

PARAGON MORTGAGES (No.26) PLC

Report and Financial Statements

Year ended 30 September 2021

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 Paragon Mortgages (No.26) PLC. These statements can be identified by the fact that they do not relate strictly to historical or current facts. They use words such as 'anticipate', 'estimate', 'expect', 'intend', 'will', 'project', 'plan', 'believe', 'target' and other words and terms of similar meaning in connection with any discussion of future operating or financial performance. These have been made by the directors in good faith using information available up to the date on which they approved this report and the Company undertakes no obligation to update these forward-looking statements other than in accordance with its legal or regulatory obligations (including under the Market Abuse Regulation, UK Listing Rules and the Disclosure Guidance and Transparency Rules of the Financial Conduct Authority).

By their nature, all forward-looking statements involve risk and uncertainty because they relate to future events and circumstances that are beyond the control of the 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 a number of factors that could cause actual future financial conditions, business performance, results or developments to differ materially from the plans, goals and expectations expressed or implied by these forward-looking statements and forecasts. As a result, you are cautioned not to place reliance on such forward-looking statements as a prediction of actual results or otherwise.

These factors include, but are not limited to: material impacts related to foreign exchange fluctuations; macro-economic activity; the impact of outbreaks, epidemics or pandemics, such as the Novel Coronavirus 19 ('Covid') pandemic and ongoing challenges and uncertainties posed by the Covid pandemic for businesses and governments around the world, including the duration, spread and any recurrence of the Covid pandemic and the extent of the impact of the Covid pandemic on overall demand for the 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 Group operates) and the consequences thereof (including, without limitation, actions taken as a result of the Covid pandemic); actions by the Company's competitors or counterparties; third party, fraud and reputational risks inherent in its operations; the UK's exit from the European Union ('EU'); unstable economic conditions and market volatility, including currency fluctuations; the risk of a global economic downturn; technological changes and risks to the security of IT and operational infrastructure, systems, data and information resulting from increased threat of cyber and other attacks; general changes in government policy that may significantly influence investor decisions (including, without limitation, actions taken in support of managing and mitigating climate change and in supporting the global transition to net zero carbon emissions); societal shifts in customer financing and investment needs; and other risks inherent to the industries in which the 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.

On 3 July 2019 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, 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 15, the Company's net interest income has increased slightly from £7,870,000 to £7,871,000. The profit after tax has decreased from £709,000 to £115,000. This is mainly due to an increase in operating expenses.

The balance sheet on page 16 of the Financial Statements shows the Company's financial position at year end. Loans to customers have decreased by 11% due to customers redeeming and repaying their accounts. As a result, asset backed loan notes have redeemed by 11% during the year. Cash held by the Company decreased from £24,200,000 to £20,003,000 during the year.

No interim dividend was paid during the year (2020: £nil). No final dividend is proposed (2020: £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 gain of £3,955,000 (2020: fair value net loss of £1,743,000) in the year due to the effectiveness 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 PBG's Annual Report, 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 UK economy in the current year has been impacted significantly by the effects of the Covid virus. This has caused major economic disruption within the UK and global economy but has also driven governments and regulators to offer unprecedented levels of support to businesses and consumers, aimed at mitigating its impact.

The Company has put contingency plans in place to ensure that it can continue to service its customers and to satisfy its obligations under the funding structure. However, should the pandemic have significant long-term impacts on the UK economy then this would significantly impact the Company's future cash flows and performance.

STRATEGIC REPORT (CONTINUED)

PRINCIPAL RISKS AND UNCERTAINTIES (CONTINUED)

Together with continuing uncertainty arising the potential impact economic impact of the UK's withdrawal from the European Union, the Covid pandemic has made the long-term economic prospects for the UK and their impacts on the Company much difficult to forecast.

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 16, a discussion of critical accounting judgements is set out in note 19 and a discussion of critical accounting estimates is set out in note 20.

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 of the Company is mindful of its duty to act in good faith and to promote the success of the Group for the benefit of its shareholders and with regard to the interests of all of its stakeholders and, in particular, the interests of the Company's noteholders. The Board confirms that, for the year ended 30 September 2021, 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 (as per section 172 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 and the Company looks to Group initiatives for guidance and takes them into account in its decision making. The Company follows Group policies and procedures as mentioned above, including those relating to the fair treatment of customers, standards of business conduct, the environment, the community and other stakeholders. More detail may be found in the Paragon Banking Group PLC 2021 Annual Report and Accounts.

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. However, in considering items of business the Board makes autonomous decisions on their own merits, after due consideration of the long-term success of the Company, those factors set out in section 172 of the Companies Act 2006, where relevant, and the stakeholders impacted.

STRATEGIC REPORT (CONTINUED)

BOARD AND STAKEHOLDERS (CONTINUED)

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 damage that might be caused by the Group's activities. The Company operates in accordance with group policies, which are described in the Paragon Banking Group PLC Annual Report, which does not form part of this Report. Further information can also be found in the Group's inaugural Responsible Business Report (published on the Paragon Banking Group PLC website).

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 Annual Report, which does not form part of this Report.

Approved by the Board of Directors

and signed on behalf of the Board



Charles Leahy

per pro MaplesFS UK Corporate Director No.1 Limited

Director

21 January 2022

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 2021.

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

J L Jones (resigned 8 October 2021)

S M H Ellis (appointed 8 October 2021)

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 16 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



Charles Leahy

per pro MaplesFS UK Corporate Director No.1 Limited

Director

21 January 2022

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 the Directors' Report and the 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 United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law) in conformity with the requirements of the Companies Act 2006 and applicable law.

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 and of the profit or loss of the Company for that period. In preparing these 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 they have been prepared in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006
- 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 Company and enable them to ensure that the 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.

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



Charles Leahy

per pro MaplesFS UK Corporate Director No.1 Limited

Director

21 January 2022

**INDEPENDENT AUDITOR'S REPORT
TO THE MEMBERS OF PARAGON MORTGAGES (NO.26) PLC**

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 2021 which comprise the:

- Profit and Loss Account
- Balance Sheet
- Statement of Movements in Equity
- Related notes, including the accounting policies in note 18.

In our opinion, the Financial Statements:

- give a true and fair view of the state of the Company's affairs as at 30 September 2021 and of the Company's profit for the year then ended;
- have been properly prepared in accordance with UK accounting standards, including Financial Reporting Standard 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 the audit committee.

We were first appointed as auditor by the shareholders on 14 January 2020. The period of total uninterrupted engagement is for the six financial years ended 30 September 2021. 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 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. We summarise below the key audit matters, 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.

**INDEPENDENT AUDITORS' REPORT
TO THE MEMBERS OF PARAGON MORTGAGES (No.26) PLC (CONTINUED)**

Key audit matter	Our response
<p>Impairment allowances on loans to customers</p> <p>Risk vs 2020: ◀▶ (£121k; 2020: £360k)</p> <p><i>Refer to the Strategic Report, accounting policy note and note 8 (financial disclosures).</i></p> <p>Subjective estimate</p> <p>The measurement of expected credit losses ('ECL') involves significant judgements and estimates. There is heightened risk of material misstatement of ECL in the current year due to the increased judgement and estimation uncertainty as a result of COVID-19. 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:</p> <p>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 determining the economic scenarios used, particularly in the context of COVID-19, and the probability weightings assigned to each economic scenario.</p> <p>Qualitative adjustments – Adjustments to the model-driven ECL results are raised by management to address issues relating to model responsiveness or emerging trends relating to COVID-19. Such adjustments are inherently uncertain and significant management judgement is involved in estimating these amounts.</p> <p>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 determine whether a 12 month or lifetime provision is recorded. Increased judgement exists in the current year relating to the treatment of those customers who were granted one or more COVID-19 payment reliefs.</p> <p>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 used in the portfolios are the key drivers of the Company's ECL results and are</p>	<p>Our audit procedures included:</p> <ul style="list-style-type: none"> • Test of details: Key aspects of our testing involved: <ul style="list-style-type: none"> - We tested the key inputs and assumptions impacting the Company's overall ECL calculation to assess their reasonableness. This included performing sensitivity analysis to understand the significance of certain assumptions; benchmarking procedures to compare the Company's key assumptions to comparable peer group organisations; and assessing the key assumptions against the Company's historical experience; and - We performed recalculations of the ECL measured on the loan portfolios. • Our economic scenario expertise: We involved our own economic specialists to assist us in assessing the appropriateness of the Company's methodology for determining the economic scenarios used and the probability weightings applied to them. We assessed the overall reasonableness of the economic forecasts by comparing the Company's forecasts to our own modelled forecasts. As part of this work we assessed the reasonableness of the Company's considerations of the economic uncertainty relating to COVID-19. • Qualitative adjustments: For each of the adjustments to the model-driven ECL results we assessed the reasonableness of the adjustments by challenging, the key assumption being the probability of default floors, inspecting the calculation methodology and tracing a sample of data used back to source data. • SICR: We assessed the ongoing predictability of the SICR criteria and independently recalculated the loans' stage for 100% of the Company's loans and receivables. In addition, we assessed the reasonableness of management's treatment of COVID-19 payment relief customers from a SICR perspective. • Our financial risk modelling expertise: We involved our own financial risk modelling specialists in evaluating certain IFRS 9 models. We used our knowledge of the Company and our experience of the industry that the Company operates in to independently assess the

**INDEPENDENT AUDITORS' REPORT
TO THE MEMBERS OF PARAGON MORTGAGES (No.26) PLC (CONTINUED)**

<p>therefore the most significant judgmental aspect of the Company's ECL modelling approach.</p> <p>The effect of these matters is that, as part of our risk assessment, we determined that the impairment of 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 8).</p> <p>Disclosure quality</p> <p>The disclosures regarding the Company's application of IFRS 9 are key to explaining the key judgements and material inputs to the IFRS 9 ECL results.</p>	<p>appropriateness of the Company's IFRS 9 models and key components.</p> <ul style="list-style-type: none"> • Assessing transparency: We evaluated whether the disclosures appropriately reflect and address the uncertainty which exists when determining the Company's overall ECL. As a part of this, we assessed the sensitivity analysis that is disclosed. In addition, we challenged whether the disclosure of the key judgments and assumptions made, including in respect of COVID-19, was sufficiently clear. <p>Our results</p> <p>The results of our testing were satisfactory, and we considered the ECL charge, provision recognised and the related disclosures to be acceptable (2020: acceptable).</p>
<p>Interest receivable on loan accounts</p> <p>Risk vs 2020: ◀▶</p> <p>(£17,393k; 2020: £19,393k)</p> <p><i>Refer to the Strategic Report, accounting policy note and page 15 (profit and loss).</i></p> <p>Subjective estimate</p> <p>The recognition of interest receivable on loan accounts under the effective interest rate ("EIR") method requires the directors to apply judgement, with the most critical estimate being the loans' expected behavioural life for originated assets.</p> <p>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 assumptions based on its forecasting process which incorporates both historical experience and judgmental overlays by management.</p>	<p>Our procedures included:</p> <ul style="list-style-type: none"> • 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. This included considering the impact of uncertainties arising from COVID-19 in the current behavioural life forecasts; • Our sector experience: We critically assessed key assumptions behind the expected behavioural lives against our own knowledge of industry experience and trends, and challenged the appropriateness of the level of segmentation applied to the loan portfolios by management when determining the expected behavioural lives; and • Sensitivity analysis: We performed sensitivity analysis over the repayment profiles by applying alternative profiles based upon 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. As a part of this, we assessed the sensitivity analysis that is disclosed. In addition, we challenged whether the disclosure of the critical estimates and assumptions made, including in respect of COVID-19, was sufficiently clear;

**INDEPENDENT AUDITORS' REPORT
TO THE MEMBERS OF PARAGON MORTGAGES (No.26) PLC (CONTINUED)**

	<p>Our results</p> <p>We found the resulting estimate of interest receivable on loan accounts and the related disclosures to be acceptable (2020: acceptable).</p>
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3 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 £3.3 million (2020: £3.7 million), determined with reference to a benchmark of the Company's total assets as at 30 September 2021, of which it represents 0.75%.

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% (2020: 75%) of materiality for the financial statements as a whole, which equates to £2.4 million (2020: £2.8 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 the Audit Committee any corrected or uncorrected identified misstatements exceeding £0.2 million, in addition to other identified misstatements that warranted reporting on qualitative grounds.

4 Going concern

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. They have also concluded that there are no material uncertainties that could have cast significant doubt over its ability to continue as a going concern for at least a year from the date of approval of the financial statements ("the going concern period").

In our evaluation of the Directors' conclusions, we considered the inherent risks to the Company's business model and analysed how those risks might affect the Company's financial resources or ability to continue operations over the going concern period. We evaluated those risks and concluded that they were not significant enough to require us to perform additional audit procedures.

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;
- we have not identified, and concur with the directors' assessment that there is not, a material uncertainty related to events or conditions that, individually or collectively, may cast significant doubt on the Company's ability to continue as a going concern for the going concern period; and
- we found the going concern disclosure in note 18 to be acceptable.

However, as we cannot predict all future events or conditions and as subsequent events may result in outcomes that are inconsistent with judgements that were reasonable at the time they were made, the above conclusions are not a guarantee that the Company will continue in operation.

**INDEPENDENT AUDITORS' REPORT
TO THE MEMBERS OF PARAGON MORTGAGES (No.26) PLC (CONTINUED)**

5 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 Company's high-level policies and procedures to prevent and detect fraud, 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.

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, and taking into account possible pressures to meet profit targets and our overall knowledge of the control environment, 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 and the risk that Company management may be in a position to make inappropriate accounting entries, and the risk of bias in accounting estimates and judgements, including loan loss provisioning.

We have not identified any additional fraud risks.

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 Company's regulatory and legal 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. We identified the following areas as those most likely to have such an effect: money laundering, financial crime 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 regulatory and legal 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.

**INDEPENDENT AUDITORS' REPORT
TO THE MEMBERS OF PARAGON MORTGAGES (No.26) PLC (CONTINUED)**

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.

6 We have nothing to report on the other information in the Annual Report

The directors are responsible for the other information presented in the Annual 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.

7 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.

**INDEPENDENT AUDITORS' REPORT
TO THE MEMBERS OF PARAGON MORTGAGES (No.26) PLC (CONTINUED)**

8 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.

9 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

21 January 2022

PROFIT AND LOSS ACCOUNT

YEAR ENDED 30 SEPTEMBER 2021

	Note	2021 £000	2020 £000
Interest receivable			
Loans to customers		17,393	19,393
Other		-	151
		<u>17,393</u>	<u>19,544</u>
Interest payable and similar charges	2	(9,522)	(11,674)
Net interest income		<u>7,871</u>	<u>7,870</u>
Other operating income		50	317
Total operating income		<u>7,921</u>	<u>8,187</u>
Operating expenses		(11,857)	(5,234)
Provisions for losses		121	(360)
		<u>(3,815)</u>	<u>2,593</u>
Fair value net gain / (loss)	4	<u>3,955</u>	<u>(1,743)</u>
Operating profit, being profit on ordinary activities before taxation	5	140	850
Tax on profit on ordinary activities	6	(25)	(141)
Profit on ordinary activities after taxation		<u><u>115</u></u>	<u><u>709</u></u>

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 profit for the current and preceding year, and consequently a separate statement of comprehensive income has not been presented.

BALANCE SHEET

30 SEPTEMBER 2021

	Note	2021 £000	2021 £000	2020 £000	2020 £000
ASSETS EMPLOYED					
FIXED ASSETS					
Financial assets	7		424,490		476,505
CURRENT ASSETS					
Debtors falling due within one year	10	498		373	
Cash at bank		20,003		24,200	
			20,501		24,573
			444,991		501,078
FINANCED BY					
EQUITY SHAREHOLDERS' DEFICIT					
Called up share capital	12	12		12	
Profit and loss account		(24)		(139)	
			(12)		(127)
CREDITORS					
Amounts falling due within one year	13	14,817		7,246	
Amounts falling due after more than one year	13	430,186		493,959	
			445,003		501,205
			444,991		501,078

These Financial Statements were approved by the Board of Directors on 21 January 2022.

Signed on behalf of the Board of Directors



Charles Leahy

per pro MaplesFS UK Corporate Director No.1 Limited
Director

STATEMENT OF MOVEMENTS IN EQUITY

YEAR ENDED 30 SEPTEMBER 2021

	Share capital £000	Profit and loss account £000	Total equity £000
<i>Total comprehensive income for the year</i>			
Profit for the year	-	115	115
Other comprehensive income	-	-	-
Total comprehensive income for the year	-	115	115
Opening equity	12	(139)	(127)
Closing equity	12	(24)	(12)

YEAR ENDED 30 SEPTEMBER 2020

	Share capital £000	Profit and loss account £000	Total equity £000
<i>Total comprehensive income for the year</i>			
Profit for the year	-	709	709
Other comprehensive income	-	-	-
Total comprehensive income for the year	-	709	709
Opening equity	12	(848)	(836)
Closing equity	12	(139)	(127)

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2021

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 2021

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

2. INTEREST PAYABLE AND SIMILAR CHARGES

	2021	2020
	£000	£000
Asset backed loan notes	7,071	9,719
Interest rate swaps	2,102	1,457
Subordinated loan interest	51	330
Interest on fee letter	68	104
Interest payable to related parties	230	64
	9,522	11,674

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

3. DIRECTORS AND EMPLOYEES

Directors' fees from the Company during the year is stated in note 5.

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 15. One director (2020: 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.

4. FAIR VALUE NET GAIN / (LOSS)

The fair value net gain of £3,955,000 (2020: fair value net loss of £1,743,000) 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 gain and loss are primarily due to timing differences in income recognition between the derivative instruments and the economically hedged assets and liabilities.

5. OPERATING PROFIT, BEING PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION

	2021	2020
	£000	£000
Operating profit is after charging:		
Amounts paid to third parties in respect to directors' services	7	8
Auditor remuneration - audit services	14	12
Deferred purchase consideration	10,841	4,056
	10,861	4,076

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 2021

6. TAX ON PROFIT ON ORDINARY ACTIVITIES

a) Tax charge for the year

	2021 £000	2020 £000
Current tax		
Corporation tax	-	-
Total current tax	<u>-</u>	<u>-</u>
Deferred tax (note 11)	-	-
Origination and reversal of timing differences	27	161
Rate change	(2)	(20)
Total deferred tax	<u>25</u>	<u>141</u>
Tax charge on profit on ordinary activities	<u>25</u>	<u>141</u>

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 charge for the year

	2021 £000	2020 £000
Profit before tax	<u>140</u>	<u>850</u>
UK corporation tax at 19% (2020: 19%) based on the profit for the year	27	161
Effects of:		
Change in rate of taxation on deferred tax balances	(2)	(20)
Tax charge for the year	<u>25</u>	<u>141</u>

The standard rate of corporation tax in the UK applicable to the Company in the period was 19.0% (2020: 19.0%), based on currently enacted legislation. During the previous period, legislation was substantively enacted, reversing the reduction in the tax rate to 17.0% which had been due to come into effect from April 2020. In the current period legislation was substantially enacted that will increase the rate to 25% with effect from 1 April 2023. Consequently, temporary differences which had been expected to reverse at a tax rate of 19% in the current year or in subsequent years, have either reversed or are expected to reverse at 19% in the year ended 30 September 2022, 22% in the year ended 30 September 2023 or 25% in subsequent years. The impact of this change has been accounted for in the year.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

7. FINANCIAL ASSETS

	2021 £000	2020 £000
Loans to customers (note 8)	424,149	476,505
Derivative financial assets (note 9)	341	-
	<u>424,490</u>	<u>476,505</u>

8. 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 7, 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 Post Model Adjustments ('PMA's) to ensure all elements of credit risk are fully addressed

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

8. 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 most significant asset classes. The PD calculation is a function of current asset performance, customer information and future economic assumptions. The structure of the models was derived through analysis of correlation in historic data, which identified which current and historical customer attributes and external economic variables were predictive of future loss. 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. 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, such as the Covid pandemic, it is likely that mechanical models will be less predictive of outcomes as the historical data used for modelling will be insufficiently representative of present conditions. In these circumstances, management carefully review all outputs to ensure provision is adequate.

At 30 September 2021 the impact of reduced economic activity in the UK from the Covid crisis had not yet been evidenced in customer credit performance and defaults, due to the lagging effect of government policy interventions. Where customers were given payment reliefs, arrears and adverse credit indicators were not recorded by the Company or other lenders, meaning that both internal credit metrics and external credit bureau data might not accurately reflect the customer's credit position leading to modelled PDs being underestimated.

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

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

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

8. 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 in its modelled portfolios primarily on the basis of the relative difference in an account's lifetime PD between origination and the reporting date. The levels of difference required to qualify as an SICR may differ between portfolios and will depend, to some extent, on the level of risk originally perceived and are monitored on an ongoing basis to ensure that this calibrates with actual experience.

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

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

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

When reviewing the subsequent payment patterns of accounts that have been granted Covid-related reliefs, it has been evident that there is higher payment volatility (both in terms of account improvement and deterioration) in these cases, particularly in cases where an extension to the payment holiday has been granted. This indicates an increased credit risk, though the impact is not significant in scale in all cases. As a result of this analysis the accounts of customers who have been granted extended payment reliefs have been placed in Stage 2, regardless of other indicators. This aligns the Group's approach to regulatory guidance which suggested that while initial payment reliefs should not automatically be taken as an indication of an SICR, an extension to such a relief was more likely to be so.

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

Definitions of default

As the IFRS 9 definition of ECL is based on PD, default must be defined for this purpose. The Company's definitions of default for its various portfolios are aligned to its internal operational procedures and the regulatory definitions of default used internally. In particular the 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 2021

8. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)*Definitions of default (continued)*

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

Credit Impaired loans

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

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

8. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)*Monitoring of ECL estimation processes (continued)*

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

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

Model development

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

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

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

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

Post Model Adjustments ('PMA's)

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

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

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

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

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

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

8. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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.

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

	Stage 1 £000	Stage 2 * £000	Stage 3 * £000	Total £000
30 September 2021				
Gross loan book	373,276	49,023	2,073	424,372
Impairment provision	(27)	(179)	(17)	(223)
Net loan book	373,249	48,844	2,056	424,149
Coverage ratio	0.01%	0.37%	0.82%	0.05%
	Stage 1 £000	Stage 2 * £000	Stage 3 * £000	Total £000
30 September 2020				
Gross loan book	445,314	31,254	294	476,862
Impairment provision	(139)	(208)	(10)	(357)
Net loan book	445,175	31,046	284	476,505
Coverage ratio	0.03%	0.67%	3.40%	0.07%

* 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 2021

8. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Analysis of Stage 2 loans

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

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.

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

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

	< 1 month arrears	Recent arrears	> 1 <= 3 months arrears	Total
	£000	£000	£000	£000
30 September 2021				
Gross loan book	-	48,183	840	49,023
Impairment provision	-	(173)	(6)	(179)
Net loan book	-	48,010	834	48,844
Coverage ratio	0.00%	0.36%	0.71%	0.37%
30 September 2020				
Gross loan book	-	30,531	723	31,254
Impairment provision	-	(207)	(1)	(208)
Net loan book	-	30,324	722	31,046
Coverage ratio	0.00%	0.68%	0.14%	0.67%

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

8. 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')
- These accounts are included in Stage 3 as they are classified as defaulted for regulatory purposes.

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

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

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

	Probation	> 3 month arrears	RoR managed	Realisations	Total
	£000	£000	£000	£000	£000
30 September 2021					
Gross loan book	159	1,829	85	-	2,073
Impairment provision	(1)	(16)	-	-	(17)
Net loan book	<u>158</u>	<u>1,813</u>	<u>85</u>	<u>-</u>	<u>2,056</u>
Coverage ratio	<u>0.63%</u>	<u>0.87%</u>	<u>0.00%</u>	<u>0.00%</u>	<u>0.82%</u>
30 September 2020					
Gross loan book	-	294	-	-	294
Impairment provision	-	(10)	-	-	(10)
Net loan book	<u>-</u>	<u>284</u>	<u>-</u>	<u>-</u>	<u>284</u>
Coverage ratio	<u>0.00%</u>	<u>3.40%</u>	<u>0.00%</u>	<u>0.00%</u>	<u>3.40%</u>

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

8. 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 £1,899,000 (2020: £281,000) 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.

Movements in impairment provision by stage

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

	2021	2020
	£000	£000
At 1 October 2020	357	3
(Released) / provided in period	(120)	356
Amounts written off	(14)	(2)
At 30 September 2021	<u>223</u>	<u>357</u>

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 2021 enforceable contractual balances of £2,000 (2020: £4,000) 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.

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 2021

8. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

A more detailed analysis of these movements by IFRS 9 stage on a consolidated basis for the year ended 30 September 2021 and 30 September 2020 is set out below.

	Stage 1 £000	Stage 2 * £000	Stage 3 * £000	Total £000
Loss allowance at 1 October 2020	139	208	10	357
New assets originated or purchased	-	-	-	-
Changes in loss allowance				
Transfer to stage 1	-	-	-	-
Transfer to stage 2	(20)	20	-	-
Transfer to stage 3	-	(3)	3	-
Changes on stage transfer	-	69	9	78
Changes due to credit risk	(92)	(115)	9	(198)
Write offs	-	-	(14)	(14)
Assets derecognised	-	-	-	-
Loss allowance at 30 September 2021	<u>27</u>	<u>179</u>	<u>17</u>	<u>223</u>
Loss allowance at 1 October 2019	2	1	-	3
New assets originated or purchased	-	-	-	-
Changes in loss allowance				
Transfer to stage 1	-	-	-	-
Transfer to stage 2	-	-	-	-
Transfer to stage 3	-	-	-	-
Changes on stage transfer	-	202	11	213
Changes due to credit risk	137	5	1	143
Write offs	-	-	(2)	(2)
Assets recognised	-	-	-	-
Loss allowance at 30 September 2020	<u>139</u>	<u>208</u>	<u>10</u>	<u>357</u>

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

8. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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

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

In the year ended 30 September 2020 the principal factor generating the increase in the loss allowance in the period was the impact of the Covid crisis, which has led to increased loss expectations across all of the Company's portfolios, primarily as a result of the forecast deterioration in key economic variables and their impact on the Company's customers. The broad availability of payment holidays was also reflected, with extended payment holiday accounts transferred to Stage 2 and PMAs made to allow for the potential delay in the recognition of credit issues due to reliefs.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

8. 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 £000	Stage 2 * £000	Stage 3 * £000	Total £000
Balances at 1 October 2020	445,314	31,254	294	476,862
New assets originated or purchased	-	-	-	-
Changes in staging				
Transfer to stage 1	147	(147)	-	-
Transfer to stage 2	(21,715)	21,715	-	-
Transfer to stage 3	(1,287)	(1,254)	2,541	-
Redemptions and repayments	(47,775)	(2,942)	(782)	(51,499)
Assets derecognised	-	-	-	-
Write offs	-	-	(14)	(14)
Other changes	(1,408)	397	34	(977)
Balance at 30 September 2021	373,276	49,023	2,073	424,372
Loss allowance	(27)	(179)	(17)	(223)
Carrying value	373,249	48,844	2,056	424,149
Balances at 1 October 2019	577,226	1,562	-	578,788
New assets originated or purchased	-	-	-	-
Changes in staging				
Transfer to stage 1	667	(667)	-	-
Transfer to stage 2	(29,626)	29,626	-	-
Transfer to stage 3	(694)	(280)	974	-
Redemptions and repayments	(102,074)	491	(682)	(102,265)
Assets derecognised	-	-	-	-
Write offs	-	-	(2)	(2)
Other changes	(185)	522	4	341
Balance at 30 September 2020	445,314	31,254	294	476,862
Loss allowance	(139)	(208)	(10)	(357)
Carrying value	445,175	31,046	284	476,505

Other changes includes interest and similar charges

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.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

8. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Impairments charged to income

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

	2021	2020
	£000	£000
(Released) / provided in year	(135)	358
Written off amounts	14	2
	<u>(121)</u>	<u>360</u>

Economic impacts

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

In developing its economic scenarios, the Company considers analysis from reputable external sources to form a general market consensus which inform its central scenario. These sources included forecasts produced by the Office of Budget Responsibility ('OBR') and the PRA as well as private sector economic research bodies.

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

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

30 September 2021

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

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

8. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

30 September 2020

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

9. 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.

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 2021 or the preceding year.

	2021 Assets £000	2021 Liabilities £000	2020 Assets £000	2020 Liabilities £000
Other derivatives				
Interest rate swaps	341	(1,295)	-	(4,938)
Total recognised derivative assets / (liabilities)	341	(1,295)	-	(4,938)

The credit risk inherent in the derivative financial assets shown above is discussed in note 16.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

9. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

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 16. 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.

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.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

9. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

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 2021

9. 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

	2021	2020
	Pay	Pay
	Fixed	Fixed
Average fixed notional interest rate	-	-
Average notional margin over SONIA	0.60%	0.63%
	£000	£000
Notional principal value		
SONIA swaps	348,725	389,329
	348,725	389,329
Maturing		
Within one year	52,000	24,000
Between one and two years	16,000	52,000
Between two and five years	280,725	313,329
	348,725	389,329
Fair value	(954)	(4,938)

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

10. DEBTORS

	2021 £000	2020 £000
Amounts falling due within one year:		
Other debtors (note 15)	475	328
Deferred tax (note 11)	8	33
Prepayments and accrued income	15	12
	<u>498</u>	<u>373</u>

11. DEFERRED TAX

The movements in the net asset for deferred tax are as follows:

	2021 £000	2020 £000
Balance at 1 October 2020	33	174
Profit and loss charge (note 6)	(27)	(161)
Rate change (note 6)	2	20
Balance at 30 September 2021	<u>8</u>	<u>33</u>
The net deferred tax liability for which provision has been made is analysed as follows:		
Other timing differences	<u>8</u>	<u>33</u>

12. CALLED UP SHARE CAPITAL

	2021 £	2020 £
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
	<u>12,501</u>	<u>12,501</u>

The Company was incorporated on 14 December 2018 with £1 share capital fully paid to Paragon Mortgages (No.26) Holdings Limited. A further 49,999 partly paid ordinary shares of £1 each were also allotted to Paragon Mortgages (No.26) Holdings Limited on 19 February 2019. These shares were a quarter paid.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

13. CREDITORS

	2021	2020
	£000	£000
Amounts falling due within one year:		
Other creditors (note 15)	13,806	6,135
Accruals and deferred income	1,011	1,111
	<u>14,817</u>	<u>7,246</u>
	2021	2020
	£000	£000
Amounts falling due after more than one year:		
Asset backed loan notes	428,891	484,299
Derivative financial liabilities (note 9)	1,295	4,938
S VFN Notes	-	4,722
	<u>430,186</u>	<u>493,959</u>

A maturity analysis and further details of the asset backed loan notes are given in note 14.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

14. 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 2021, the amount of restricted cash and investments held within the Company was £20,003,000 (2020: £24,200,000). 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.

Interest is payable at a fixed margin above:

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

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 May 2023.

Notes in issue at 30 September 2021 and 30 September 2020 were:

Notes	Maturity date	Call date	Principal outstanding 2021	Principal outstanding 2020	Note margin 2021	Note margin 2020
			£000	£000		
'A1'	May 2045	Aug 2024	188,600	243,500	1.05%	1.05%
'A2'	May 2045	Aug 2024	151,500	151,500	1.20%	1.20%
'B'	May 2045	Aug 2024	24,700	24,700	1.90%	1.90%
'C'	May 2045	Aug 2024	18,600	18,600	2.25%	2.25%
'D'	May 2045	Aug 2024	20,100	20,100	2.60%	2.60%
'Z'	May 2045	Aug 2024	20,100	20,100	3.60%	3.60%
'S'	May 2045	Aug 2024	6,300	7,200	4.00%	4.00%
'SVFN'	May 2045	Aug 2024	-	4,700	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 2021 and 30 September 2020.

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

15. 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 £3,848,000 (2020: £1,080,000) to PM2010, a company under common control as defined by IAS 24, at the balance sheet date in relation to deferred purchase consideration, and £3,000 (2020: £3,000) for mortgage fees and insurance which is included in other creditors.

The Company was owed £262,000 (2020: £nil) 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 £900,000 (2020: £1,056,000) in servicing fees. At the balance sheet date, the Company owed £142,000 (2020: £160,000) to PF in relation to servicing fees, which is included in accruals and deferred income.

At the balance sheet date PF was owed £1,165,000 (2020: £2,003,000) 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 £1,103,000 (2020: £1,858,000), which is included in other creditors as mentioned above. During the year PF earned £68,000 (2020: £104,000) in Fee letter interest and at the balance sheet date the Company owed £6,000 (2020: £10,000) 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 13 and 14. 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 2021 and 30 September 2020 which is included in prepayments and accrued income:

Notes	Maturity date	Call date	Principal notes held		Interest PF earned		Interest PF was owed	
			2021	2020	2021	2020	2021	2020
			£000	£000	£000	£000	£000	£000
'A1'	May 2045	Aug 2024	9,400	12,200	119	212	13	17
'A2'	May 2045	Aug 2024	7,600	7,600	95	117	12	12
'B'	May 2045	Aug 2024	24,700	24,700	483	556	61	60
'C'	May 2045	Aug 2024	18,600	18,600	427	482	54	53
'D'	May 2045	Aug 2024	20,100	20,100	533	593	67	66
'Z'	May 2045	Aug 2024	20,100	20,100	734	795	92	91
'S'	May 2045	Aug 2024	6,300	7,200	270	364	32	36
'SVFN'	May 2045	Aug 2024	-	4,700	51	329	-	24

NOTES TO THE ACCOUNTS - ANALYSIS

YEAR ENDED 30 SEPTEMBER 2021

15. RELATED PARTY TRANSACTIONS (CONTINUED)

Transactions with Paragon Bank PLC (PB)

The Company owed £8,785,000 (2020: £3,040,000) to PB, a company under common control as defined by IAS 24, at the balance sheet date in relation to deferred purchase consideration, and £5,000 (2020: £8,000) for mortgage fees and insurance which is included in other creditors.

The Company was owed £201,000 (2020: £316,000) 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 13 and 14:

Notes	Maturity Date	Call date	Principal notes held 2021	Principal notes held 2020
			£000	£000
'A2'	May 2045	Aug 2024	144,000	144,000

During the year PB earned £1,800,000 (2020: £2,224,000) in Class A2 note interest. At the balance sheet date, the Company owed £227,000 (2020: £223,000) 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 2021

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.

16. 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 2021 approximates to the carrying value of loans to customers (note 8). 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 2021 91.0% (2020: 68.2%) of the Company's mortgage loans by value had a loan-to-value ('LTV') ratio of 70% or less. The weighted average LTV was 60.0% (2020: 64.8%). 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 2021****16. 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 13 and 14. 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 2021

16. 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 9.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2021

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.

17. BASIS OF PREPARATION

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

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

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

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

Adoption of new and revised reporting standards

In the preparation of these financial statements, the following accounting standards are being applied for the first time.

- 2020 amendments to IAS 39 – ‘Interest Rate Benchmark Reform’ and consequential amendments to IFRS 7

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2021

17. BASIS OF PREPARATION (CONTINUED)

Adoption of new and revised reporting standards (continued)*IAS 39 amendments 'Interest Rate Benchmark Reform'*

In August 2020 the IASB issued a further amendment to IAS 39 'Interest Rate Benchmark Reform – Phase 2'. This amendment sets out accounting requirements for the treatment of Interbank Offered Rate ('IBOR') - linked financial assets and liabilities under the amortised cost method when a firm replaces the IBOR linkage in the underlying instruments with a replacement benchmark. It is therefore potentially applicable to the Company's London Interbank Offered Rate ('LIBOR') - linked intercompany loans where interest is charged on the basis of LIBOR or other IBOR rates.

The intention of the standard is that, where the transition is effectively a like for like replacement, no windfall gain or loss should occur on transition.

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

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.

18. ACCOUNTING POLICIES

Accounting convention

The Financial Statements are 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, 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 14 the Company will continue to trade in the same way as it did in the year ended 30 September 2021 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 14, exercisable for the first time in August 2024 is exercised; or
- The final repayment date for the notes in May 2045 is reached

The directors have reviewed the balance sheet performance of the company and consider that it is unlikely that any of these events will occur within twelve months of the date of approval of these financial statements.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION**YEAR ENDED 30 SEPTEMBER 2021****18. ACCOUNTING POLICIES (CONTINUED)****Going concern (continued)**

Before this point, repayments of the principal liabilities of the Company, the mortgage backed floating rate notes described in note 14, 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 this point, satisfying all liabilities as they fall due.

On the basis of this analysis, the directors have concluded that 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 it is appropriate to continue to adopt the going concern basis in the preparation of these financial statements.

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 procurement 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 a provision impairment.

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 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, whether accounted for under IFRS 9 or IAS 17, 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.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2021

18. ACCOUNTING POLICIES (CONTINUED)**Impairment of loans and receivables (continued)**

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.

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

- For Stage 1, at an amount equal to 12-month ECL, i.e. 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; or
- For Stage 2 and 3 accounts, at an amount equal to lifetime ECL, i.e. 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.

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, a tenant is in place and arrears are reduced or cleared, the account will not necessarily be considered to be credit impaired. 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

Current tax, including UK corporation tax, is provided at amounts expected to be paid (or recovered) using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION**YEAR ENDED 30 SEPTEMBER 2021****18. 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 Effective Interest Rate basis.

Derivative financial instruments

Derivative instruments utilised by the Company comprise currency swaps and interest rate swaps. All such instruments are used for hedging purposes to alter the risk profile of the existing underlying exposure of the Company in line with the Company’s risk management policies (note 16).

The Company does not enter into speculative derivative contracts.

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.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2021

18. ACCOUNTING POLICIES (CONTINUED)**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, for other hedges the adjustment is made to the carrying value of the hedged asset or liability. 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.

Where a derivative is used to hedge the variability of cash flows of an asset or liability, it may be designated as a cash flow hedge so long as this relationship meets the hedging requirements of IAS 39. For such an instrument the effective portion of the change in the fair value of the derivative is taken initially to equity, with the ineffective part taken to profit or loss. The amount taken to equity is released to the profit and loss account at the same time as the hedged item affects the profit and loss account. Where a cash flow hedge relationship is terminated, or deemed ineffective, the amount taken to equity will remain there until the hedged transaction is recognised, or is no longer highly probable.

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.

Revenue

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

Fee and commission income

Other income includes administration fees charged to borrowers, which are credited to the profit and loss account when the related service is performed.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION**YEAR ENDED 30 SEPTEMBER 2021****18. ACCOUNTING POLICIES (CONTINUED)****Deferred purchase consideration**

Under the Mortgage sale agreement profits from the company are 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. Paragon Mortgages (2010) Limited, to whom deferred purchase consideration is paid, is a fellow group company.

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 2021****19. CRITICAL ACCOUNTING JUDGEMENTS**

The most significant judgements which the directors have made in the application of the accounting policies set out in note 18 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.

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

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

More information on the definition of SICR adopted is given in note 8.

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 8.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION**YEAR ENDED 30 SEPTEMBER 2021****19. CRITICAL ACCOUNTING JUDGEMENTS (CONTINUED)****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; and
- The nature of the contractual cash flows inherent in the assets

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

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.

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.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

YEAR ENDED 30 SEPTEMBER 2021

20. 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 significant of these 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.

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

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

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

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

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

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION**YEAR ENDED 30 SEPTEMBER 2021****20. CRITICAL ACCOUNTING ESTIMATES (CONTINUED)****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. For purchased accounts this will involve estimating the likely future performance of the accounts at the time of acquisition. These estimates are based on historical data and reviewed regularly. For purchased accounts historical data obtained from the vendor will be examined.

The accuracy of the EIR applied would therefore be compromised by any differences between actual repayment profiles and that predicted, which in turn would depend directly or indirectly on customer behaviour.

Fair values

Where financial assets and liabilities are carried at fair value, in the majority of cases this can be derived by reference to quoted market prices. Where such a quoted price is not available the valuation is based on cash flow models, based, where possible on independently sourced parameters. The accuracy of the calculation would therefore be affected by unexpected market movements or other variances in the operation of the models or the assumptions used.

21. 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.