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

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

(a) Regulatory capital

The Group is subject to supervision by the PRA on a consolidated basis, as a group containing an authorised bank. For regulatory purposes the Company is designated as a CRR consolidation entity, as defined by the PRA rulebook. As part of this supervision the regulator will issue a Total Capital Requirement ('TCR') setting the amount of regulatory capital which the Group is required to hold at all times, in order to safeguard depositors from loss in the event of severe losses being incurred by the Group. This requirement is set in accordance with the international Basel III rules, issued by the Basel Committee on Banking Supervision ('BCBS'), which, following the implementation of the Financial Services Act 2021 on 1 January 2022, are implemented through the PRA Rulebook.

The Group's regulatory capital is monitored by the Board, its Risk and Compliance Committee and the Asset and Liability Committee, which 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.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

33. CAPITAL MANAGEMENT (CONTINUED)

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 ended 30 September 2021, while maintaining the transitional arrangements for impairment provisions created before those years. In order to increase institutions lending capacity in the short term, the EU 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.

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

The tables below demonstrate that at 30 September 2022 the Group's total regulatory capital of £1,371.8m (2021: £1,205.8m) exceeded the amounts required by the regulator, including £660.6m (2021: £604.2m) in respect of its TCR, which is comprised of fixed and variable elements (amounts not subject to audit).

The total regulatory capital at 30 September 2022 on the fully loaded basis of £1,346.0m (2021: £1,176.1m) was in excess of the TCR of £658.4m (2021: £601.8m) on the same basis (amounts not subject to audit).

At 30 September 2022, the Group's TCR represented 8.8% of the total risk exposure ('TRE') (2021: 8.8%).

The CRR also requires firms to hold additional capital buffers, including a Capital Conservation Buffer ('CCoB') of 2.5% of risk weighted assets (at 30 September 2022) (2021: 2.5%) and a Counter-cyclical Capital Buffer ('CCyB'), currently 0.0% of risk weighted assets (2021: 0.0%). The UK CCyB will increase to 1.0% of TRE from December 2022 and to 2.0% of TRE from July 2023, which is expected to be its long-term rate in a standard risk environment. Firm specific buffers may also be required.

The Group's regulatory capital differs from its equity as certain adjustments are required by the PRA Rulebook or the regulator. A reconciliation of the Group's equity to its regulatory capital determined in accordance with the PRA Rulebook at 30 September 2022 is set out below.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

33. CAPITAL MANAGEMENT (CONTINUED)

	Note	Regulatory basis		Fully loaded basis	
		2022	2021	2022	2021
		£m	£m	£m	£m
Total equity		1,417.3	1,241.9	1,417.3	1,241.9
Deductions					
Proposed final dividend	28	(44.9)	(46.6)	(44.9)	(46.6)
IFRS 9 transitional relief	*	25.8	29.7	-	-
Intangible assets	21	(170.2)	(170.5)	(170.2)	(170.5)
Pension surplus net of deferred tax		(5.3)	-	(5.3)	-
Software relief	†	-	1.4	-	1.4
Prudent valuation adjustments	§	(0.9)	(0.1)	(0.9)	(0.1)
Insufficient coverage	ψ	(0.0)	-	(0.0)	-
Common Equity Tier 1 ('CET1') capital		1,221.8	1,055.8	1,196.0	1,026.1
Other tier 1 capital		-	-	-	-
Total Tier 1 capital		1,221.8	1,055.8	1,196.0	1,026.1
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')		1,371.8	1,205.8	1,346.0	1,176.1

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

† 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 was calculated in accordance with Article 36 (1) (b) of the CRR. This relief was rescinded for UK firms from 1 January 2022

§ 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 PRA Rulebook.

ψ Regulatory deduction where there is insufficient coverage for non-performing exposures required under Article 47(c) of the CRR, which remains in force in the UK for the time being under the Brexit arrangements. The amount required at 30 September 2022 was less than £0.1m.

Φ The PRA Rulebook restricts the amount of tier 2 capital which is eligible for regulatory purposes to 25% of TCR.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

33. CAPITAL MANAGEMENT (CONTINUED)

The total risk exposure amount calculated under the PRA Rulebook 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	
	2022	2021	2022	2021
	£m	£m	£m	£m
Credit risk				
Balance sheet assets	6,652.1	6,073.5	6,652.1	6,073.5
Off balance sheet	85.4	143.9	85.4	143.9
IFRS 9 transitional relief	25.8	29.7	-	-
Total credit risk	6,763.3	6,247.1	6,737.5	6,217.4
Operational risk	633.1	576.0	633.1	576.0
Market risk	-	-	-	-
Other	118.6	13.7	118.6	13.7
Total risk exposure amount ('TRE')	7,515.0	6,836.8	7,489.2	6,807.1
Solvency ratios	%	%	%	%
CET1	16.3	15.4	16.0	15.1
TRC	18.3	17.6	18.0	17.3

This table is not subject to audit

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

Leverage ratio

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%.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

33. CAPITAL MANAGEMENT (CONTINUED)

	Note	2022 £m	2021 £m
Total balance sheet assets		16,653.6	15,137.0
Add: Credit fair value adjustments on loans to customers	12	559.9	-
Debit fair value adjustments on retail deposits	22	99.7	3.0
Adjusted balance sheet assets		17,313.2	15,140.0
Less: Derivative assets	19	(779.0)	(44.2)
Central bank deposits	11	(1,612.5)	(1,142.0)
CRDs		(30.2)	(23.7)
Accrued interest on sovereign exposures		(1.0)	-
On-balance sheet items		14,890.5	13,930.1
Less: Intangible assets	21	(170.2)	(170.5)
Pension surplus		(7.1)	-
Add back: Software relief		-	1.4
Total on balance sheet exposures		14,713.2	13,761.0
Regulatory exposure for derivatives		434.7	-
Derivative assets	19	-	44.2
Potential future exposure on derivatives		-	36.3
Total derivative exposures		434.7	80.5
Post offer pipeline at gross notional amount		1,307.9	1,380.3
Adjustment to convert to credit equivalent amounts		(1,094.1)	(1,128.3)
Off balance sheet items		213.8	252.0
Tier 1 capital		1,221.8	1,055.8
Total leverage exposure before IFRS 9 relief		15,361.7	14,093.5
IFRS 9 relief		25.8	29.7
Total leverage exposure		15,387.5	14,123.2
UK leverage ratio		7.9%	7.5%

This table is not subject to audit

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

33. CAPITAL MANAGEMENT (CONTINUED)

The fully loaded leverage ratio is calculated as follows

	2022 £m	2021 £m
Fully loaded Tier 1 capital	1,196.0	1,026.1
Total leverage exposure before IFRS 9 relief	15,361.7	14,093.5
Fully loaded UK leverage exposure	7.8%	7.3%

This table is not subject to audit

Following regulatory changes introduced from 1 January 2022, the Group calculates regulatory exposure on derivatives using the Standardised Approach for Counterparty Credit Risk ('SA-CCR'), which includes elements based on the market value of derivative assets adjusted for collateral, amongst other things, and based on potential future exposure in respect of all derivatives held. In previous years the Mark-to-Market approach was used, however this is no longer available.

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

Capital requirements in subsidiary entities

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 FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

33. 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 2022 is derived as follows:

	Note	2022 £m	2021 £m
Profit for the year after tax		313.6	164.5
Amortisation of intangible assets		2.0	2.0
Adjusted profit		315.6	166.5
Divided by			
Opening equity		1,241.9	1,156.0
Opening intangible assets	21	(170.5)	(170.1)
Opening tangible equity		1,071.4	985.9
Closing equity		1,417.3	1,241.9
Closing intangible assets	21	(170.2)	(170.5)
Closing tangible equity		1,247.1	1,071.4
Average tangible equity		1,159.3	1,028.7
Return on Tangible Equity		27.2%	16.2%

This table is not subject to audit

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

33. 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. In addition to the payment of dividends, the Board may also consider whether it is appropriate to apply excess capital in the market purchase of the Group's shares.

The distributable reserves of the Company comprise its profit and loss account balance (note 26) 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 9.4p per share was declared, in line with this policy (2021: 7.2p).

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. In particular the levels of provision in the Group's loan portfolios and the potential for further provision under stress in the event of a worsening UK economic position were considered by the Board. These were compared to the regulatory capital position at the year end 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.

The Board particularly considered the appropriateness of including net gains relating to fair value adjustments from hedging in the calculation of any dividend or distribution, as these will reverse over time. Given the size of such adjustments in the period, the Board concluded that their inclusion was not consistent with its overarching aim of delivering a sustainable dividend which grows with the earnings of the business.

On the basis of this analysis the Board concluded that a dividend of around 40% of earnings excluding fair value items could be paid.

The Board will therefore propose a final dividend for the year of 19.2p per share (2021: 18.9p per share) for approval of the 2023 AGM, making a total dividend for the year of 28.6p per share (2021: 26.1p per share).

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

33. CAPITAL MANAGEMENT (CONTINUED)

The Board authorised share buy-backs in the year: firstly the completion of the buy-back announced in 2021 and incomplete at that year end; and secondly a new buy-back, originally of £50.0m, which was extended to £75.0m in June 2022. The amount expended in these programmes in the year was £66.9m (note27) and £10.8 million remained to be completed at the year end. An irrevocable instruction to undertake the remaining purchases was given to the Group's brokers before the year end, and the buy-back was completed on 7 November 2022.

As part of its consideration of capital described above the Board of Directors authorised a new buy-back of up to £50.0m to commence shortly after the announcement of the Group's 2022 results. All shares acquired in buy-back programmes are initially held in treasury.

The directors have considered the distributable resources of the Company and concluded that these distributions are appropriate.

The most recent policy review, in November 2022, 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. Share buy-backs will be considered where excess capital has arisen, either operationally or as a result of changed regulatory requirements.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

34. 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 2022 are analysed as follows:

	2022		2021	
	£m	%	£m	%
Buy-to-let mortgages	12,086.0	85.1%	11,413.2	85.2%
Owner-occupied mortgages	36.4	0.2%	47.4	0.3%
Total first charge residential mortgages	12,122.4	85.3%	11,460.6	85.5%
Second charge mortgage loans	206.3	1.4%	281.7	2.1%
Loans secured on residential property	12,328.7	86.7%	11,742.3	87.6%
Development finance	719.9	5.1%	608.2	4.5%
Loans secured on property	13,048.6	91.8%	12,350.5	92.1%
Asset finance loans	498.8	3.5%	440.5	3.3%
Motor finance loans	261.3	1.8%	229.2	1.7%
Aircraft mortgages	33.7	0.3%	28.2	0.2%
Structured lending	178.7	1.3%	118.9	0.9%
Invoice finance	25.7	0.2%	20.9	0.2%
Total secured loans	14,046.8	98.9%	13,188.2	98.4%
Professions finance	60.9	0.4%	33.1	0.3%
RLS, CBILS and BBLS	88.0	0.6%	83.8	0.6%
Other unsecured commercial loans	14.6	0.1%	10.3	0.1%
Unsecured consumer loans	-	-	87.3	0.6%
Total loans to customers	14,210.3	100.0%	13,402.7	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 balances are generally short term unsecured loans made to firms of lawyers and accountants for working capital purposes.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

34. CREDIT RISK (CONTINUED)

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

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

There are no significant concentrations of credit risk to individual counterparties due to the large number of customers included in the portfolios. All lending is to customers within the UK. The total gross carrying value of the Group's loans to customers due from customers with total portfolio exposures over £10.0m is analysed below by product type.

	2022 £m	2021 £m
Buy-to-let mortgages	151.9	163.3
Development finance	306.9	217.9
Structured lending	179.4	108.7
Asset finance	-	10.4
	638.2	500.3

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

Credit grading

An analysis of the Group's loans to customers by absolute level of credit risk at 30 September 2022 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 2022					
Very low risk	10,270.3	846.7	1.1	9.2	11,127.3
Low risk	1,563.9	932.0	63.6	1.9	2,561.4
Moderate risk	118.6	114.1	4.3	2.5	239.5
High risk	35.0	34.6	9.7	4.1	83.4
Very high risk	44.4	35.1	42.2	9.3	131.0
Not graded	124.8	1.1	3.5	1.8	131.2
Total gross carrying amount	12,157.0	1,963.6	124.4	28.8	14,273.8
Impairment	(25.5)	(8.0)	(28.5)	(1.5)	(63.5)
Total loans to customers	12,131.5	1,955.6	95.9	27.3	14,210.3

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

34. CREDIT RISK (CONTINUED)

	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

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 15, 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 the external credit score.

A small proportion of the loan book (2022: 0.9%, 2021: 1.0%) is classed as 'not graded' above. This rating generally relates to loans that have been fully underwritten at origination but where the customer falls outside the automated assessment techniques used post-completion.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

34. CREDIT RISK (CONTINUED)

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 Loan-to-Value ('LTV') ratio for those loan accounts secured on residential property by value at 30 September 2022 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	
	2022	2021	2022	2021
	%	%	%	%
Loan to value ratio				
Less than 70%	89.2	83.8	95.6	88.4
70% to 80%	9.4	14.3	2.4	8.5
80% to 90%	0.4	0.5	0.8	1.5
90% to 100%	0.3	0.3	0.2	0.6
Over 100%	0.7	1.1	1.0	1.0
	100.0	100.0	100.0	100.0
Average LTV ratio	57.8	61.1	50.6	56.1
Of which:				
Buy-to-let	57.9	61.2		
Owner-occupied	37.6	42.0		

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 9.5% in the year ended 30 September 2022 (2021: 10.0%).

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

34. 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	
	2022	2021	2022	2021
	%	%	%	%
East Anglia	3.3	3.3	3.3	3.3
East Midlands	5.7	5.5	6.2	6.3
Greater London	18.2	18.5	7.8	7.8
North	3.3	3.1	4.1	4.0
North West	10.3	10.3	7.7	7.4
South East	31.2	31.8	38.2	39.3
South West	8.8	8.7	8.4	8.3
West Midlands	5.9	5.5	7.4	7.1
Yorkshire and Humberside	7.8	8.1	6.1	6.0
Total England	94.5	94.8	89.2	89.5
Northern Ireland	0.1	0.1	2.0	1.8
Scotland	2.3	2.0	5.4	5.2
Wales	3.1	3.1	3.4	3.5
	100.0	100.0	100.0	100.0

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

34. CREDIT RISK (CONTINUED)

Development finance

Development finance loans have an average term of 24 months (2021: 21 months). Settlement of principal and accrued interest takes place either on the sale of the development, or units within it, where appropriate, or on the refinancing of the property following its completion. 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.

	2022	2022	2021	2021
	By value	By number	By value	By number
LTGDV	%	%	%	%
50% or less	7.9	5.1	2.9	5.3
50% to 60%	17.0	21.7	27.3	20.6
60% to 65%	45.0	39.1	44.3	49.4
65% to 70%	22.2	27.2	22.8	21.9
70% to 75%	5.8	6.2	1.4	1.6
Over 75%	2.1	0.7	1.3	1.2
	100.0	100.0	100.0	100.0

The average LTGDV cover at the year end was 62.1% (2021: 61.7%).

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 2022, the development finance portfolio comprised 276 accounts (2021: 247) with a total carrying value of £719.9m (2021: £608.2m). Of these accounts only nine were included in Stage 2 at 30 September 2022 (2021: ten), with no accounts classified as Stage 3 (2021: nil). In addition, one acquired account had been classified as POCI (2021: one). An allowance for this loss was made in the IFRS 3 fair value calculation.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

34. CREDIT RISK (CONTINUED)

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

	2022 %	2021 %
East Anglia	2.8	3.6
East Midlands	11.7	6.3
Greater London	10.5	6.1
North	1.2	2.4
North West	0.1	1.1
South East	46.3	57.5
South West	13.0	13.5
West Midlands	7.1	4.8
Yorkshire and Humberside	6.0	3.5
Total England	98.7	98.8
Northern Ireland	-	-
Scotland	1.3	1.2
Wales	-	-
	100.0	100.0

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 52 months (2021: 51 months) while that of the motor finance loans was 67 months (2021: 64 months), but historical behaviour suggests 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.

	2022 %	2021 %
Commercial vehicles	37.4	33.4
Construction plant	33.2	34.2
Manufacturing	6.1	6.2
Technology	4.9	7.0
Other vehicles	4.7	4.3
Refuse disposal vehicles	3.7	4.3
Agriculture	2.4	3.1
Print and paper	1.3	2.3
Other	6.3	5.2
	100.0	100.0

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

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

34. CREDIT RISK (CONTINUED)

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.

	2022	2021
Number of active facilities	8	8
Total facilities (£m)	220.5	185.5
Carrying value (£m)	178.7	118.9

The maximum advance under these facilities was generally 80% of the underlying assets, except where loans secured by residential property form the security for the facility, where 90% is admissible.

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.

At 30 September 2022, all of these facilities were identified as Stage 1. At 30 September 2021 one of these facilities was identified as Stage 2 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 has subsequently been extended twice. It is currently expected to be available for new lending until June 2024.

The Group offered term loans and asset finance loans under the CBIL scheme. Interest and fees were 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 paid 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, after the application of any proceeds from the asset financed (if applicable), on applications received before 1 January 2022 and up to 70% for applications received thereafter.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

34. CREDIT RISK (CONTINUED)

The Group's outstanding RLS, CBILS and BBLS loans at 30 September 2022 were:

	2022 £m	2021 £m
RLS		
Term loans	0.6	0.1
Asset finance	41.5	20.7
Total RLS	42.1	20.8
CBILS		
Term loans	18.3	28.1
Asset finance	23.6	29.9
Total CBILS	41.9	58.0
BBLS	4.0	5.0
	88.0	83.8
Total term loans	22.9	33.2
Total asset finance	65.1	50.6
	88.0	83.8

At 30 September 2022, £0.6m of this balance was considered to be non-performing (2021: £0.2m).

Unsecured consumer loans

The Group disposed of almost all its unsecured consumer loan portfolio during the year (note 5). It retains an interest only in a limited number of unsecured accounts excluded from the sale.

Almost all the Group's unsecured consumer loan assets were 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. Collections on purchased accounts remained in excess of those implicit in the purchase prices until the point of sale in June 2022.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

34. CREDIT RISK (CONTINUED)

Arrears performance

The number of accounts in arrears by asset class, based on the most commonly quoted definition of arrears for the type of asset, at 30 September 2022 and 30 September 2021, compared to the industry averages at those dates published by UK Finance ('UKF') and the FLA, was:

	2022 %	2021 %
First mortgages		
Accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	0.15	0.21
Buy-to-let accounts excluding receiver of rent cases	0.11	0.14
Owner-occupied accounts	2.79	4.48
UKF data for mortgage accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	0.41	0.47
Buy-to-let accounts excluding receiver of rent cases	0.39	0.45
Owner-occupied accounts	0.80	0.94
All mortgages	0.72	0.85
Second charge mortgage loans		
Accounts more than 2 months in arrears		
All accounts	21.33	19.08
Post-2010 originations	1.88	1.18
Legacy cases (Pre-2010 originations)	24.45	23.12
Purchased assets	27.71	24.76
FLA data for secured loans	7.50	8.60
Motor finance loans		
Accounts more than 2 months in arrears		
All accounts	2.07	4.15
Originated cases	1.58	2.30
Purchased assets	8.94	14.07
FLA data for consumer point of sale hire purchase	3.40	3.40
Asset finance loans		
Accounts more than 2 months in arrears	0.08	0.27
FLA data for business lease / hire purchase loans	0.80	0.70

No published industry data for asset classes comparable to the Group's other books has been identified. Where revised data at 30 September 2021 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.

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.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

34. CREDIT RISK (CONTINUED)

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 second charge mortgage 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

A significant proportion of the Group' second charge mortgage balances and, historically, almost all its unsecured consumer loan assets are, or were, 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 or the year ended 30 September 2022

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

In the debt purchase industry, Estimated Remaining Collections ('ERC') 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 FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

34. 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.

	2022	2021	2020
	£m	£m	£m
All purchased consumer assets			
Carrying value	75.3	185.2	235.3
84 month ERCs	88.6	221.2	277.8
120 month ERCs	94.2	245.2	313.7
POCI assets only			
Carrying value	21.4	113.2	139.8
84 month ERCs	29.9	143.9	176.9
120 month ERCs	33.0	163.4	203.7

Amounts shown above are disclosed as loans to customers (note 12). They include first mortgages, second charge mortgage loans and, in the amounts shown for 2021 and 2020, unsecured consumer loans.

The reduction in the year primarily reflects the disposal of the Group's unsecured consumer lending assets (note 5).

NOTES TO THE FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2022

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

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

35. 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. For the year ended 30 September 2022 the Group has prepared its Annual Report and Accounts using the same accounting polices set out in its 2021 accounts, except as set out below.

The Group is required, by the Companies Act 2006 and the Listing Rules of the FCA, to prepare its financial statements for the year ended 30 September 2022 in accordance with UK-adopted international accounting standards. In the financial years reported on this also means, in the Group's circumstances, that the financial statements also accord with IFRS as approved by the International Accounting Standards Board.

In previous periods financial statements had been prepared under EU endorsed IFRS, however the change of framework does not change the substance of the requirements applying to the Group and no prior-year restatement of the financial statements is required.

The Group has historically chosen to present an additional comparative balance sheet.

Restatement of segments

Following the scale of a substantial part of the assets of the former Idem Capital segment (note 5) the remaining segment represented a disproportionately small part of the Group compared to the other two segments. The directors determined it was appropriate to adopt a new segmental analysis, described in note 2 and comparative amounts have been restated.

This restatement has no impact on the overall profit, assets and liabilities, equity, capital, or cash flows of the Group.

The segment results of the Idem Capital segment reported in 2021 (profit of £17.1m) and the loan assets of the segment (£225.2m) have been subsumed into the two ongoing segments in the comparative disclosures.

Adoption of new and revised reporting standards

In the preparation of the 2022 financial statements, no accounting standards have been applied for the first time.

Standards not yet adopted

There are no standards and interpretations in issue but not effective which address matters relevant to the Group's accounting and reporting.

NOTES TO THE FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2022

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 38.

36. CRITICAL ACCOUNTING JUDGEMENTS

The most significant judgements which the directors have made in the application of the accounting policies 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.

As part of its consideration of the adequacy of its impairment provisioning, management have considered whether there are any factors not reflected in its normal approach which indicate that a group, or groups of accounts should be considered as having an SICR. No such accounts were identified.

If additional accounts were determined to have an SICR, these balances would attract additional impairment provision, as such cases are provided on the basis of lifetime expected loss, rather the 12-month expected loss, and the overall provision charge would be higher. Conversely, if cases are incorrectly identified as SICR, impairment provisions will be overstated. Furthermore, adjustments to current PD estimates in the Group's models may also have the effect of identifying more or less accounts as having an SICR.

More information on the definition of SICR adopted is given in note 14.

(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 14.

NOTES TO THE FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2022

36. CRITICAL ACCOUNTING 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. There were no significant changes in the nature of the Group's products, nor in the business models in which they are held, during the year.

37. CRITICAL ACCOUNTING ESTIMATES

Certain 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 important of these, those which could, if revised significantly in the next financial year, have a material impact on the carrying amounts of assets or liabilities are:

(a) 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 (such as keeping current tenants in place, refurbish and relet, immediate sale etc).

NOTES TO THE FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2022

37. CRITICAL ACCOUNTING ESTIMATES (CONTINUED)

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

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

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

In evaluating the potential impact of the economic situation at 30 September 2022 this process is made more complex by both the elevated level of uncertainties and the lack of recent experience of similar situations against which to benchmark. At the same time, the level to which Covid-related 'scarring' has yet to manifest itself in credit metrics is still unclear.

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 2022 have been derived in light of the current economic situation, at that date, modelling a variety of possible outcomes as described in note 17. It should be noted, however, that there remains a significant range of different opinions amongst economists about the longer-term prospects for the UK, which have diverged again over the period since September 2021, with both UK economic and geopolitical uncertainties building.

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.

NOTES TO THE FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2022

37. CRITICAL ACCOUNTING ESTIMATES (CONTINUED)

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 is considered that the current forecast scenarios, which include higher rates of interest and inflation than in the historically observed data, represent situations where its models may not be able to fully allow for potential economic impacts on its loan portfolios. It therefore assessed, 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.

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 judgemental adjustments are set out in note 14.

The position after considering all these matters is set out in notes 13 to 18, together with further information on the Group's approach. The economic scenarios described above and their impact on the overall provision are set out in note 17, while sensitivity analyses on impairment provisioning are set out in note 18.

(b) 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 £13.3m (2021: £12.0m), while an increase of the assumed asset lives of such assets by three months would increase balance sheet assets by £13.3m (2021: £12.1m)
- 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 £8.8m (2021: £11.2m)
- A reduction (or increase) in estimated cash flows from purchased loan assets of 5% would reduce (or increase) balance sheet assets by £2.0m (2021: £7.1m)

NOTES TO THE FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2022

37. CRITICAL ACCOUNTING ESTIMATES (CONTINUED)

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

(c) 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 21, 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 21.

(d) 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.

38. 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.

NOTES TO THE FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2022

38. GOING CONCERN (CONTINUED)

Financial and capital forecasting

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.

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

- Higher buy-to-let volumes – This scenario allows the Board to see what impact higher buy-to-let volumes at a reduced yield has on the profitability of the business. The higher volumes also allow the Board to determine whether capital resources and liquidity would be stretched due to the higher cash and capital requirements
- Higher funding costs – This scenario allows the Board to see 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 volume and yield – This scenario replicates a significant increase in competition within the sector (potentially from market shrinkage), reducing yields and impacting the Group's market share. Since development finance is the highest yielding product, its reduction shows the Board the impact of a lower mix on the contribution to costs and what other ratios may be affected from such a drop in volume
- Higher buy-to-let redemptions – This scenario highlights to the Board the potential risk that is inherent in the currently held EIR buy-to-let debtor and invites discussion as to what mitigating action could be taken to avoid such an impact
- Bad debt stress – This scenario simulates a significant short-term capital and profitability shock with prolonged house price deflation across the plan horizon. To ensure that it is a worst-case stress point and also to avoid replicating the ICAAP process, only bad debt rates are altered in these scenarios – all new business and other assumptions remain with no management actions included
- Combined downside stress – This presents a plausible set of adverse factors to the business model that allows the Board to see how this impacts the strategy across the five-year horizon

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 status. 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.

NOTES TO THE FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2022

38. GOING CONCERN (CONTINUED)

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.

Availability of funding and liquidity

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

The Group's retail deposits of £10,669.2m (note 22), raised through Paragon Bank, are repayable within five years, with 80.8% of this balance (£8,620.5m) 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 2022 Paragon Bank held £1,505.5m 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 £1,655.5m.

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 £1,776.0m. 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 2022 the Group had £455.2m of such notes available for use, of which £213m were rated AAA. The available AAA notes would give access to £171.6m 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 £112.5m retail bond, due August 2024. No central bank debt is payable until 2025.

The Group's access to debt is enhanced by its corporate BBB+ rating, upgraded by Fitch Ratings in March 2022, and its status as an issuer is evidenced by the BBB- investment grade rating of its £150.0m Tier-2 bond. It has regularly accessed the capital markets for warehouse funding and corporate and retail bonds over recent years and continues to be able to access these markets.

The Group has access to the short-term repo market for liquidity purposes which it uses from time to time.

NOTES TO THE FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2022

38. GOING CONCERN (CONTINUED)

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 33 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, during the year ended 30 September 2021, resulted in a reduction of the minimum capital level. Its capital at 30 September 2022 was in excess of regulatory requirements and its forecasts indicate this will continue to be the case.

Going concern assessment

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

After performing this assessment, the directors concluded that there was no material uncertainty as to whether the Group and the Company 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 and the Company.

39. 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 2022 or the year ended 30 September 2021 carried at fair value and valued using level 3 measurements, other than contingent consideration amounts (note 24).

NOTES TO THE FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2022

39. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

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

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

(a) Assets and liabilities carried at fair value

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

	Note	**2022**	**2021**
		£m	**£m**
Financial assets			
Derivative financial assets	19	779.0	44.2
		779.0	44.2
Financial liabilities			
Derivative financial liabilities	19	102.1	43.9
Contingent consideration	24	2.2	7.5
		104.3	51.4

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

The Company has no financial assets or liabilities carried at fair value.

Derivative financial assets and liabilities

Derivative financial instruments are stated at their fair values in the accounts. The Group uses a number of techniques to determine the fair values of its derivative assets and liabilities, for which observable prices in active markets are not available. These are principally present value calculations based on estimated future cash flows arising from the instruments, discounted using a market interest rate, adjusted for risk as appropriate.

The principal inputs to these valuation models are SONIA (and formally LIBOR) benchmark interest rates for the currencies in which the instruments are denominated, being sterling, EUR and dollars. The cross-currency basis swaps, which were terminated during 2021, had a notional principal related to the outstanding currency borrowings and therefore the estimated rate of repayment of these notes also affected 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.

NOTES TO THE FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2022

39. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

Contingent consideration

The value of the contingent consideration balances shown in note 24 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	2022 Carrying amount £m	2022 Fair value £m	2021 Carrying amount £m	2021 Fair value £m
Financial assets					
Cash	11	1,930.9	1,930.9	1,360.1	1,360.1
Loans to customers	12	14,210.3	13,898.4	13,402.7	13,470.6
Sundry financial assets		35.4	35.4	65.7	65.7
		16,176.6	15,864.7	14,828.5	14,896.4
Financial liabilities					
Short term bank borrowings		0.4	0.4	0.3	0.3
Asset backed loan notes		409.3	409.3	516.0	516.0
Secured bank borrowings		586.0	586.0	730.0	730.0
Retail deposits	22	10,669.2	10,592.9	9,300.4	9,308.5
Corporate and retail bonds		261.5	254.4	386.1	411.9
Other financial liabilities		491.2	491.2	66.2	66.2
		12,417.6	12,334.2	10,999.0	11,032.9

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

NOTES TO THE FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2022

39. 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 FINANCIAL INFORMATION

APPENDICES TO THE FINANCIAL INFORMATION

For the year ended 30 September 2022

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.

	2022 £m	2021 £m
Profit on ordinary activities before tax	417.9	213.7
Add back: Fair value adjustments	(191.9)	(19.5)
Profit on disposal of loans	(4.6)	-
Underlying profit	221.4	194.2

Underlying basic earnings per share, calculated on the basis of underlying profit adjusted for tax, is derived as follows.

	2022 £m	2021 £m
Underlying profit	221.4	194.2
Tax on underlying result	(51.8)	(44.7)
Underlying earnings	169.6	149.5
Basic weighted average number of shares (note 10)	242.7	252.3
Underlying earnings per share	69.9p	59.3p

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

A. UNDERLYING RESULTS

In the year ended 30 September 2022 tax has been charged on the underlying profit at 23.4%, being the effective rate at which would result from the exclusion of the adjusting items from the corporation tax calculation. In 2021 tax on underlying profit was allowed was allowed for at 23.0%, the overall effective rate for the year, due to the much smaller impact of the adjustments in that year.

Underlying return on tangible equity is derived using underlying earnings calculated on the same basis, shown above. Tangible equity is calculated excluding the impacts of fair value hedging. This approach has been adopted in 2022 for the first time, due to the materiality of the balance sheet effect of the hedges. While this effect was not significant in previous years the underlying RoTE for 2021 has been restated on the new basis.

	Note	2022 £m	2021 £m
Underlying earnings		169.6	149.5
Amortisation of intangible assets		2.0	2.0
Adjusted underlying earnings		171.6	151.5
Opening underlying tangible equity			
Equity		1,241.9	1,156.0
Intangible assets	21	(170.5)	(170.1)
Balance sheet impact of fair values	19	(8.8)	15.1
Deferred tax thereon		(2.2)	0.2
		1,060.4	1,001.2
Closing underlying tangible equity			
Equity		1,417.3	1,241.9
Intangible assets	21	(170.2)	(170.5)
Balance sheet impact of fair values	19	(216.7)	(8.8)
Deferred tax thereon		53.2	(2.2)
		1,083.6	1,060.4
Average underlying tangible equity		1,072.0	1,030.8
Underlying RoTE		16.0%	14.7%

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

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 2022

	Note	Mortgage Lending £m	Commercial Lending £m	Total £m
Opening loans to customers	12	11,829.6	1573.1	13,402.7
Closing loans to customers	12	12,328.7	1,881.6	14,210.3
Average loans to customers		12,079.2	1,727.3	13,806.5
Net interest	2	261.5	113.1	371.2
NIM		2.16%	6.55%	2.69%
Impairment provision charge	7	4.6	9.4	14.0
Cost of risk		0.04%	0.54%	0.10%

Year ended 30 September 2021 (restated)

	Note	Mortgage Lending £m	Commercial Lending £m	Total £m
Opening loans to customers	12	11,101.1	1,530.3	12,631.4
Closing loans to customers	12	11,829.6	1,573.1	13,402.7
Average loans to customers		11,465.3	1,551.7	13,017.0
Net interest	2	238.7	95.2	310.5
NIM		2.08%	6.14%	2.39%
Impairment provision (release) / charge	7	(7.6)	2.9	(4.7)
Cost of risk		(0.07)%	0.19%	(0.04)%

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

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

C. COST:INCOME RATIO

Cost:income ratio is derived as follows:

	2022 £m	2021 £m
Cost – operating expenses	153.0	135.4
Total operating income	393.0	324.9
Cost / Income	38.9%	41.7%

Underlying cost: Income ratio is derived as follows:

	2022 £m	2021 £m
Cost – as above	153.0	135.4
Income – as above	393.0	324.9
Less: profit on disposal of loans	(4.6)	-
	388.4	324.9
Underlying cost income ratio	39.4%	41.7%

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2022

D. DIVIDEND COVER

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.

For the current year the Board has determined that is appropriate to exclude the post-tax impact of fair value gains from its calculation. The dividend cover for the year, subject to the approval of the 2022 final dividend at the AGM in March 2023 is therefore as set out below.

	Note	2022	2021
Earnings per share (p)	10	129.2	65.2
Attributable fair value gains (p)		(79.1)	-
Attributable tax thereon (p)		21.4	-
Adjusted earnings (p)		71.5	65.2
Proposed dividend per share in respect of the year (p)	28	28.6	26.1
Dividend cover (times)		2.50	2.50

E. NET ASSET VALUE

	Note	2022	2021
Total equity (£m)		1,417.3	1,241.9
Outstanding issued shares (m)	25	241.4	262.5
Treasury shares (m)	27	(3.6)	(12.1)
Shares held by ESOP schemes (m)	27	(3.9)	(3.7)
		233.9	246.7
Net asset value per £1 ordinary share		£6.06	£5.03
Tangible equity (£m)	33	1,247.1	1,071.4
Tangible net asset value per £1 ordinary share		£5.33	£4.34

CAUTIONARY STATEMENT

Sections of this announcement, including but not limited to the Introduction and 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, and the extent of their impact 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; 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 UK and global economic conditions and market volatility, including currency and interest rate fluctuations and inflation or deflation; the risk of a global economic downturn; acts of terrorism and other acts of hostility or war and responses to, and consequences of those acts; 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 announcement should be construed as a profit forecast.