Company Registration No: 11727898

PARAGON MORTGAGES (No.26) PLC

Report and Financial Statements

Year ended 30 September 2023

CAUTIONARY STATEMENT

Sections of this Annual Report, including but not limited to the Directors' Report and the Strategic 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 Paragon Mortgages (No.26) PLC ('the Company). 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 Company 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 and UK Listing Rules and the Disclosure Guidance).

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 Company 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 Company'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 Company operates) and the consequences thereof; actions by the Company'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 Company operates.

Nothing in this Annual Report should be construed as a profit forecast.

STRATEGIC REPORT

BUSINESS REVIEW AND PRINCIPAL ACTIVITIES

Paragon Mortgages (No.26) PLC ('the Company') is a special purpose company established to act as a funding vehicle within Paragon Banking Group PLC ('the Group') and was set up to provide finance for its mortgage loan assets, by issuing mortgage backed floating rate loan notes and using the proceeds to purchase mortgage loans from other group companies of the Group.

The Company issued floating rate notes and used the proceeds to purchase mortgage loans from Paragon Mortgages 2010 Limited and Paragon Bank PLC, fellow Group companies. During the year the Company operated in the United Kingdom ('UK'), the principal activity of the Company is the provision of first mortgage loans. The directors are not aware, at the date of this report, of any likely major changes in the Company's activities in the next year.

As shown in the Company's profit and loss account on page 18, the Company's net interest has decreased from an income of £3,906,000 in 2022 to an expense of £1,759,000 in 2023, this was mainly due to an increase in interest on funding costs following the increase in base rates. The result after tax has decreased from a profit of £11,508,000 to a loss of £4,788,000. This is due to a fair value loss in the current year compared to a fair value gain in the preceding year.

The balance sheet on page 19 of the Financial Statements shows the Company's financial position at year end. Loans to customers have decreased by 15% due to customers redeeming and repaying their accounts. As a result, asset backed loan notes have redeemed by 24% during the year. Cash held by the Company decreased from £60,169,000 to £16,084,000 during the year. The decrease in cash relates to cash paid down to the noteholders.

No interim dividend was paid during the year (2022: £nil). No final dividend is proposed (2022: £nil).

The Company has entered into derivative contracts in order to provide an economic hedge against its exposure to fixed rate loans to customers. Although these instruments provide an economic hedge the prescriptive nature of the requirements of International Accounting Standard 39 – 'Financial Instruments: Recognition and Measurement' ('IAS 39') means that hedge accounting cannot always be achieved. This has led to the Company recognising a fair value net loss of £6,385,000 (2022: fair value net gain of £16,049,000) in the year due to the ineffectiveness of the hedge relationship. This represents a timing difference and cumulative gains and losses recognised will tend to zero over time.

The Group manages its operations on a centralised basis. For this reason, the Company's directors believe that further key performance indicators for the Company are not necessary or appropriate for an understanding of the development, performance or position of the business. The performance of the Group's mortgage lending operation, which includes the Company, is discussed in the Annual Report of Paragon Banking Group PLC, which does not form part of this Report.

PRINCIPAL RISKS AND UNCERTAINTIES

The assets of the Company are located entirely in the United Kingdom and its results are therefore impacted by the economic environment within the UK. A material downturn in economic performance could increase the numbers of customers who default on loans and / or cause the values of the properties over which the Company enjoys security to fall.

The current year has seen both inflation and interest rates in the UK reach their highest level for several years, with interest rates at the year end reaching the highest level since April 2008 and cost pressures on both customers and businesses increasing. It is considered likely, that this will have an impact on both project performance and credit quality, though the full impact is not yet clear.

STRATEGIC REPORT (CONTINUED)

PRINCIPAL RISKS AND UNCERTAINTIES (CONTINUED)

The Company has established processes in place and proved on a through-the-cycle basis which will allow it to support its customers through any adverse economic conditions and optimise outcomes for both customers and investors.

The Company is a securitisation company and has been structured so as to avoid, in as far as is possible, all forms of financial risk with its outstanding loan notes match-funded to maturity. An analysis of the Company's exposure to risk, including financial risk, and the steps taken to mitigate these risks are set out in note 17, a discussion of critical accounting judgements is set out in note 20 and a discussion of critical accounting estimates is set out in note 21.

FUTURE PROSPECTS

After considering the above, the directors have a reasonable expectation that the Company will have adequate resources to continue in operational existence for the foreseeable future, this is further discussed in note 18.

BOARD AND STAKEHOLDERS

The Board is mindful of its duty to act in good faith and to promote the long-term sustainable success of the Company for the benefit of its shareholders and to fulfil the Company's purpose, having regard to the interests of all of its stakeholders. The Board confirms that, for the year ended 30 September 2023, it has acted to promote the success of the Company for the benefit of its members as a whole and continues to have due regard to the following matters insofar as they are applicable (as per section 172 (1) of the Companies Act 2006):

a. The likely consequences of any decision in the long-term
b. The interests of the Group's employees
c. The need to foster the Company's business relationships with suppliers, customers and others
d. The impact of the Company's operations on the community and the environment
e. The desirability of the Company maintaining a reputation for high standards of business conduct
f. The need to act fairly as between members of the Company

As part of the Group, stakeholder engagement, for stakeholder groups where there is substantial common identity between the non-shareholder stakeholders of the Company and of the Group, takes place at a group level. The Company looks to group initiatives for guidance and takes them into account in its decision making. The Company follows group policies and procedures, including those relating to the fair treatment of customers, standards of business conduct, the environment, the community and other stakeholders, insofar as they are applicable to the Company. More detail may be found in the Paragon Banking Group PLC 2023 Annual Report and Accounts and its 2023 Responsible Business Report (available on the Paragon Banking Group PLC website).

In its decision making, the Board of Directors will also have regard to the rights and interests of the holders of the Mortgage Backed Floating Rate Notes in accordance with the transaction documents under which they were issued.

As a securitisation entity the decision-making powers of the Board of Directors are limited so long as the notes remain outstanding. Key policies have been predetermined at the time of issuance and the operational roles have been assigned to third parties with their roles strictly governed by the transaction documents.

STRATEGIC REPORT (CONTINUED)

BOARD AND STAKEHOLDERS (CONTINUED)

However, in considering items of business the Board makes autonomous decisions on their own merits, with a view to promoting the long-term success of the Company, taking into account those factors set out in section 172 of the Companies Act 2006 insofar as they are relevant, and the stakeholders impacted by such decisions.

Board meetings are held periodically where the directors consider Company business, including its results and performance. As a special purpose funding vehicle for the Group, the Board also reviews strategy, financial and operational performance, as well as information covering areas such as key risks and legal and regulatory compliance. This information is presented to the Board through reports sent in advance of each Board meeting and through in person presentations.

More information on the Company's impact on individual stakeholder groups is set out below.

SHAREHOLDERS

The Company has a single shareholder, Paragon Mortgages (No.26) Holdings Limited. However, the transaction documents limit this entity to a nominal interest in the risks and rewards of the business of the Company. Those risks and rewards attach to non-equity securities and fall to their holders which are companies within the Group.

ENVIRONMENT

The Group recognises the importance of its environmental responsibilities, monitors its impact on the environment, and designs and implements policies to reduce any impacts that might result from the Group's activities. The Company operates in accordance with group policies, which are described in the Paragon Banking Group PLC 2023 Annual Report, which does not form part of this Report. Further information can also be found in the Group's 2023 Responsible Business Report (published on the Paragon Banking Group PLC corporate website), which does not form part of this report.

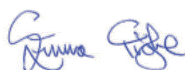
EMPLOYEES

The Company has no employees. All operational services are provided by employees of the Group. The Group's employment policies are described in the Paragon Banking Group PLC 2023 Annual Report, with supplementary information included in the Group's 2023 Responsible Business Report, neither of which forms part of this report.

This Strategic Report has been drawn up and presented in accordance with, and in reliance upon, applicable English company law, in particular Chapter 4A of the Companies Act 2006, and the liabilities of the directors in connection with this report shall be subject to the limitations and restrictions provided by such law.

Approved by the Board of Directors

and signed on behalf of the Board



Emma Tighe

per pro MaplesFS UK Corporate Director No.1 Limited

Director

25 January 2024

DIRECTORS' REPORT

The directors present their Annual Report prepared in accordance with Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 and the audited Financial Statements of Paragon Mortgages (No.26) PLC, a company registered in England and Wales with registration no: 11727898, for the year ended 30 September 2023.

CORPORATE GOVERNANCE

The directors have been charged with governance in accordance with the transactional documentation detailing the mechanism and structure of the transaction. The structure of the Group is such that the key policies have been predetermined at the time of issuance and the operational roles have been assigned to third parties with their roles strictly governed by the transaction documents.

DIRECTORS

The directors during the year and subsequently were:

MaplesFS UK Corporate Director No.2 Limited

MaplesFS UK Corporate Director No.1 Limited

J P Giles

E M Tighe

DIRECTORS' INDEMNITIES

The Company has made qualifying third party indemnity provisions for the benefit of its directors which were made during the year and remain in force at the date of this report.

AUDITOR

The directors have taken all necessary steps to make themselves and the Company's auditor, KPMG LLP, aware of any information needed in preparing the audit of the Annual Report and Financial Statements for the year, and, as far as each of the directors is aware, there is no relevant audit information of which the auditor are unaware.

This confirmation is given and should be interpreted in accordance with the provisions of Section 418 (2) of the Companies Act 2006.

A resolution for the re-appointment of KPMG LLP as the auditor of the Company is to be proposed at the forthcoming Annual General Meeting.

INFORMATION PRESENTED IN OTHER SECTIONS

Certain information required to be included in a directors' report by Schedule 7 can be found in the other sections of the Annual Report, as described below. All of the information presented in these sections is incorporated by reference into this Directors' Report and is deemed to form part of this report.

- Commentary on the likely future developments in the business of the Company is included in the Strategic Report
- A description of the Company's financial risk management objectives and policies, and its exposure to risks arising from its use of financial instruments are set out in note 17 to the accounts
- Disclosure on any dividends paid during the year is included in the Strategic Report

DIRECTORS' REPORT (CONTINUED)

Approved by the Board of Directors

and signed on behalf of the Board

Emma Tighe

per pro MaplesFS UK Corporate Director No.1 Limited

Director

25 January 2024

Registered Office: 51 Homer Road, Solihull, West Midlands, B91 3QJ

STATEMENT OF DIRECTORS' RESPONSIBILITIES IN RESPECT OF THE ANNUAL REPORT, THE DIRECTORS' REPORT AND THE FINANCIAL STATEMENTS

The directors are responsible for preparing the Annual Report and the Company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with UK accounting standards and applicable law (UK Generally Accepted Accounting Practice), including FRS 101 *Reduced Disclosure Framework*.

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 Company's profit or loss for that period. In preparing each of the Company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently
- make judgements and estimates that are reasonable, relevant and reliable
- state whether applicable UK accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements
- assess the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern
- use the going concern basis of accounting unless they either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the parent Company and enable them to ensure that its financial statements comply with the Companies Act 2006. They are responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, 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 Company and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the directors are also responsible for preparing a Strategic Report and Directors' Report that complies with that law and those regulations.

Responsibility statement of the directors in respect of the annual financial report

We confirm that to the best of our knowledge:

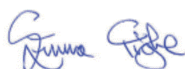
- the financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company

- the strategic report includes a fair review of the development and performance of the business and the position of the issuer, together with a description of the principal risks and uncertainties that they face

STATEMENT OF DIRECTORS' RESPONSIBILITIES IN RESPECT OF THE ANNUAL REPORT, THE DIRECTORS' REPORT AND THE FINANCIAL STATEMENTS (CONTINUED)

We consider the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's position and performance, business model and strategy.

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



Emma Tighe

per pro MaplesFS UK Corporate Director No.1 Limited

Director

25 January 2024

1 Our opinion is unmodified

We have audited the financial statements of Paragon Mortgages (No.26) PLC ("the Company") for the year ended 30 September 2023 which comprise the:

- Profit and Loss Account
- Balance Sheet
- Statement of Movements in Equity
- and the related notes, including the accounting policies in note 19.

In our opinion the financial statements:

- give a true and fair view of the state of the Company's affairs as at 30 September 2023 and of its loss for the year then ended;
- have been properly prepared in accordance with UK accounting standards, including FRS 101 *Reduced Disclosure Framework*; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities are described below. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion. Our audit opinion is consistent with our report to those charged with governance.

We were first appointed as auditor by the shareholders for the financial year ended 30 September 2019. The period of total uninterrupted engagement is for the five financial years ended 30 September 2023. We have fulfilled our ethical responsibilities under, and we remain independent of the Company in accordance with, UK ethical requirements including the FRC Ethical Standard as applied to listed public interest entities. No non-audit services prohibited by that standard were provided.

2 Material uncertainty related to going concern

	The Risk	Our Response
Going concern We draw attention to note 22 to the financial statements which indicates that there is a call option exercisable in August 2024, which if exercised, will cause the company to cease trading. These events and conditions, along with the other matters explained in note 22, constitute a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.	***Disclosure quality*** The financial statements explain how the Board has formed a judgement that it is appropriate to adopt the going concern basis of preparation for the Company. That judgement is based on an evaluation of the inherent risks to the Company's business model and how those risks might affect the Company's financial resources or ability to continue operations over a period of at least a year from the date of approval of the financial statements. There is little judgement involved in the directors' conclusion that risks and circumstances described in note 22 to the financial statements represent a material uncertainty over the ability of the Company to continue as a going concern for a period of at least a year from the date of approval of the financial statements. However, clear and full disclosure of the facts and the directors' rationale for the use of the going concern basis of preparation, including that there is a related material uncertainty, is a key financial statement disclosure and so was the focus of our audit in this area. Auditing standards require that to be reported as a key audit matter.	**Our procedures included:** • **Assessing transparency** - Assessing the completeness and accuracy of the matters covered in the going concern disclosure by considering the structure of the Company by reference to the prospectus and enquiry of the directors as to the likelihood of exercise of the call option. - Assessing the going concern disclosure for adequacy, including that there is a disclosure of a material uncertainty. **Our results** We found the going concern disclosure in note 22 with a material uncertainty to be acceptable (2022: we found the going concern disclosure with no material uncertainty to be acceptable).

3 Other key audit matters: our assessment of risks of material misstatement

Key audit matters are those matters that, in our professional judgement, were of most significance in the audit of the financial statements and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by us, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. Going concern is a significant key audit matter and is described in section 2 of our report. We summarise below the other key audit matters (unchanged from 2022), in decreasing order of audit significance, in arriving at our audit opinion above, together with our key audit procedures to address those matters and, as required for public interest entities, our results from those procedures. These matters were addressed, and our results are based on procedures undertaken, in the context of, and solely for the purpose of, our audit of the financial statements as a whole, and in forming our opinion thereon, and consequently are incidental to that opinion, and we do not provide a separate opinion on these matters.

Key audit matter	Our response
Impairment allowances on loans to customers Risk vs 2022: ◄► (£(117)k; 2022: £52k) *Refer to the Strategic Report, accounting policy note and note 9 (financial disclosures).* **Subjective estimate** The measurement of expected credit losses ('ECL') involves significant judgements and estimates. The risk of material misstatement of ECL remains heightened in the current year due to the increased judgement and estimation uncertainty as a result of the ongoing economic uncertainties. The key areas where we identified greater levels of management judgement and therefore increased levels of audit focus in the Company's estimation of ECL are: ***Economic scenarios*** – IFRS 9 requires the Company to measure ECL on a forward-looking basis reflecting a range of future economic conditions. Significant management judgement is applied to determine the economic scenarios used, particularly in the current economic environment, and the probability weightings assigned to each economic scenario. ***Judgmental adjustments*** – Management makes adjustments to the model-driven ECL results to address issues relating to model responsiveness or emerging trends relating to the current economic environment as well as risks not captured by the models. Such adjustments are inherently subjective and significant management judgement is involved in estimating these amounts. ***Significant Increase in Credit Risk ('SICR')*** – The criteria selected to identify a significant increase in credit risk is a key area of judgement within the Company's ECL calculation as these criteria	We performed the tests below rather than seeking to rely on the Company's controls because the nature of the balance is such that we would expect to obtain audit evidence primarily through the detailed procedures described. Our procedures included: • **Our economics expertise:** We involved our own economic specialists, who assisted us in: — assessing the reasonableness of the Company's methodology for determining the economic scenarios used and the probability weightings applied to them; and — assessing the overall reasonableness of the economic forecasts by comparing the Company's forecasts to our own modelled forecasts. • **Our credit risk modelling expertise:** We involved our own credit risk modelling specialists, who assisted us in: — evaluating the Company's impairment methodologies for compliance with IFRS 9; — assessing the reasonableness of the BTL model predictions by reperforming the model monitoring to compare the predictions against actual results and evaluating the resulting differences. — evaluating the model output for the BTL model by rebuilding the model code in line with the corresponding model functionality and comparing our output with management's output; and — independently applying management's staging methodology and inspecting model code for the calculation of the ECL model to

determine whether a 12-month or lifetime provision is recorded. ***Model estimations*** – Inherently judgmental modelling is used to estimate ECLs which involves determining Probabilities of Default ('PD'), Loss Given Default ('LGD'), and Exposures at Default ('EAD'). The LGD models and assumptions used are the key drivers of the Company's ECL results and are therefore the most significant judgmental aspect of the Company's ECL modelling approach. The effect of these matters is that, as part of our risk assessment, we determined that the impairment allowances on loans to customers has a high degree of estimation uncertainty, with a potential range of reasonable outcomes greater than our materiality for the financial statements as a whole, and possibly many times that amount. The financial statements disclose the sensitivities estimated by the Company (note 9). **Disclosure quality** The disclosures regarding the Company's application of IFRS 9 are important in explaining the key judgements and material inputs to the IFRS 9 ECL results, as well as the sensitivity of the ECL results to changes in these judgements or management's assumptions, in light of the estimation uncertainty arising.	assess its consistency with the approved staging criteria and the output of the model. • **Test of details:** Key aspects of our testing in addition to those set out above involved: — assessing the reasonableness of each judgmental adjustment by comparing these against our independent assessment calculated by applying alternative calculations and assumptions and performing sensitivity analysis; — testing the key LGD assumptions impacting the Company's overall ECL model calculation to assess their reasonableness. This included performing sensitivity analysis to understand the significance of certain assumptions and assessing the key assumptions against the Company's historical experience; — reperforming the calculation of the loan staging applied to the BTL model and comparing to management's staging outputs; and — reperforming the calculation of the LGD and the ECL measured on the loan portfolio. • **Benchmarking assumptions:** Key aspects of our testing involved: — assessing the completeness of judgmental adjustments to the model-driven ECL by performing benchmarking to comparable peer group organisations and using our knowledge of the Company and its industry to challenge the completeness of risks addressed in the adjustments; and — testing the key LGD assumptions impacting the Company's overall ECL model calculation by comparing the Company's assumptions to those of comparable peer group organisations. • **Sensitivity analysis:** We performed sensitivity analysis over the key assumptions including the economic scenarios and weightings as well as certain PD and LGD assumptions, by applying alternative assumptions.

	• **Assessing transparency:** We evaluated whether the disclosures appropriately reflect and address the uncertainty which exists when determining the Company's overall ECL. We assessed the sensitivity analysis that is disclosed. In addition, we challenged whether the disclosure of the key judgements and assumptions made was sufficiently clear. **Our results** As a result of our work, we found the impairment provision recognised and the related disclosures to be acceptable (2022: acceptable).
Interest receivable on loan accounts Risk vs 2022: ▲ (£10,525k; 2022: £13,790k) *Refer to the Strategic Report, accounting policy note and note 2 (financial disclosures).* **Subjective estimate** The recognition of interest receivable on loan accounts under the effective interest rate ('EIR') method requires management to apply judgement, with the most critical estimate being the loans' expected behavioural life and the expectations regarding future reversionary interest rates. The expected life assumptions utilise repayment profiles which represent how customers are expected to pay. These profiles extend significantly into the future which creates a high degree of estimation uncertainty and subjects the judgement to future market changes. The Company makes its expected life and reversionary interest rate assumptions based on its forecasting process which incorporates historical experience. Ongoing developments in the UK economy result in a greater degree of subjectivity in this assessment for the current year. The effect of these matters is that, as part of our risk assessment, we determined that interest receivable on loan accounts has a high degree of estimation uncertainty, with a potential range of reasonable outcomes greater than our materiality for the financial statements as a whole.	We performed the tests below rather than seeking to rely on the Company's controls because the nature of the balance is such that we would expect to obtain audit evidence primarily through the detailed procedures described. Our procedures included: • **Historical comparison:** We critically assessed the Company's analysis and key assumptions over the repayment profiles by comparing them to the Company's historical trends and actual portfolio behaviour. We also applied alternative repayment profiles based on our recalculations. The historical comparison included considering the potential impact of uncertainties arising from the current economic environment on the behavioural life forecasts. • **Our sector experience:** We critically assessed key assumptions behind the Company's expected behavioural lives and reversionary interest rates against our own knowledge of industry experience and trends, including market rates. We also challenged the appropriateness of the level of segmentation applied to the loan portfolios by management. • **Sensitivity analysis:** We performed sensitivity analysis over the repayment profiles by applying alternative profiles incorporating the results from the above procedures. • **Assessing transparency:** We evaluated whether the disclosures appropriately reflect and address the uncertainty which exists when determining the Company's EIR adjustments and interest receivable. We assessed the sensitivity analysis that is disclosed. In addition, we challenged

Disclosure quality The disclosures regarding the Company's application of EIR accounting are important in explaining the key judgements and material inputs to the EIR adjustment, as well as the sensitivity of the EIR adjustment to changes in these judgements or management's assumptions, in light of the estimation uncertainty arising.	whether the disclosure of the critical estimates and assumptions made, was sufficiently clear. **Our results** As a result of our work, we found the interest receivable on loan accounts and the related disclosures to be acceptable (2022: acceptable).

4 Our application of materiality and an overview of the scope of our audit

Materiality for the Company financial statements as a whole was set at £2.6 million (2022: £3.4 million), determined with reference to a benchmark of the Company's total assets as at 30 September 2023, of which it represents 0.9% (2022: 0.9%).

In line with our audit methodology, our procedures on individual account balances and disclosures were performed to a lower threshold, performance materiality, so as to reduce to an acceptable level the risk that individually immaterial misstatements in individual account balances add up to a material amount across the financial statements as a whole.

Performance materiality was set at 75.0% (2022: 75.0%) of materiality for the financial statements as a whole, which equates to £1.9 million (2022: £2.6 million) for the Company.

We applied this percentage in our determination of performance materiality because we did not identify any factors indicating an elevated level of risk.

We agreed to report to Those Charged with Governance, any corrected or uncorrected identified misstatements exceeding £0.1 million (2022: £0.2 million), in addition to other identified misstatements that warranted reporting on qualitative grounds.

5 Going concern basis of preparation

The directors have prepared the financial statements on the going concern basis as they do not intend to liquidate the Company or to cease its operations, and as they have concluded that the Company's financial position means that this is realistic for at least a year from the date of approval of the financial statements ("the going concern period"). As stated in section 2 of our report, they have also concluded that there is a material uncertainty related to going concern.

An explanation of how we evaluated management's assessment of going concern is set out section 2 of our report.

Our conclusions based on this work:

- we consider that the directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate; and
- we found the going concern disclosure in note 22 to be acceptable.

6 Fraud and breaches of laws and regulations – ability to detect

Identifying and responding to risks of material misstatement due to fraud

To identify risks of material misstatement due to fraud ('fraud risks') we assessed events or conditions that could indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. Our risk assessment procedures included:

- Enquiring of directors and inspection of policy documentation as to the Group's high-level policies and procedures to prevent and detect fraud, including the Group's channel for 'whistleblowing', as well as whether they have knowledge of any actual, suspected or alleged fraud.

- Reading Board minutes.
- Using analytical procedures to identify any unusual or unexpected relationships.
- Involving our forensics specialists in assessing the completeness and appropriateness of the identified fraud risk factors and associated fraud risks.

We communicated identified fraud risks throughout the audit team and remained alert to any indications of fraud throughout the audit.

As required by auditing standards, we perform procedures to address the risk of management override of controls, and the risk of fraudulent revenue recognition, in particular the risk that the EIR adjustment on interest income may be misstated, the risk that management may be in a position to make inappropriate accounting entries, and the risk of bias in accounting estimates and judgements including the impairment allowances on loans to customers.

Further detail in respect of interest income on loans and impairment allowances on loans to customers is set out in the key audit matter disclosures in section 3 of this report.

We did not identify any additional fraud risks.

We performed procedures including:

- Identifying journal entries to test based on risk criteria and comparing the identified entries to supporting documentation. This included searching for those posted and approved by the same user, journals posted to seldom used accounts, unbalanced journal postings and those including specific descriptors, and testing any journal entries identified where applicable;
- Assessing whether the judgements made in making accounting estimates are indicative of a potential bias.

Identifying and responding to risks of material misstatement due to non-compliance with laws and regulations

We identified areas of laws and regulations that could reasonably be expected to have a material effect on the financial statements from our general commercial and sector experience, through discussion with the directors and other management (as required by auditing standards), and from inspection of the Group's regulatory correspondence and discussed with the directors and other management, the policies and procedures regarding compliance with laws and regulations.

We communicated identified laws and regulations throughout our team and remained alert to any indications of non-compliance throughout the audit.

The potential effect of these laws and regulations on the financial statements varies considerably.

Firstly, the Company is subject to laws and regulations that directly affect the financial statements including financial reporting legislation (including related companies' legislation), distributable profits legislation and taxation legislation and we assessed the extent of compliance with these laws and regulations as part of our procedures on the related financial statement items.

Secondly, the Company is subject to many other laws and regulations where the consequences of non-compliance could have a material effect on amounts or disclosures in the financial statements, for instance through the imposition of fines or litigation or the loss of the Company's licence to operate. We identified the following areas as those most likely to have such an effect: money laundering, financial crime, certain aspects of company legislation and various requirements governing securitisation transactions recognising the financial nature of the Company's activities and its legal form. Auditing standards limit the required audit procedures to identify non-compliance with these laws and regulations to enquiry of the directors and other management and inspection of Group regulatory correspondence, if any. Therefore, if a breach of operational regulations is not disclosed to us or evident from relevant correspondence, an audit will not detect that breach.

Context of the ability of the audit to detect fraud or breaches of law or regulation

Owing to the inherent limitations of an audit, there is an unavoidable risk that we may not have detected some material misstatements in the financial statements, even though we have properly planned and performed our audit in accordance with auditing standards. For example, the further removed non-compliance with laws and regulations is from the events and transactions reflected in the financial statements, the less likely the inherently limited procedures required by auditing standards would identify it.

In addition, as with any audit, there remained a higher risk of non-detection of fraud, as these may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal controls. Our audit procedures are designed to detect material misstatement. We are not responsible for preventing non-compliance or fraud and cannot be expected to detect non-compliance with all laws and regulations.

7 We have nothing to report on the other information in the Report and Financial Statements

The directors are responsible for the other information presented in the Report together with the financial statements. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except as explicitly stated below, any form of assurance conclusion thereon.

Our responsibility is to read the other information and, in doing so, consider whether, based on our financial statements audit work, the information therein is materially misstated or inconsistent with the financial statements or our audit knowledge. Based solely on that work we have not identified material misstatements in the other information.

Strategic report and directors' report

Based solely on our work on the other information:

- we have not identified material misstatements in the strategic report and the directors' report;
- in our opinion the information given in those reports for the financial year is consistent with the financial statements; and
- in our opinion those reports have been prepared in accordance with the Companies Act 2006.

8 We have nothing to report on the other matters on which we are required to report by exception

Under the Companies Act 2006, we are required to report to you if, in our opinion:

- adequate accounting records have not been kept by the Company, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

We have nothing to report in these respects.

9 Respective responsibilities

Directors' responsibilities

As explained more fully in their statement set out on page 7, the directors are responsible for: the preparation of the financial statements including being satisfied that they give a true and fair view; such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and using the going concern basis of accounting unless they either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue our opinion in an auditor's report. Reasonable assurance is a high level of assurance but does not guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

A fuller description of our responsibilities is provided on the FRC's website at www.frc.org.uk/auditorsresponsibilities.

10 The purpose of our audit work and to whom we owe our responsibilities

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Michael Davidson (Senior Statutory Auditor)

for and on behalf of KPMG LLP, Statutory Auditor

Chartered Accountants

1 Sovereign Square

Sovereign Street

Leeds

LS1 4DA

25 January 2024

PROFIT AND LOSS ACCOUNT

YEAR ENDED 30 SEPTEMBER 2023

	Note	2023 £000	2022 £000
Interest receivable and similar income	2	15,519	13,591
Interest payable and similar charges	3	(17,278)	(9,685)
Net interest (expense) / income		(1,759)	3,906
Other operating income		36	96
Total operating (expense) / income		(1,723)	4,002
Operating income / (expenses)		1,840	(4,759)
Provisions for losses		(117)	52
		-	(705)
Fair value net (loss) / gain	5	(6,385)	16,049
Operating (loss) / profit, being (loss) / profit on ordinary activities before taxation	6	(6,385)	15,344
Tax on (loss) / profit on ordinary activities	7	1,597	(3,836)
(Loss) / profit on ordinary activities after taxation		(4,788)	11,508

All activities derive from continuing operations.

Interest receivable arises from financial assets held at amortised cost.

There are no recognised gains or losses other than the loss for the current year and the profit for the preceding year, and consequently a separate statement of comprehensive income has not been presented.

BALANCE SHEET

30 SEPTEMBER 2023

	Note	2023 £000	2023 £000	2022 £000	2022 £000
ASSETS EMPLOYED					
FIXED ASSETS					
Financial assets	8		274,292		325,118
CURRENT ASSETS					
Debtors falling due within one year	11	118		967	
Cash at bank		16,084		60,169	
			16,202		61,136
			290,494		386,254
FINANCED BY					
EQUITY SHAREHOLDERS' FUNDS					
Called up share capital	12	12		12	
Profit and loss account		6,696		11,484	
			6,708		11,496
PROVISIONS FOR LIABILITIES	13		2,231		3,828
CREDITORS					
Amounts falling due within one year	14	13,114		17,416	
Amounts falling due after more than one year	14	268,441		353,514	
			281,555		370,930
			290,494		386,254

These Financial Statements were approved by the Board of Directors on 25 January 2024.

Signed on behalf of the Board of Directors

Emma Tighe

per pro MaplesFS UK Corporate Director No.1 Limited

Director

STATEMENT OF MOVEMENTS IN EQUITY

YEAR ENDED 30 SEPTEMBER 2023

	Share capital £000	Profit and loss account £000	Total equity £000
Total comprehensive income for the year			
Loss for the year	-	(4,788)	(4,788)
Other comprehensive income	-	-	-
Total comprehensive income for the year	-	(4,788)	(4,788)
Opening equity	12	11,484	11,496
Closing equity	12	6,696	6,708

YEAR ENDED 30 SEPTEMBER 2022

	Share capital £000	Profit and loss account £000	Total equity £000
Total comprehensive income for the year			
Profit for the year	-	11,508	11,508
Other comprehensive income	-	-	-
Total comprehensive income for the year	-	11,508	11,508
Opening equity	12	(24)	(12)
Closing equity	12	11,484	11,496

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2023

1. GENERAL INFORMATION

Paragon Mortgages (No.26) PLC ('the Company') is a company domiciled in the United Kingdom and incorporated in England and Wales under the Companies Act 2006 with company number 11727898. The address of the registered office is 51 Homer Road, Solihull, West Midlands, B91 3QJ. The nature of the Company's operations and its principal activities are set out in the Strategic Report.

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

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

- Analysis – providing further analysis and information on the amounts shown in the primary financial statements
- Financial Risk – providing information on the Company's management of its principal financial risks
- Basis of preparation – providing details of the Company's accounting policies and of how they have been applied in the preparation of the financial statements

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

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 Company.

2. INTEREST RECEIVABLE AND SIMILAR INCOME

Interest receivable is analysed as follows.

	2023 £000	2022 £000
Interest on loans to customers	10,525	13,790
Effect of fair value hedging of loan assets	4,102	(429)
Interest on loans to customers after hedging	14,627	13,361
Interest on deposits	892	230
	15,519	13,591

The above amounts relate to:

	2023 £000	2022 £000
Financial assets held at amortised cost	11,417	14,020
Derivative financial instruments held at fair value	4,102	(429)
	15,519	13,591

3. INTEREST PAYABLE AND SIMILAR CHARGES

	2023 £000	2022 £000
Asset backed loan notes	16,203	9,025
Interest on fee letter	44	43
Interest payable to related parties	1,031	617
	17,278	9,685

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

4. DIRECTORS AND EMPLOYEES

Directors' fees from the Company during the year is stated in note 6.

The Company had no employees in the current or preceding year. All administration is performed by employees of the related companies under the servicing agreement described in note 16. One director (2022: one director) of the Company is employed by Paragon Finance PLC, a related party, and their remuneration is disclosed within the financial statements of that company, which do not form part of this Report.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

5. FAIR VALUE NET (LOSS) / GAIN

The fair value net loss of £6,385,000 (2022: fair value net gain of £16,049,000) represents the accounting volatility on derivative instruments which are matching risk exposure on an economic basis. 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 (loss) / gain is primarily due to timing differences in income recognition between the derivative instruments and the economically hedged assets and liabilities.

6. OPERATING (LOSS) / PROFIT, BEING (LOSS) / PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION

	2023 £000	2022 £000
Operating (loss) / profit is after charging / (crediting):		
Amounts paid to third parties in respect to directors' services	8	8
Auditor remuneration - audit services	19	17
Deferred purchase consideration	(2,518)	3,858

Non audit fees provided to the Group are disclosed in the accounts of the parent company and the exemption from disclosure of fees payable to the Company's auditor in respect to non-audit services in these financial statements has been taken.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

7. TAX ON (LOSS) / PROFIT ON ORDINARY ACTIVITIES

a) Tax (credit) / charge for the year

	2023 £000	2022 £000
Current tax		
Corporation tax	-	-
Total current tax	-	-
Deferred tax (note 13)	-	-
Origination and reversal of timing differences	(1,405)	2,915
Rate change	(192)	921
Total deferred tax	(1,597)	3,836
Tax (credit) / charge on (loss) / profit on ordinary activities	(1,597)	3,836

The Company is set up as a securitisation entity within the permanent regime under UK tax law. It is taxed on the retained profit of £1,000 per annum. The accounting profit is not considered for the tax computation. Due to the requirements of accounting standards, the accounting profit of the entity may vary from the £1,000 amount and deferred tax is provided on the difference which will reverse over time.

b) Factors affecting the tax (credit) / charge for the year

	2023 £000	2022 £000
(Loss) / profit before tax	(6,385)	15,344
UK corporation tax at 22% (2022: 19%) based on the (loss) / profit for the year	(1,405)	2,915
Effects of:		
Change in rate of taxation on deferred tax balances	(192)	921
Tax (credit) / charge for the year	(1,597)	3,836

The standard rate of corporation tax in the UK applicable to the Company in the period was 22.0% (2022: 19.0%), based on currently enacted legislation. During the previous period, legislation was substantively enacted, that increased the rate to 25.0% with effect from 1 April 2023 resulting in an effective rate of 22.0% for the current period and 25.0% for future periods. Consequently, temporary differences at the balance sheet date reverse at 25.0%.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

8. FINANCIAL ASSETS

	2023 £000	2022 £000
Loans to customers (note 9)	264,444	309,698
Derivative financial assets (note 10)	9,848	15,420
	274,292	325,118

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS

This note sets out information on the Company's impairment provisioning under IFRS 9 for the loans to customers balances set out in note 8, loans held at amortised cost, accounted for under IFRS 9, subject to the IFRS 9 impairment requirements.

The disclosures are set out under the following headings:

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

Basis of provision

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

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

- The methods used for the calculation of ECL
- How it defines SICR
- How it defines default
- How it identifies which loans are credit impaired, as defined by IFRS 9
- How the ECL estimation process is monitored and controlled
- How the Group develops and enhances the models it uses in the ECL estimation process
- How the Group uses judgemental adjustments to ensure all elements of credit risk are fully addressed

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Calculation of expected credit loss ('ECL')

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

PD on both a twelve month and lifetime basis is estimated based on statistical models for the Company's loan book. 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 Company 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 and costs of recovery. These calculations allow for the Company'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 Company 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 conditions at the balance sheet date. 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.

During the current financial year interest rates have risen to their highest levels in some time, and with usual speed. Rates of inflation in the UK have been subject to significant fluctuations in the year, reaching 9.6% in October 2022, which the ONS suggested was a forty-year high point. This type of economic environment is not significantly represented in the historic data sets used by the Group to construct its IFRS 9 impairment models. It was also noted that the rate of change in the economic situation over the year might lead to a lagging impact on the credit bureau data which forms an input to models of customer behaviour, which may delay the recognition of an account potentially at risk.

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 ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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 Company'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 Company assesses SICR 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 Company's hands concerning the customers present credit position is included in the evaluation, as well as the impact of future economic expectations.

As part of its determination of whether model outputs form a reliable basis for impairment provisioning, the Company 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 2023 or 30 September 2022, and hence no additional accounts were identified as having an SICR.

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 Company'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 Company's definition, combined with qualitative and quantitative factors specific to each portfolio.

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 Company's buy-to-let mortgage portfolio the appointment of a receiver of rent to manage the property on the customers behalf is considered a default.

This ensures that Company'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 Company's receiver of rent cases are defined as defaulted for modelling purposes as the behaviour of the case after that point is significantly influenced by internal management decisions.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Credit Impaired loans

IFRS 9 defines a credit impaired account as one where an account has suffered one or more event which has had a detrimental effect on future cash flows. It is thus a back-ward 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.

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 are reviewed by senior finance management including the CFO in conjunction with the latest credit risk operational and economic metrics to ensure that the impairment provision by assets type remains appropriate. This exercise will be the subject of particular focus at year end and half year.

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

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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.

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 Coved 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.

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.

In the year ended 30 September 2023 the most significant factors in these considerations were the extent to which uncertainties in the UK economy arising from rapidly rising interest rates, increases in the cost of living and doing business in the UK and the impacts of the continuing conflict in Ukraine were reflected in current customer performance at the period end and were being fully addressed by the Group's provision modelling, particularly in view of the lack of recent observations relating to similar conditions.

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.

The Group's approach to impairment modelling is based on the analysis of historical credit data. 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 and broker feedback, insight surveys, industry intelligence, evidence on the wider economy and quantitative and qualitative data and statements from industry, government and regulatory bodies. These were combined with the expert knowledge within the business to form a broad estimate of the level of provision required across the Group.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Judgemental Adjustments (continued)

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.

At 30 September the amount of judgemental adjustments was £50,000 (2022: £nil).

Impairments by Stage

IFRS 9 calculations and related disclosures require loan assets to be divided into three stages.

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

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

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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

	Stage 1	Stage 2 *	Stage 3 *	Total
	£000	£000	£000	£000
30 September 2023				
Gross loan book	244,248	17,919	2,546	264,713
Impairment provision	(58)	(35)	(176)	(269)
Net loan book	244,190	17,884	2,370	264,444
Coverage ratio	0.02%	0.20%	6.91%	0.10%

	Stage 1	Stage 2 *	Stage 3 *	Total
	£000	£000	£000	£000
30 September 2022				
Gross loan book	237,694	70,041	2,133	309,868
Impairment provision	(2)	(130)	(38)	(170)
Net loan book	237,692	69,911	2,095	309,698
Coverage ratio	0.00%	0.19%	1.78%	0.05%

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

In terms of the Company'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.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Analysis of Stage 2 loans

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

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 reduced over the year. This is driven principally by a lower number of accounts identified through model based criteria which are driven by the economic scenarios input into the models. The economic forecasts at 30 September 2022 included significant short term shifts in interest rates and house prices. These have been reflected in actual economic performance, to some extent, and the initial part of the September 2023 scenarios have lower rate movements.

Provision levels have decreased compared to the previous year.

	< 1 month arrears	**Recent arrears**	**> 1 <= 3 months arrears**	**Total**
	£000	**£000**	**£000**	**£000**
30 September 2023				
Gross loan book	17,032	363	524	17,919
Impairment provision	(30)	-	(5)	(35)
Net loan book	17,002	363	519	17,884
Coverage ratio	0.18%	0.00%	0.95%	0.20%
30 September 2022				
Gross loan book	69,493	-	548	70,041
Impairment provision	(127)	-	(3)	(130)
Net loan book	69,366	-	545	69,911
Coverage ratio	0.18%	0.00%	0.55%	0.19%

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Analysis of Stage 3 loans

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

- In the process of sale or other enforcement procedures ('Realisations')
- Where a receiver of rent ('RoR') has been appointed by the Company to manage the property on the customer's behalf
- Which are being managed on a long-term basis and where full recovery 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 2023 have increased from those at 30 September 2022, however the number of new defaults in the year remained low. RoR cases have increased which has led to the impairment provision increasing in the current year

Coverage levels in the Mortgage Lending segment on Stage 3 cases have remained broadly similar, despite the falls in house prices and thus security cover in the year.

	Probation	**> 3 month arrears**	**RoR managed**	**Realisations**	**Total**
	£000	**£000**	**£000**	**£000**	**£000**
30 September 2023					
Gross loan book	82	1,408	854	202	2,546
Impairment provision	-	(9)	(167)	-	(176)
Net loan book	82	1,399	687	202	2,370
Coverage ratio	0.00%	0.64%	19.56%	0.00%	6.91%
30 September 2022					
Gross loan book	285	1,604	158	86	2,133
Impairment provision	-	(18)	(20)	-	(38)
Net loan book	285	1,586	138	86	2,095
Coverage ratio	0.00%	1.12%	12.66%	0.00%	1.78%

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Analysis of Stage 3 loans (continued)

The exposure at default in the calculation shown above for stage 3 accounts is reduced by £2,239,000 (2022: £1,990,000) in respect of the value of security given by customers. The estimated value of the security represents, for each account, the lesser of the valuation estimate and the exposure value in the central economic scenario. Security values are based on the most recent valuation of the relevant property held by the Company, indexed as appropriate.

The RoR managed accounts are being managed to ensure the optimal resolution for landlords, tenants and lenders and have largely reached a long-term, stable position, but the existence of the RoR arrangement causes the accounts to be treated as defaulted for regulatory purposes.

Movements in impairment provision by stage

The movements in the impairment provision calculated under IFRS 9 is set out below.

	2023	**2022**
	£000	**£000**
At 1 October 2022	170	223
Provided / (released) in period	119	(49)
Amounts written off	(20)	(4)
At 30 September 2023	269	170

Accounts are considered to be written off for accounting purposes when 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 2023 enforceable contractual balances of £nil (2022: £nil) were outstanding on assets written off in the period. This will exclude those accounts where a full and final settlement was agreed and those where the contractual terms do not permit any further action. Enforceable balances will be kept under review for operational purposes but no amounts will be recognised in respect of such accounts unless further cash is received or there is a strong expectation that it will be.

A more detailed analysis of these movements by IFRS 9 stage for the year ended 30 September 2022 and 30 September 2022 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 period.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

	Stage 1	Stage 2 *	Stage 3 *	Total
	£000	£000	£000	£000
Loss allowance at 1 October 2022	2	130	38	170
New assets originated or purchased	-	-	-	-
Changes in loss allowance				
Transfer to stage 1	70	(66)	(4)	-
Transfer to stage 2	-	-	-	-
Transfer to stage 3	-	(1)	1	-
Changes on stage transfer	(66)	6	182	122
Changes due to credit risk	52	(34)	(21)	(3)
Write offs	-	-	(20)	(20)
Assets derecognised	-	-	-	-
Loss allowance at 30 September 2023	58	35	176	269
Loss allowance at 1 October 2021	27	179	17	223
New assets originated or purchased	-	-	-	-
Changes in loss allowance				
Transfer to stage 1	44	(44)	-	-
Transfer to stage 2	(4)	4	-	-
Transfer to stage 3	-	-	-	-
Changes on stage transfer	(44)	69	4	29
Changes due to credit risk	(21)	(78)	21	(78)
Write offs	-	-	(4)	(4)
Assets recognised	-	-	-	-
Loss allowance at 30 September 2022	2	130	38	170

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

During the year ended 30 September 2023 the impairment allowance increased, driven mostly by the increase in Stage 3 cases, a result of the level of actual defaults in the period, and by reduced levels of available security through declining house prices in the mortgage segment.

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.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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

	Stage 1	Stage 2 *	Stage 3 *	Total
	£000	£000	£000	£000
Balances at 1 October 2022	237,694	70,041	2,133	309,868
New assets originated or purchased	-	-	-	-
Changes in staging				
Transfer to stage 1	47,699	(47,143)	(556)	-
Transfer to stage 2	(4,051)	4,145	(94)	-
Transfer to stage 3	(1,044)	(839)	1,883	-
Redemptions and repayments	(33,313)	(7,170)	(780)	(41,263)
Assets derecognised	-	-	-	-
Write offs	-	-	(20)	(20)
Other changes	(2,737)	(1,115)	(20)	(3,872)
Balance at 30 September 2023	244,248	17,919	2,546	264,713
Loss allowance	(58)	(35)	(176)	(269)
Carrying value	244,190	17,884	2,370	264,444
Balances at 1 October 2021	373,276	49,023	2,073	424,372
New assets originated or purchased	-	-	-	-
Changes in staging				
Transfer to stage 1	19,766	(19,766)	-	-
Transfer to stage 2	(48,473)	49,081	(608)	-
Transfer to stage 3	(538)	(641)	1,179	-
Redemptions and repayments	(100,065)	(8,022)	(507)	(108,594)
Assets derecognised	-	-	-	-
Write offs	-	-	(4)	(4)
Other changes	(6,272)	366	-	(5,906)
Balance at 30 September 2022	237,694	70,041	2,133	309,868
Loss allowance	(2)	(130)	(38)	(170)
Carrying value	237,692	69,911	2,095	309,698

Other changes includes interest and similar charges

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Impairments charged / (credited) to income

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

	2023	2022
	£000	£000
Provided / (released) in year	96	(56)
Written off amounts	20	4
	116	(52)

Economic impacts

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

The Group uses four distinct economic scenarios chosen to represent the range of possible outcomes and allow for the impact of economic asymmetry in the calculations. Each scenario comprises a number of economic parameters and while models for different portfolios may not use all of the variables, the set, as a whole, is defined for the Group and must be consistent.

As the Group does not have an internal economics function, in developing its economic scenarios it considers analysis from reputable external sources to form a general market consensus which informs its central scenario. These sources include data and forecasts produced by the Office of Budget Responsibility ('OBR') and the PRA as well as private sector economic research bodies. The Group also takes account of public statements from bodies such as the Bank of England and the UK Government to inform its final position.

The central scenario used for IFRS 9 impairment purposes is the same scenario which forms the basis of the Group's business planning and forecasting and will therefore generally carry the highest probability weighting. In its September 2023 forecasting cycle (the 'October reforecast'), the Group has adopted a central economic scenario derived using a broadly equivalent approach to that used in September 2022, with the starting point of the scenario updated to reflect the actual movements of economic variables in the year.

The general trend of the Group's central forecasts follows that published by the Bank of England in August 2023, however the Group has taken a more pessimistic position than the Bank. Monetary policy is forecast to remain tight, with pressure on real incomes, leading to minimal growth, rising unemployment and a slow decline in inflation. As a result interest rates are forecast to remain stable, with a short-term decline in property values.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Compared to the central scenario adopted at 30 September 2022, the new central forecast is generally more pessimistic across most variables, with a much more severe decline in house prices than in the earlier scenario and a more prolonged period of elevated interest rates. The scenario also begins from the actual September 2023 economic position, so the interest rate rises, increased inflation and house price falls observed in the period are included in the starting position.

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 forecast period, with the upside scenario having a more rapid reduction in inflation, leading to a faster reduction in base rates and a stronger recovery. The downside includes traditional recessionary factors with additional pressure on house prices and rising unemployment, with interest rates being reduced more rapidly in response.

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 ('ACS') being used at 30 September 2023. This scenario is based on a pronounced recession with interest rates remaining high, rising unemployment and a slump in house prices.

Following a review of the weightings of the different scenarios, set against the overall potential for variability in the future economic outlook, the Group decided to maintain the scenario weightings used at 30 September 2022. While the economic outlook is more settled than it was twelve months earlier there remains a significant divergence in opinions on the likely outlook for the UK economy, with a potential for serious downside outcomes. This supports the maintenance of the September 2022 weightings.

The weightings attached to each scenario are set out below

	2023	**2022**
Central scenario	40%	40%
Upside scenario	10%	10%
Downside scenario	30%	30%
Severe scenario	20%	20%
	100%	100%

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

9. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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

30 September 2023

	Central scenario		Upside scenario		Downside scenario		Severe scenario	
	Max %	Min %	Max %	Min %	Max %	Min %	Max %	Min %
Economic driver								
GDP	1.2	0.3	2.3	0.9	1.2	(0.8)	1.2	(5.0)
HPI	4.4	(8.2)	7.4	(3.1)	4.1	(13.4)	7.2	(16.4)
BBR	5.5	4.0	5.3	3.5	5.8	2.0	6.0	3.3
CPI	5.0	1.5	4.3	1.8	6.0	0.4	17.0	2.0
Unemployment	6.0	4.5	4.8	3.8	7.0	5.0	8.5	5.2
Secured lending	3.0	-	3.8	0.8	3.0	(0.8)	3.0	(2.0)
Consumer credit	5.0	2.0	5.8	2.8	5.0	1.3	5.0	-

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)

10. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING

Hedge accounting is applied where appropriate, though some derivatives, while forming part of an economic hedge relationship, do not qualify for this accounting treatment under the IAS 39 rules, particularly where the hedged risk relates to an off balance sheet item. In other cases, hedge accounting has not been adopted either because natural accounting offsets are expected or because complying with the IAS 39 hedge accounting rules would be particularly onerous.

The Company's hedging arrangements can be analysed between fair value hedges of portfolio interest rate risk, which are used to manage the interest rate basis risk inherent in fixed rate lending.

In addition, the Company utilises currency derivatives to hedge its exposure on the small amount of its lending denominated in foreign currencies.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

10. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

The analysis below splits derivatives between those accounted for as part of the portfolio fair value and those which, despite representing an economic hedge, do not qualify for this treatment. There were no individual interest rate risk hedging arrangements in place either in the year ended 30 September 2023 or the preceding year.

	2023 Assets £000	2023 Liabilities £000	2022 Assets £000	2022 Liabilities £000
Other derivatives				
Interest rate swaps	9,848	(132)	15,420	-
Total recognised derivative assets / (liabilities)	9,848	(132)	15,420	-

The credit risk inherent in the derivative financial assets shown above is discussed in note 17.

Fair value hedges

Background and hedging objectives

The Company's fair value hedges of portfolios of interest rate risk ('macro hedges') arise from its management of the interest basis risk inherent in its fixed rate lending activities. These activities would expose the Company to movement in market interest rates if not hedged.

This position arises naturally where fixed rate loans are funded with floating rate borrowings, as in the Company's securitisation transactions, but may also arise where retail deposit funding is used. Where possible the Company takes advantage of natural hedging between fixed rate assets and deposit, but it is unlikely that a precise match for value and tenor of the instruments could be achieved leaving unmatched items on both sides. These net exposures are addressed through portfolio hedging arrangements.

This position arises naturally where fixed rate loans are funded with floating or variable rate borrowings but may also arise where retail deposit funding is used. Where possible the Company takes advantage of natural hedging between fixed rate assets and deposits, but it is unlikely that a precise match for value and tenor of the instruments could be achieved leaving unmatched items on both sides. This is referred to as repricing risk and controlled within limits under the Company's interest rate risk management process, described in note 17. In order to manage these exposures, they are hedged with financial derivatives and form part of the Company's portfolio hedging arrangements. Repricing risk is monitored regularly to ensure mismatches or gaps remain within limits set by policy.

Responsibility to direct and oversee structural risk management has been delegated by the Board to ALCO. A Hedging strategy is developed for each fixed product considering behavioural characteristics, such as whether a customer is likely to prepay before contractual maturity. This is reviewed from time to time with any changes agreed with ALCO.

10. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

In order to manage potential exposure to increases in interest rates it may be necessary to undertake pre-hedging of fixed rate assets in the pipeline. Interest rate swaps used to hedge pipeline loan exposures, which are not yet recognised on the balance sheet, can cause unmatched fair value cost or credit to arise until both sides of the hedge can be recognised within the interest rate portfolio hedging arrangement, generally a few months after the inception of the derivative contract.

In managing interest rate exposure, the Treasury function may use interest rate swaps, forward rate agreements, swaptions or interest rate caps and floors. However, interest rate swaps are the most generally used instruments.

The policy creates 'loan hedge' matching fixed rate buy-to-let mortgage assets with interest rate swaps to convert the interest receivable to a floating rate; and

The principal sterling reference rate used by the Company in its interest rate risk management is SONIA (sterling overnight index average). SONIA is an important interest rate benchmark which is based on actual transactions and reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions and other institutional investors.
Where fixed rate assets or liabilities have been hedged with interest rate swaps, these currently reference SONIA.

The designation of the two macro hedges is updated, on a month by month basis, using software which compares the overall tenor, value and rate positions to match the expected fair value movement of the swaps with the expected interest rate risk related movement in the fair value of the relevant assets or liabilities over the designation period as closely as possible. The software applies regression analysis techniques to the potential impact of changes in expected interest rates over the designation period to maximise expected hedge effectiveness on a prospective basis. The value of the portfolio of loans or deposits selected is then designated, as a monetary amount of interest rate risk, as the hedged item, while the portfolio of swaps selected are designated as the hedging instruments.

Any swaps not selected in this process are disclosed as derivatives not in hedging relationships.

At the end of each designation period the Company will assess the effectiveness of each hedge retrospectively, based on fair value movements (relating to interest rate risk components only) which have actually occurred in the period. Movements are compared to pre-determined test thresholds to determine whether the hedge was effective in the period.

Hedging Instruments

The hedging portfolios consist of a large number of sterling denominated swaps. Settlement on all swaps is due quarterly where:

One payment is calculated based on a fixed rate of interest and the nominal value of the swap.

An opposite payment is calculated based on the same nominal value but using a floating interest rate set at a fixed margin over the SONIA reference rate.

Basis exposure on loan assets is hedged by swaps where the Company pays fixed rate and receives floating, that on deposits by swaps where the Company pays floating rate and receives fixed.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

10. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

Derivatives not in a hedging relationship

The Company's other derivatives comprise:

- Interest rate swaps which are economically part of the Company's portfolio hedging arrangements but failed to find a match in the hedge designation, including swaps hedging interest rate risk on the new lending pipeline

The principal terms of this derivatives are set out below.

Interest rate swaps

	2023 Pay Fixed	**2022 Pay Fixed**
Average fixed notional interest rate	-	-
Average notional margin over SONIA	2.37%	1.70%
	£000	**£000**
Notional principal value		
SONIA swaps	205,873	233,799
	205,873	233,799
Maturing		
Within one year	82,773	26,500
Between one and two years	32,000	111,199
Between two and five years	91,100	96,100
	205,873	233,799
Fair value	9,716	15,420

11. DEBTORS

	2023 £000	**2022 £000**
Amounts falling due within one year:		
Other debtors (note 16)	4	927
Amounts due from group companies	12	12
Prepayments and accrued income	102	28
	118	967

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

12. CALLED UP SHARE CAPITAL

	2023 £	2022 £
Allotted:		
49,999 ordinary shares of £1 each (25p called up and paid)	12,500	12,500
1 ordinary shares of £1 each (fully paid)	1	1
	12,501	12,501

13. PROVISIONS FOR LIABILITIES

Deferred tax

The movements in the net liability / (asset) for deferred tax are as follows:

	2023 £000	2022 £000
Balance at 1 October 2022	3,828	(8)
Profit and loss (credit) / charge (note 7)	(1,405)	2,915
Rate change (note 7)	(192)	921
Balance at 30 September 2023	2,231	3,828
The net deferred tax liability for which provision has been made is analysed as follows:		
Other timing differences	2,231	3,828

14. CREDITORS

	2023 £000	2022 £000
Amounts falling due within one year:		
Other creditors (note 16)	10,566	15,645
Accruals and deferred income	2,548	1,771
	13,114	17,416

	2023 £000	2022 £000
Amounts falling due after more than one year:		
Asset backed loan notes	268,309	353,514
Derivative financial liabilities (note 10)	132	-
S VFN Notes	-	-
	268,441	353,514

A maturity analysis and further details of the asset backed loan notes are given in note 15.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

15. BORROWINGS

The mortgage backed floating rate notes are secured over a portfolio comprising fixed and variable rate mortgage loans secured by first charges over residential properties in the United Kingdom. The notes are subject to mandatory redemption in part on each interest payment date in an amount equal to the principal received or recovered in respect of the mortgage. As a result of this structure, cash received in respect of loan assets is not immediately available for distribution. At 30 September 2023, the amount of restricted cash and investments held within the Company was £16,084,000 (2022: £60,169,000). The maturity date of the notes matches the maturity date of the underlying assets. It is likely that a substantial proportion of these notes will be repaid within five years.

The Company has the option to repay all of the notes at an earlier date (the 'call date') or at any interest payment date thereafter, at the outstanding principal amount. This option may only be exercised if sufficient funds to satisfy all outstanding amounts will be available to the Company on the intended repayment date, as discussed in note 22.

Interest is payable at a fixed margin above:

- the Sterling Over Night Index Average ('SONIA') on notes denominated in sterling

All payments in respect of the notes are required to be made in the currency in which they are denominated.

The margin has a step-up to a higher rate from Aug 2024.

Notes in issue at 30 September 2023 and 30 September 2022 were:

Notes	Maturity date	Call date	Principal outstanding 2023	Principal outstanding 2022	Note margin 2023	Note margin 2022
			£000	£000		
'A1'	May 2045	Aug 2024	29,862	113,586	1.05%	1.05%
'A2'	May 2045	Aug 2024	151,540	151,540	1.20%	1.20%
'B'	May 2045	Aug 2024	24,741	24,741	1.90%	1.90%
'C'	May 2045	Aug 2024	18,555	18,555	2.25%	2.25%
'D'	May 2045	Aug 2024	20,102	20,102	2.60%	2.60%
'Z'	May 2045	Aug 2024	20,105	20,105	3.60%	3.60%
'S'	May 2045	Aug 2024	3,740	5,571	4.00%	4.00%
'SVFN'	May 2045	Aug 2024	-	-	4.00%	4.00%

All of the above notes are listed on the main market of the London Stock Exchange.

If the issuer elects not to call and repay the Class A1, A2, B, C, D, Z and S on or after the Call Date / Turbo date, the excess revenue that otherwise would have been paid to the administrator, such as interest on the S VFN note, is used to repay the Class 'A' Noteholders.

The Class S VFN Notes represents the Amortised Cost Adjustment.

There are no amounts of committed but undrawn facilities at 30 September 2023 and 30 September 2022.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

16. RELATED PARTY TRANSACTIONS

The Group has identified the following transactions which are required to be disclosed under the terms of IAS 24 - 'Related Party Disclosures' ('IAS 24').

Transactions with Paragon Mortgages (2010) Limited (PM2010)

The Company owed £4,967,000 (2022: £5,117,000) to PM2010, a company under common control as defined by IAS 24, at the balance sheet date in relation to deferred purchase consideration, and £2,000 (2022: £3,000) for mortgage fees and insurance which is included in other creditors.

The Company was owed £1,000 (2022: £2,000) from PM2010 relating to monies received by the servicer, that are yet to be passed onto the Company, which is included in other debtors.

Transactions with Paragon Finance PLC (PF)

During the year PF, a company under common control as defined by IAS 24, acted as servicer of the mortgages for the Company and earned £568,000 (2022: £792,000) in servicing fees. At the balance sheet date, the Company owed £89,000 (2022: £117,000) to PF in relation to servicing fees, which is included in accruals and deferred income.

At the balance sheet date PF was owed £446,000 (2022: £791,000) from the Company in relation to payments made on behalf of the Company, which is included in other creditors.

PF is the Fee Letter provider to the Company which is repaid over a four-year period. At the balance sheet date, the outstanding Fee Letter was £400,000 (2022: £745,000), which is included in other creditors as mentioned above. During the year PF earned £44,000 (2022: £43,000) in Fee letter interest and at the balance sheet date the Company owed £5,000 (2022: £6,000) in relation to Fee Letter interest, which is included in accruals and deferred income.

At the balance sheet date PF held the following notes as disclosed in notes 14 and 15. It shows the amount of interest earned during the current and preceding years by PF from holding the asset backed loan notes and what PF is owed in interest as at 30 September 2023 and 30 September 2022 which is included in prepayments and accrued income:

Notes	Maturity date	Call date	Principal notes held		Interest PF earned		Interest PF was owed	
			2023	2022	2023	2022	2023	2022
			£000	£000	£000	£000	£000	£000
'A1'	May 2045	Aug 2024	1,494	5,684	116	138	12	22
'A2'	May 2045	Aug 2024	7,577	7,577	389	145	62	31
'B'	May 2045	Aug 2024	24,741	24,741	1,443	648	227	123
'C'	May 2045	Aug 2024	18,555	18,555	1,147	551	178	100
'D'	May 2045	Aug 2024	20,102	20,102	1,313	667	202	118
'Z'	May 2045	Aug 2024	20,105	20,105	1,514	868	228	144
'S'	May 2045	Aug 2024	3,740	5,571	341	277	44	43
'SVFN'	May 2045	Aug 2024	-	-	-	-	-	-

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2023

16. RELATED PARTY TRANSACTIONS (CONTINUED)

Transactions with Paragon Bank PLC (PB)

The Company owed £5,134,000 (2022: £9,700,000) to PB, a company under common control as defined by IAS 24, at the balance sheet date in relation to deferred purchase consideration, and £3,000 (2022: £30,000) for mortgage fees and insurance which is included in other creditors.

The Company was owed £3,000 (2022: £925,000) from PB relating to monies received by the servicer, that are yet to be passed onto the Company, which is included in other debtors.

At the balance sheet date PB held the following notes as disclosed in notes 14 and 15

Notes	Maturity Date	Call date	Principal notes held 2023	Principal notes held 2022
			£000	£000
'A2'	May 2045	Aug 2024	143,963	143,963

During the year PB earned £7,385,000 (2022: £2,762,000) in Class A2 note interest. At the balance sheet date, the Company owed £1,190,000 (2022: £584,000) to PB in Class A note interest which is included in accruals and deferred income.

NOTES TO THE ACCOUNTS – FINANCIAL RISK

YEAR ENDED 30 SEPTEMBER 2023

The note below describes the processes and measurements which the Company use to manage their exposure to financial risks including credit, liquidity, interest rate and foreign exchange risk.

17. FINANCIAL RISK MANAGEMENT

The Company's operations are financed principally by floating rate, asset backed loan notes and, to a lesser extent, by a mixture of share capital and loans from other group companies of the Group. The Company issues financial instruments to finance the acquisition of its portfolio of loans to customers and uses derivative financial instruments to hedge interest rate risk arising from fixed rate lending. In addition, various financial instruments, for example debtors and accruals, arise directly from the Company's operations.

The principal risks arising from the Company's financial instruments are credit risk, liquidity risk and interest rate risk. The board of the Company's holding company reviews and agrees policies for all companies in the Group managing each of these risks and they are summarised below. These policies have remained unchanged throughout the year and since the year end.

Credit risk

The Company's credit risk is primarily attributable to its loans to customers. The maximum credit risk at 30 September 2023 approximates to the carrying value of loans to customers (note 9). There are no significant concentrations of credit risk due to the large number of customers included in the portfolios.

The Company acquired mortgages from Paragon Mortgages (2010) Limited and Paragon Bank PLC, fellow group companies of the Group which place strong emphasis on good credit management at the time of underwriting new loans.

The acquired mortgages are secured by first charges over residential properties in the United Kingdom. Despite this security, in assessing credit risk an applicant's ability to repay the loan remains the overriding factor in the decision to lend by the originating lender. Additionally, each mortgage has the benefit of one or more life assurance policies and certain mortgages have the benefit of a mortgage guarantee indemnity insurance policy.

At 30 September 2023, 87.8% (2022: 96.5%) of the Company's mortgage loans by value had a loan-to-value ('LTV') ratio of 70% or less. The weighted average LTV was 58.4% (2022: 55.0%). LTV for each account is calculated by comparing the current balance to the most recent valuation of the mortgaged property, indexed as appropriate.

Paragon Mortgages (2010) Limited and Paragon Bank PLC, fellow group companies of the Group, continues to administer the mortgages on behalf of Paragon Mortgages (No.26) PLC and the collections process is the same as that utilised for all companies in the group.

In order to control credit risk relating to counterparties to the Company's financial instruments, the board of the Company's holding company determines on a group basis, which counterparties the group of companies will deal with, establishes limits for each counterparty and monitors compliance with those limits.

The terms of the debt issue require that the companies cash balances are held at institutions with a credit rating greater than P-1 by Moody's and/or A-1 by Standard and Poors and/or F1 by Fitch Ratings.

NOTES TO THE ACCOUNTS – FINANCIAL RISK

YEAR ENDED 30 SEPTEMBER 2023

17. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk

The Company's assets are principally financed by asset backed loan notes issued through the securitisation process. Details of the Company's borrowings are given in notes 14 and 15. Securitisation effectively eliminates the Company's liquidity risk by matching the maturity profile of the Company's funding to the profile of the assets to be funded.

Interest rate risk

The Company's policy is to maintain floating rate liabilities and match these with floating rate assets by the use of interest rate swap agreements.

The rates payable on the asset backed loan notes issued by the Company are reset quarterly on the basis of Sterling Overnight Index Average ('SONIA'). The Company's assets predominantly bear SONIA linked interest rates or are hedged fixed rate assets. The interest rates charged on the Company's variable rate loan assets are determined by reference to, inter alia, the Company's funding costs and the rates being charged on similar products in the market. Generally this ensures the matching of changes in interest rates on the Company's loan assets and borrowings and any exposure arising on the interest rate resets is relatively short term.

In part, the Company's interest rate hedging objectives are achieved by the controlled mismatching of the dates on which instruments mature, redeem or have their interest rates reset.

Currency risk

The Company has no material exposure to foreign currency risk.

Use of derivative financial instruments

The Company uses derivative financial instruments for risk management purposes. Such instruments are used only to limit the exposure of the Company to movements in market interest rates, as described above.

It is, and has been throughout the year under review, the Company's policy that no trading in financial instruments shall be undertaken, and hence all of the Company's derivative financial instruments are for commercial hedging purposes. These are used to protect the Company from exposures principally arising from fixed rate lending. Hedge accounting is applied where appropriate, though it should be noted that some derivatives, while forming part of an economic hedge relationship, do not qualify for this accounting treatment under IAS 39 either because natural accounting offsets are expected, or obtaining hedge accounting would be especially onerous.

The Company has designated a number of derivatives as fair value hedges. In particular this treatment is used for hedging the interest rate risk of groups of fixed rate prepayable loan assets with interest rate derivatives on a portfolio basis. The Company believes this solution is the most appropriate as it is consistent with the economic hedging approach taken by the Company to these assets.

NOTES TO THE ACCOUNTS – FINANCIAL RISK

YEAR ENDED 30 SEPTEMBER 2023

17. FINANCIAL RISK MANAGEMENT (CONTINUED)

Fair values of financial assets and financial liabilities

Derivative financial instruments are stated at their fair values in the accounts. The Group uses a number of techniques to determine the fair values of its derivative assets and liabilities, for which observable prices in active markets are not available. These are principally present value calculations based on estimated future cash flows arising from the instruments, discounted using a risk adjusted interest rate. The principal inputs to these valuation models are SONIA benchmark interest rates for the currencies in which the instruments are denominated, sterling and euros. 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. Details of these assets are given in note 10.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2023

The notes set out below describe the accounting basis on which the Company prepare their accounts, the particular accounting policies adopted by the Company 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.

18. BASIS OF PREPARATION

The Financial Statements have been prepared in accordance with applicable United Kingdom ('UK') accounting standards. Disclosures have been made in accordance with Financial Reporting Standard 101 – 'Reduced Disclosure Framework' ('FRS 101').

As permitted by FRS 100 – 'Application of Financial Reporting Requirements' ('FRS 100') the Company has applied the measurement and recognition requirements of International Financial Reporting Standards as adopted by the UK (UK-adopted international accounting standards) ('UK-IAS') but makes amendments where necessary in order to comply with the Companies Act 2006 and has set out below where advantage of disclosure exemptions provided by FRS 101 has been taken.

The particular accounting policies adopted have been set out in note 19 and the critical accounting judgements and estimates which have been regarded in preparing these financial statements are described in notes 20 and 21 respectively.

Adoption of new and revised reporting standards

In the preparation of these financial statements, no new accounting standards are being 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 Company's accounting and reporting.

Disclosures

In preparing these financial statements the Company has taken advantage of the exemptions from disclosure provided by FRS 101 in respect of:

- The requirement to produce a cash flow statement and related notes
- Disclosures in respect of transactions with wholly owned subsidiaries
- Disclosures in respect of capital management
- The effects of new, but not yet effective IFRSs
- Disclosures in respect of key management personnel
- Disclosures of transactions with a management entity which provides key management personnel services to the Company

As the consolidated financial statements of Paragon Banking Group PLC, the ultimate parent undertaking of the Company, include equivalent disclosures the Company has also taken advantage of these further exemptions provided by FRS 101:

- Certain disclosures required by IFRS 13 – 'Fair Value Measurement'
- Certain disclosures required by IFRS 7 – 'Financial Instruments Disclosures'

The Company presently intends to continue to apply these exemptions in future periods.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2023

19. ACCOUNTING POLICIES

The particular policies applied by the Company in preparing these financial statements in accordance with the measurements and recognition requirements of UK-IAS are described below.

Accounting convention

The financial statements have been prepared under the historical cost convention, except as required in the valuation of certain financial instruments which are carried at fair value.

Going concern

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

The directors have adopted this basis following a going concern assessment for the Group and the Company covering a period of at least twelve months following the date of approval of these financial statements. Details of this assessment are set out in note 22.

Loans to customers

Loans to customers includes assets accounted for as financial assets. The Company assesses the classification and measurement of a financial asset based on the contractual cash flow characteristics of the asset and its business model for managing the asset. The Company has concluded that its business model for its customer loan assets is of the type defined as 'Hold to collect' by IFRS 9 and the contractual terms of the asset should give rise to cash flows that are solely payments of principal and interest ('SPPI'). Such loans are therefore accounted for on the amortised cost basis.

Loans advanced are valued at inception at the initial advance amount, which is the fair value at that time, inclusive of procuration fees paid to brokers or other business providers and less initial fees paid by the customer. Loans acquired from third parties are initially valued at the purchase consideration paid or payable. Thereafter, all loans to customers are valued at this initial amount less the cumulative amortisation calculated using the Effective Interest Rate ('EIR') method. The loan balances are then reduced where necessary by an impairment provision.

The EIR method spreads the expected net income arising from a loan over its expected life. The EIR is that rate of interest which, at inception, exactly discounts the future contracted cash payments and receipts arising from the loan to the initial carrying amount.

Impairment of loans and receivables

The carrying values of all loans to customers, are reduced by an impairment provision based on their expected credit loss ('ECL'), determined in accordance with IFRS 9. These estimates are reviewed throughout the year and at each balance sheet date.

All assets are assessed to determine whether there has been a significant increase in credit risk ('SICR') since the point of first recognition (origination or acquisition). Assets are also reviewed to identify any which are 'Credit Impaired'. SICR and credit impairment are identified on the basis of pre-determined metrics including qualitative and quantitative factors relevant to each portfolio, with a management review to ensure appropriate allocation.

Assets which have not experienced an SICR are referred to as 'Stage 1' accounts, assets which have experienced an SICR but are not credit impaired are referred to as 'Stage 2' accounts, while credit impaired assets are referred to as 'Stage 3' accounts.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2023

19. ACCOUNTING POLICIES (CONTINUED)

Impairment of loans and receivables (continued)

An impairment allowance is provided on an account by account basis:

- For Stage 1, at an amount equal to 12-month ECL, the total expected ECL that results from those default events that are possible within 12 months of the reporting date, weighted by the probability of those events occurring
- For Stage 2 and 3 accounts, at an amount equal to lifetime ECL, the total expected ECL that results from any future default events, weighted by the probability of those events occurring

In establishing an ECL allowance, the Company assesses its probability of default, loss given default and exposure at default for each reporting period, discounted to give a net present value. The estimates used in these assessments must be unbiased and take into account reasonable and supportable information including forward-looking economic inputs.

While the Group uses statistical models as the basis for its calculation of ECLs where appropriate, expert judgement will always be used to assess the adequacy of any calculated amount and additional provision made if required.

Within its buy-to-let portfolio the Company utilises a receiver of rent process, whereby the receiver stands between the landlord and tenant and will determine an appropriate strategy for dealing with any delinquency. This strategy may involve the immediate sale of any underlying security or the short or long term letting of the property to cover arrears and principal shortfalls. Such cases are automatically considered to have an SICR, but where a letting strategy is adopted by the receiver and a tenant is in place arrears may be reduced or cleared. Properties in receivership are eventually either returned to their landlord owners or sold.

For financial accounting purposes, provisions for impairments of loans to customers are held in an impairment allowance account from the point at which they are first recognised. These balances are released to offset against the gross value of the loan when it is written off for accounting purposes. This occurs when standard enforcement processes have been completed, subject to any amount retained in respect of expected salvage receipts. Any further gains from post-write off salvage activity are reported as impairment gains.

Cash at bank

Balances shown as cash at bank in the balance sheet comprise demand deposits and short-term deposits with banks with initial maturities of not more than 90 days.

Current tax

The charge for taxation represents the expected UK corporation tax and other income taxes arising from the Company's profit for the year. This consists of the current tax which will be shown in tax returns for the year and tax deferred because of temporary differences. This in general, represents the tax impact of items recorded in the current year but which will impact tax returns for periods other than the one in which they are included in the financial statements.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2023

19. ACCOUNTING POLICIES (CONTINUED)

Deferred taxation

Deferred taxation is provided in full on temporary differences that result in an obligation at the balance sheet date to pay more tax, or a right to pay less tax, at a future date, at rates expected to apply when they crystallise based on current tax rates and law. Deferred tax assets are recognised to the extent that it is regarded as probable that they will be recovered. As required by IAS 12 – 'Income Taxes', deferred tax assets and liabilities are not discounted to take account of the expected timing of realisation.

Borrowings

Borrowings are carried in the balance sheet on the amortised cost basis. The initial value recognised includes the principal amount received less any discount on issue or costs of issuance.

Interest and all other costs of the funding are expensed to the profit and loss account as interest payable over the term of the borrowing on an EIR.

Derivative financial instruments

All derivatives are carried in the balance sheet at fair value, as assets where the value is positive or as liabilities where the value is negative. Fair value is based on market prices, where a market exists. If there is no active market, fair value is calculated using present value models which incorporate assumptions based on market conditions and are consistent with accepted economic methodologies for pricing financial instruments. Changes in the fair value of derivatives are recognised in the profit and loss account, except where such amounts are permitted to be taken to equity as part of the accounting for a cash flow hedge.

Hedging

IFRS 9 paragraph 7.2.21 permits an entity to elect, as a matter of accounting policy, to continue to apply the hedge accounting requirements of IAS 39 in place of those set out in Chapter 6 of IFRS 9. The Company has made this election and the accounting policy below has been determined in accordance with IAS 39.

For all hedges, the Company documents, at inception, the relationship between the hedging instruments and the hedged items, as well as its risk management strategy and objectives for undertaking the transaction. The Company also documents its assessment, both at hedge inception and on an ongoing basis, of whether the hedging arrangements put in place are considered to be 'highly effective' as defined by IAS 39.

For a fair value hedge, as long as the hedging relationship is deemed 'highly effective' and meets the hedging requirements of IAS 39, any gain or loss on the hedging instrument recognised in income can be offset against the fair value loss or gain arising from the hedged item for the hedged risk. For macro hedges (hedges of interest rate risk for a portfolio of loan assets) this fair value adjustment is disclosed in the balance sheet alongside the hedged item. Only the net ineffectiveness of the hedge is charged or credited to income. Where a fair value hedge relationship is terminated, or deemed ineffective, the fair value adjustment is amortised over the remaining term of the underlying item.

19. ACCOUNTING POLICIES (CONTINUED)

Amounts owed by or to group companies

The balances owed by or to other group companies are carried at the current amount outstanding less any provision. Where balances owing between group companies fall within the definition of either financial assets or financial liabilities given in IAS 32 – 'Financial Instruments – Presentation' they are classified as assets or liabilities at amortised cost as defined by IFRS 9.

Revenue

The revenue of the Company comprises interest receivable and similar charges and other income. The accounting policy for the recognition of each element of revenue is described separately within these accounting policies.

Other income

Other income which is accounted for in accordance with IFRS 15, includes event based administration fees charged to borrowers (other than the initial fees included in amortised costs) which are credited to the profit and loss account when the related service is performed.

Deferred purchase consideration

Under the Mortgage Sale Agreement excess revenue arising in the Company is paid up to the companies which originated the loans by way of deferred purchase consideration. Deferred purchase consideration is recognised in the period in which it becomes payable and is paid when sufficient cash resources allow.

20. CRITICAL ACCOUNTING JUDGEMENTS

The most significant judgements which the directors have made in the application of the accounting policies set out in note 19 relate to:

Significant Increase in Credit Risk ('SICR')

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

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 9.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2023

20. CRITICAL ACCOUNTING JUDGEMENTS (CONTINUED)

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 9.

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 other comprehensive income, or at fair value through profit or 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 Company 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.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2023

21. 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:

Impairment losses on loans to customers

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

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

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

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

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

In evaluating the potential impact of the economic situation at 30 September 2023 there is little recent history against which to benchmark likely customer behaviour. Interest rates have risen to higher levels, at a more rapid rate than at any time in recent history. UK base rates had reached 5.25% at the balance sheet date, a level they had not touched since April 2008, since when significant regulatory intervention in the UK's lending markets has taken place.

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

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2023

21. CRITICAL ACCOUNTING ESTIMATES (CONTINUED)

Impairment losses on loans to customers (continued)

In order to provide forward looking economic inputs to the modelling of the ECL, the Group must derive a set of scenarios which are internally coherent. The Group addresses these requirements using four distinct economic scenarios chosen to represent the range of possible outcomes. As noted above, there remains a significant range of different opinions amongst economists about the longer-term prospects for the UK, although these have converged, to some extent, over the twelve months since 30 September 2022, when the impact of the September 2022 mini-budget had significantly broadened the range of plausible outcomes.

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

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

The economic variables will also inform assumptions about the Company's approach to account management given a particular scenario.

In addition to uncertainty created by the economic scenarios, the Group recognises that the present situation lies outside the range of situations considered when it originally derived its IFRS 9 approach to impairment. It 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 PMA's are set out in note 9.

The position after considering all these matters is set out in note 9.

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 loan and hence the cash flows relating thereto, including those relating to early redemption charges. For purchased accounts this will involve estimating the likely future 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.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2023

22. GOING CONCERN

The financial statements have been prepared on the going concern basis, as defined in IAS 1 – 'Presentation of Financial Statements'. In order to prepare financial statements on this basis the directors must conclude that the management does not intend to liquidate the Company or cease trading, and that the Company has the ability to continue to trade and will be able to satisfy its liabilities as they fall due.

As a result of the transaction documents governing the Company's mortgage backed floating rate note borrowings described in note 15 the Company will continue to trade in the same way as it did in the year ended 30 September 2023 until either:

- All of the A1, A2, B, C, D, Z, and S notes are repaid from principal cash flows arising from the Company's mortgage portfolio
- The call option described in note 15, exercisable for the first time in August 2024 is exercised; or
- The final repayment date for the notes in May 2045 is reached

Before this point repayments of the principal liabilities of the Company, the mortgage backed floating rate notes described in note 15, are limited to available principal cash received on the Company's loan portfolio until the final repayment date. Therefore, the directors have a reasonable expectation that the Company has adequate resources to continue in operational existence until one of the settlement transactions referred to above takes place.

No positive decision to exercise the call option had been made at the date of signing these accounts. However, it is normal practice in similar funding structures for call options to be exercised soon after the time they become available. In order to repay the notes after the call option was exercised all of the Company's loan balances would need to be disposed of, therefore the existence of this option means that there is a material uncertainty as to whether the Company will continue to trade for the whole of the coming year and hence whether IAS1 would permit the use going concern basis of preparation.

On that basis, the directors have concluded the Company is able to continue as a going concern for at least twelve months from the date of approval of these financial statements and that therefore that it is appropriate to continue to adopt the going concern basis in the preparation of these financial statements. However, the existence of the call option described above creates a material uncertainty related to events or conditions that, may cast significant doubt on the Company's ability to continue as a going concern and, therefore, to continue realising its assets and discharging its liabilities in the normal course of business. The financial statements do not include any adjustments which might be necessary if a different basis of preparation had been adopted.

In the paragraph above 'ability to continue as a going concern' is used as it is in IAS (UK) 570. The term 'ability to continue as a going concern' is equivalent to the term 'ability to adopt the going concern basis of accounting in the future'.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2023

23. ULTIMATE PARENT COMPANY

The immediate parent undertaking is Paragon Mortgages (No.26) Holdings Limited.

The ultimate parent undertaking is Maples Fiduciary Services (UK) Limited who holds the entire share capital of the Company on a discretionary trust basis for the benefit of certain charities. The directors regard Paragon Banking Group PLC as the ultimate controlling party.

The smallest and largest group into which the Company is consolidated is that of Paragon Banking Group PLC, registered in England and Wales.

Copies of the Group's financial statements are available from that company's registered office at 51 Homer Road, Solihull, West Midlands, B91 3QJ.