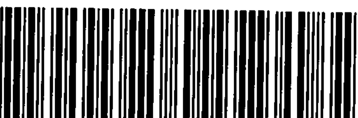
Paragon Bank PLC
Registered No: 5390593

Paragon Bank PLC

Annual Report & Accounts

For the year ended 30 September 2019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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 plans and current goals and expectations relating to the future financial condition, business performance and results of Paragon Bank PLC. 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 Bank undertakes no obligation to update these forward-looking statements. 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 Paragon Bank PLC and depend upon circumstances that may or may not occur in the future. 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. Nothing in this document should be construed as a profit forecast

STRATEGIC REPORT

BUSINESS MODEL

Paragon Bank PLC (the 'Bank') was one of the first UK banks to be authorised under the regulatory regime introduced in 2014. It is a subsidiary of Paragon Banking Group PLC ('PBG'), a listed FTSE-250 company. PBG is the parent company of a group specialising in consumer finance and SME lending (the 'Group') of which the Bank is a member. It operates on a centralised basis with the majority of its employees based in Solihull, West Midlands.

The Bank's strategic aim is to be a leading provider of specialist finance to individuals and small and medium sized enterprises ('SMEs').

The operating structure of the Group is such that the majority of its activities are undertaken through the Bank and its subsidiary entities. The Bank plays a key role in supporting the Group's diversified funding strategy through its retail deposit taking capabilities. Retail deposits are expected to represent the majority of Group and Bank funding going forward, augmented by tactical securitisation and other wholesale issuances.

PROFITABILITY OF THE BUSINESS

The profitability of the business in the long term builds on:

- vigilance in the underwriting process to mitigate losses, leaning on the Group's long history of strong credit performance
- appropriate pricing of new advances or purchased loans, with a disciplined approach to the relationship between growth, risk and returns
- careful management of loan accounts to increase retention and reduce levels of delinquency, which utilises the operating model employed by the Group over many years
- arranging appropriate funding sources to sustain the business, where retail deposits form the core of the funding programme supported by wholesale issuance
- maintaining control of operating costs and ensuring the efficient use of resources

GENERATION OF ASSETS

The Bank generates assets for its balance sheet through a combination of direct and intermediary distribution. No branch network exists, but direct sales are delivered through a series of local sales teams servicing specialist markets. It offers loans in a variety of niche and specialist fields in the consumer and SME finance markets including:

- Buy-to-let and specialist residential mortgages
- Development finance
- Structured lending
- Second charge mortgage loans
- Motor finance

The Bank also generates income through its asset and development finance subsidiaries which provide SME customers with leasing products and related services.

LENDING

New business advances in the year, together with the year end loan balances are summarised below:

	Advances in the year		Net loan balances at the year end	
	2019	2018	2019	2018
	£m	£m	£m	£m
Mortgages	1,486.3	1,520.2	4,930.5	4,262.7
Commercial Lending	198.6	306.2	451.3	392.7
	1,684.9	1,826.4	5,381.8	4,655.4

The Bank's total loan book increased by 15.6% in the year, with new advances 7.74% lower than in the previous financial year, after the Group's development finance new lending was transferred to a fellow subsidiary.

MORTGAGES

The Bank offers buy-to-let first charge and owner-occupied first and second charge mortgages on residential property in the UK. In all its offerings, it targets niche markets where its focus on detailed case-by-case underwriting and its robust and informed approach to property risk differentiate it from mass market and other specialist lenders.

New lending in this sector during the year is set out below.

	2019	2018
	£m	£m
First charge buy-to-let	1,402.5	1,392.5
First charge owner-occupied	11.9	56.5
Second charge	71.9	71.2
	1,486.3	1,520.2

Total mortgage lending, comprising buy-to-let products and other mortgage offerings, decreased by 2.2% in the year. Within this total, buy-to-let lending increased by 0.72% year on year.

In the professional buy-to-let market the Bank's strategy of focussing on specialist customers (those operating through corporate structures and those with larger portfolios) has delivered positive results. These are the customers best suited to the Bank's service model and this targeting, coupled with a disciplined approach to underwriting and valuation, has enabled margins and retention rates to be increased while providing the customers with a high standard of support for their business needs.

The Bank's second charge mortgage lending has increased marginally by 1.1% during the year, but remains at modest levels. The second charge market is currently not large, with total lending in the financial year reported by the Finance and Leasing Association ('FLA') of £1,207 million (2018: £1,031 million). However, much of the increase has come from sub-prime activity, which falls outside the Bank's risk appetite. The Bank seeks to target only that population of customers with the strongest credit quality in this area, avoiding any form of sub-prime business, which necessarily limits the addressable market for second charge lending.

STRATEGIC REPORT (Continued)

In residential mortgage lending, margins have been generally compressed and the Bank has maintained credit discipline at acceptable yields, meaning that the amount of new business has fallen. The opportunities for the Bank in this area principally relate to highly specialised propositions, where the Bank's operational approach can be beneficial, including lending to the existing specialist landlord customer base. In the short term only small volumes of lending are expected in this area.

The Bank's outstanding first and second mortgage loan balances are set out below, analysed by business line.

	30 September 2019 £m	30 September 2018 £m
Originated assets		
First charge buy-to-let	4,567.8	3,902.2
First charge owner-occupied	68.3	59.4
Second charge	171.5	141.3
	4,807.6	4,102.9
Acquired assets		
Second charge	122.9	159.8
	4,930.5	4,262.7

At 30 September 2019 the balance on the Bank's mortgage portfolio was 15.7% higher than a year earlier, with the buy-to-let book having grown by 17.2%, despite the sale of a £469.58m portfolio of loans into Paragon Mortgages (No. 26) PLC ('PM26') securitisation.

The annualised redemption rate on all of the Group's post-2010 buy-to-let mortgage assets at 10.7% (2018: 16.7%), has reduced from the high level seen in 2018, reflecting both the profile of product maturities and the changing focus towards specialist landlord customers (those with corporate structures, larger portfolios or specialist property types).

The redemption rate was also reduced by greater numbers of the Bank's customers opting to re-fix their loans during the period, rather than redeem and refinance elsewhere. This affected both customers on products which reached the end of their initial fixed rates and also those already on reversionary rates. This process was enhanced by systems developments to make the process as easy as possible for customers. While the Bank earns a smaller margin on these switch products, the customers should then stay with the Bank for a longer period on their new fixed rates, offsetting the reduction in margin over the medium term.

Arrears on the buy-to-let book as a whole have marginally increased in the year to 0.03% (2018: 0.01%). These arrears remain very low compared to the national buy-to-let market, with UKF reporting arrears of 0.42% across the buy-to-let sector at 30 September 2019 (2018: 0.42%). This exemplary performance reflects the Bank's focus on underwriting on the basis of the credit quality and financial capability of its customers, underpinned by a detailed and thorough assessment of the value and suitability of the property as security.

Arrears on originated second charge mortgages increased to 0.38% from 0.21% in the year, as the book began to season, with performance remaining strong, while the new residential lending has yet to see any arrears, although the loans are still comparatively unseasoned.

STRATEGIC REPORT (Continued)

Arrears on the acquired secured lending business have increased to 7.7% (2018: 7.6%), the increase arose from the purchase of accounts in the year which are currently making full monthly payments but had missed payments at some point in the past. These arrears levels remain lower than the average for the sector with average arrears for secured lending of 8.4% at 30 September 2019 reported by the FLA (2018: 9.4%).

The Bank has established a significant market position in specialist buy-to-let which offers good prospects for future earnings and profitability, though significant expansion of volumes is not anticipated in the year ending 30 September 2020.

COMMERCIAL LENDING

The Banks's focus within commercial lending is on lending to SME and mid-sized corporate customers. Its loan assets include development finance, motor finance and structured lending balances, while asset finance and further development finance lending is conducted through subsidiary entities, funded by the Bank.

A deceleration in global economic growth and continued political uncertainty in the UK during the year have had an adverse impact on UK business investment, however this has not led to a reduction in the Bank's volumes.

The Bank's focus across all its Commercial Lending business lines in the year has been on growing the scope of its operations to address a wider range of funding propositions for SME customers, while enhancing service, maintaining credit discipline and improving yields.

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

	2019 £m	2018 £m
Motor finance	148.9	177.9
Development finance	-	87.7
Structured lending	49.7	40.6
	198.6	306.2

Commercial lending decreased by 31.9% in the period. This was principally a result of a decision to make all new development finance loans through a subsidiary company.

The motor finance business saw a drop in advances with a 16.3% decrease in new lending. The Bank continues to target its motor finance offerings on those specialist propositions which are not addressed the by mass-market lenders who control the majority of the market. This limits the potential to grow market share and the level of advances in 2019 has been below that achieved in 2018, in part due to a continued level of new business pricing discipline. The Bank has reviewed its business model for motor finance following the publication of the FCA's review of the sector. It has identified the changes required by the FCA's proposed new rules and considers that is well placed to comply, compared to other market participants.

STRATEGIC REPORT (Continued)

The Bank's structured lending business, which made its first loans in the second half of 2018 has made further progress in the year. The structured lending unit provides senior debt to the UK non-bank lending market and deploys loans to help support 'best-in-class' businesses working across consumer and commercial lending. Transactions are secured on underlying assets and structured using established robust methodologies. The business addresses certain segments where the Group may be under-weight or has no exposure at all and where working with a recognised industry expert is preferable to organic expansion. There are now eight transactions in place, compared to three at the previous year end, with more prospects at various stages of development. Outstanding facilities at 30 September 2019 have reached £130.6 million, of which £88.0m had been drawn at the year end.

Following the Bank's purchase of the Titlestone property development business in 2018, it was decided that the pre-acquisition organically developed business be merged with the acquired business in a subsidiary entity and therefore the Bank make no significant development finance advances in future periods, nor will it do in future periods.

Across all business lines growth has been carefully controlled with credit quality and margins prioritised over expansion and care has been taken to focus effort on those sectors or subsectors of the market most suited to the Bank's business model and most likely to provide it with a good return on capital.

The Bank's outstanding commercial loan balances are set out below, analysed by business line.

	30 September 2019 £m	30 September 2018 £m
Motor finance	281.3	256.6
Development finance	81.9	97.4
Structured lending	88.1	38.7
	451.3	392.7

Margins on commercial lending have remained strong. Arrears on the commercial lending business remain low with arrears in the motor finance business at 1.27% (2018: 0.93%), comparable to those in the wider sector, with the FLA reporting average arrears for car finance at 2.70% at 30 September 2019 (2018: 2.50%).

Credit quality in the development finance book has been good, and the overall performance of the projects has been in line with expectations. These accounts are monitored on a case-by-case basis by the Credit Risk function. At 30 September 2019 no accounts had been identified by the monitoring process as being likely to result in a loss. The average loan to gross development value for the portfolio at the year end, a measure of security cover, was 61.6% (2018: 61.2%).

The Bank's intention is to continue to develop its commercial lending business, both on balance sheet and through investment in subsidiaries, selectively focussing on those areas where the greatest return can be achieved. This will involve both increasing the reach of its existing offerings and adding further product lines or specialisms, to improve the diversity of its loan book. It will also prioritise maintaining margins and customer relationships in the existing books.

STRATEGIC REPORT (Continued)

GROUP ENTITIES

During the period the amounts loaned to other Group entities decreased to £1,176.0 million (2018: £1,215.4 million). The reduction resulted from the Group entities generating significant cashflows which were used to repay the loans. During the year the Bank invested in £195.0 million in notes issued as part of the Paragon Mortgages (No 25) PLC ('PM25') securitisation and subscribed for £143.9 million of AAA rated notes as part of the PM26 securitisation.

STRATEGIC REPORT (Continued)

FUNDING

The Bank is funded primarily through retail savings deposits accepted from the general public. It is regulated and authorised by the Prudential Regulation Authority ('PRA') and regulated by the Financial Conduct Authority ('FCA'). Other sources of funding include central bank facilities provided by the Bank of England and group funding.

The Bank's external funding at 30 September 2019 and 30 September 2018 is summarised as follows:

	2019 £m	2018 £m
Retail deposit balances	6,391.9	5,296.6
Central bank facilities	994.4	1,024.4
Total on balance sheet funding	7,386.3	6,321.0
Off balance sheet central bank facilities	108.9	108.7
	7,495.2	6,429.7

RETAIL FUNDING

The Bank's savings business provides customers with a range of deposit options, offering value for money and competitive rates, combined with the protection provided by the Financial Services Compensation Scheme ('FSCS'). While the business currently sources the majority of deposits through its own website, it also has an increasing presence on wealth management platforms and is expanding to offer postal accounts.

Retail deposits continue to represent a reliable, cost-effective and scalable source of finance for the Bank. The volume of retail deposits has continued to grow significantly during the period, in line with the Bank's funding strategy, with balances at 30 September 2019, at £6,391.9 million, having increased by 20.7% over the year (2018: £5,296.6 million).

The Bank's share of the overall UK savings market remains small, with opportunities identified to expand the franchise. Household savings balances reported by the Bank of England increased by 3.7% in the year ended 30 September 2019 to £1,220.9 billion (2018: £1,177.3 billion), although these deposits remain overwhelmingly with clearing banks and building societies. While this market position enhances the Bank's funding flexibility, it does mean that rates may be influenced by the funding needs of other, larger, participants in the market, which are beyond the Bank's control.

New entrants in the banking market have sought to access similar segments of the savings market as the Bank, and therefore competition for internet-sourced deposits has increased. However, the Bank's competitive position on pricing, products and service, have meant that it has been able to achieve its required funding levels at attractive prices.

STRATEGIC REPORT (Continued)

Savings balances at the year end are analysed below.

	Average interest rate		Average initial balance		Proportion of deposits	
	2019	2018	2019	2018	2019	2018
	%	%	£000	£000	%	%
Fixed rate deposits	2.02%	1.94%	16	19	65.0%	68.8%
Variable rate deposits	1.43%	1.36%	16	16	35.0%	31.2%
All balances	1.81%	1.76%	16	18	100.0%	100.0%

The average initial term of fixed rate deposits was 28 months (2018: 27 months).

Market rates for new easy access accounts and one year deposits reported by the Bank of England have increased year-on-year, with rates on longer dated products falling, which is consistent with the picture shown above.

At 30 September 2019 the proportion of easy access deposits, which are repayable on demand, at 27.8% was a little higher than its level at the beginning of the year (30 September 2018: 25.5%), and represented £1,778.0 million of the balance (2018: £1,384.7 million). This percentage can be expected to rise going forward as the Group generates richer behavioural data to support its liquidity requirement assumptions for easy access business.

The core route to market for the deposit proposition is through its online presence, with traffic driven by strong repeat business flows, organic searches, a presence on price comparison websites and recommendations from industry savings experts. This has been enhanced in the period by the launch of alternative deposit sources, such as investment platforms outside the main business flow.

The first of these alternative sources, the Hargreaves Lansdown Active Savings platform came on stream in November 2018, with further relationships with Flagstone, a wealth management solution and Monzo, the digital bank, launched later in the year. These arrangements allow the Bank to access an additional customer base, as the platforms target different demographics to its online direct savings channel. The Group will seek to develop such relationships further in future periods.

The Bank's products, process and approach have been recognised in the industry and by customers winning the 'Best Monthly Interest Provider' award in the 2019 Moneynet awards, its second consecutive victory in this category. It was also named as 'Best Online Cash ISA Provider' in the 2019 YourMoney.com Awards and 'Best Savings Provider for Existing Customers' in the 2019 Savings Champion awards.

In customer feedback 89% of those opening a savings account with the Bank in the year who provided data, stated that they would 'probably' or 'definitely' take a second product (2018: 90%). The net promoter score in the same survey was +65, up from +61 for the 2018 financial year.

When customers with maturing savings balances in the year were surveyed 91% stated that they would 'probably' or 'definitely' consider taking out a replacement product with the Bank (2018: 90%) with a net promoter score at maturity of +53, up from +50 for the 2018 financial year. This performance is particularly valuable to the Group, given the benefits of customer and deposit retention.

The Bank's outsourced administration platform continues to meet its needs and provides a cost-effective, stable and scalable solution in the medium to long term. The Group has a close relationship with the service provider through which it seeks to enhance both its offerings and its customer service levels.

STRATEGIC REPORT (Continued)

The size and diversity of the Bank's deposit base is expected to continue to expand, forming the principal funding source for new lending activities. This will be driven through expanding distribution and developing the product range to serve additional customer groups. The guarantee provided by the FSCS scheme is likely to reduce the potential for an economic downturn to impact liquidity and the profile of the Group's target customers suggests that they are likely to be more resilient than average in such circumstances.

Overall, the savings proposition provides the Group with a stable funding platform, with a focus on term funding to manage interest rate risk and the ability to limit product availability to short periods of time, giving the funding channel flexibility and manageability. The additional routes to market enhance this flexibility.

CENTRAL BANK FACILITIES

The Bank has continued to make use of facilities offered by the Bank of England to support its lending to households and businesses. Its drawings under the Term Funding Scheme ('TFS') remain in place and provide £944.4 million of the Bank's funding (2018: £944.4 million), with all drawings remaining in place until at least 2021. The Bank also utilised the Indexed Long-Term Repo scheme ('ILTR') for six-month borrowings, with £50.0 million outstanding at the period end (2018: £80.0 million).

The Bank's liquidity drawdown under the Funding for Lending Scheme ('FLS'), which provides liquidity of £108.9 million (2018: £108.7 million) remained in place throughout the period. The terms of this facility are such that neither the drawing nor the liquidity provided appear on the Bank's balance sheet.

The Bank has also pre-positioned further mortgage loans and certain other assets with the Bank of England to act as collateral for further drawings on central bank funding lines, if and when required, providing access to liquidity of up to £1,095.0 million. It can also use the retained notes in recent securitisation transactions, which are externally rated, for this purpose.

The Bank will continue to utilise central bank facilities in future, subject to availability, as part of its integrated funding framework.

GROUP FACILITIES

The Bank is also funded by its parent entity, using equity and various forms of debt, including £150.0m Tier 2 Bond issuance which ensures that the capital structure of the Bank is similar to that of the Group as a whole, rather than consisting entirely of equity. Indebtedness to Group entities decreased in the year from £408.9 million at 30 September 2018 to £338.4 million at 30 September 2019.

DIVIDENDS AND DISTRIBUTIONS

During the year the Bank paid an interim dividend of £18.2 million (2018: £6.9 million). With a growing balance sheet and with a view to future growth opportunities the Bank did not declare a final dividend in respect of its earnings for the year to 2019. The Bank anticipates making a dividend payment in respect of its 2019 profit during the year ending 30 September 2020, subject to its anticipated capital requirements and its trading performance.

STRATEGIC REPORT (Continued)

REGULATORY CAPITAL

The Bank is subject to supervision by the PRA. As part of this supervision, the regulator will issue individual capital guidance setting an amount of regulatory capital, defined under the international Basel III rules, implemented through the Capital Requirements Regulation and Directive ('CRD IV'), which the Bank is required to hold relative to its risk weighted assets in order to safeguard depositors in the event of severe losses being incurred. For the Bank, these amounts are calculated by reference to the entity together with certain subsidiaries (together the 'Bank's regulatory group').

The Bank regulatory group maintains extremely strong capital and leverage ratios, with a total capital ratio of 16.1% at 30 September 2019 (2018: 16.7%), increased by the issue of Tier 2 capital to its parent, and a UK leverage ratio at 7.2% (2018: 6.4%) (note 7). The CET1 ratio, 13.8% at 30 September 2019, reduced during the period (2018: 14.2%), reflecting the growth in the balance sheet, acquisition of goodwill and distributions to shareholders.

The Bank's principal capital measures are set out below. It has been granted transitional relief on the adoption of IFRS 9, with the impact on capital being phased in over a five-year period, with only 5% of the effect being recognised in the first year. However, firms are also required to disclose capital measures as if the relief has not been given (referred to as the 'fully loaded' basis).

		2019	**2018**
		IFRS 9	**IAS 39**
		£m	**£m**
CET1 capital	Basic	977.21	881.29
	Fully loaded	956.76	881.29
Total Regulatory Capital ('TRC')	Basic	1,127.21	1,036.22
	Fully loaded	1,106.76	1,036.22

The Bank's CET1 capital comprises its equity shareholders' funds, adjusted as required by the CRD IV rules. TRC, in addition, includes tier 2 capital representing the Tier 2 Bonds. Additional tier 2 capital arising from credit loss allowances is no longer included in regulatory capital following the introduction of IFRS 9.

The Bank's capital requirements include the Pillar 1 + 2a amount which is specific to the Group and is set by the regulator. This may include both variable and fixed components. At 30 September 2019 this requirement was £727.0 million on the transitional basis and £725.9 million on the fully loaded basis (2018: IAS 39 £705.0 million), with the increased requirement principally driven by the growth in the Group's asset base.

The Bank's capital must also cover the CRD IV buffers, the Counter-Cyclical ('CCyB') and Capital Conservation ('CCoB') buffers. These apply to all firms and are based on a percentage of total risk exposure. These buffers were both increased in the period, with the CCoB increasing from 1.875%, to 2.500%, its long-term rate, from January 2019 and the CCyB increasing from 0.5% to 1.0%, from November 2018. These increases in standard CRD IV buffers have added over £73.9 million to the Banks's capital requirement. Further buffers may be set by the PRA on a firm-by-firm basis but may not be disclosed.

The Bank continues to maintain a healthy capital surplus, although this has been eroded by the 1.125 percentage point increase in the CRD IV buffers in the period and the introduction of IFRS 9.

STRATEGIC REPORT (Continued)

The Bank's capital ratios are set out below.

		2019 IFRS 9	2018 IAS 39
CET1 ratio	Basic	14.9%	14.2%
	Fully loaded	14.6%	14.2%
Total capital ratio	Basic	17.2%	16.7%
	Fully loaded	16.9%	16.7%
UK leverage ratio	Basic	7.2%	6.4%
	Fully loaded	7.1%	6.4%

Capital ratios remain largely in line with previous performance, with IFRS 9 transition not having a major impact.

During the year the Bank has undertaken a thorough review of the risk weightings applied to its assets for capital purposes, partly in response to market concerns across the sector. This exercise confirmed the weightings being applied under the Standardised Approach for credit risk ('SA') and the appropriateness of the Bank's risk weighted asset values and hence its capital measures.

The regulatory authorities in the UK and EU have also continued their work to put in place the December 2017 amendments to the Basel III capital adequacy regime, published in the BCBS document 'Basel III: Finalising post-crisis reforms'. This addresses both the SA for credit risk, presently used by the Bank and the Internal Ratings Basis ('IRB'), which is based on firms' own internal calculations and subject to supervisory approval.

These proposals are expected to increase capital requirements under the SA for a number of asset classes, including buy-to-let lending, and stricter parameters within which IRB approaches must operate. The Bank has monitored developments during the year and revised its capital strategy where necessary.

The Bank's project to develop an Internal Ratings Based ('IRB') approach to credit risk for capital adequacy purposes has continued throughout the year. A considerable amount of work has been completed, using both internal and external resources, generating system enhancements as well as progressing the application process. However, in September 2019 the PRA published a consultation paper (CP 21/19) which would enact significant new EBA regulations governing IRB techniques in the UK. At the same time the CP highlighted a need for firms applying for IRB accreditation to comply with certain future regulatory requirements where the authorisation process is expected to extend beyond 2020.

The Bank's models already reflect the most material requirements arising from the CP, however, whilst only a consultation at this stage, the Board has decided to ensure its IRB models are fully compliant with the requirements of the CP before delivering the first part of its the application to the PRA.

LIQUIDITY

The Bank's operational capital and funding requirements are also influenced by the need to retain sufficient liquidity in the business to meet its cash requirements in the short and long term, as well as to provide a buffer under stress. There is also a regulatory requirement to hold liquidity. The Board regularly reviews liquidity risk appetite and closely monitors a number of key internal and external measures. The most significant of these, which are calculated for the Bank's regulatory group on a basis which is standardised across the banking industry are set out below.

STRATEGIC REPORT (Continued)

Indicator	2019	2018	Regulatory minimum
LCR – Liquidity coverage ratio	138%	144%	100%
NSFR – Net stable funding requirement	115%	113%	100% ‡

‡Not yet a binding requirement

This shows the available liquidity at the year end to be well in excess of regulatory minimums.

FINANCIAL REVIEW

The Bank receives interest income from the assets on its own balance sheet but, also receives significant levels of dividends and other returns from its operating subsidiaries, reflected as other operating income in its income statement. Operating profits before tax for the Bank decreased to £107.0 million in 2019 (2018: £164.5 million).

	2019 Total £m	2018 Total £m
Interest receivable	247.4	177.1
Interest payable and similar charges	(136.2)	(98.2)
Net interest income	111.2	78.9
Other income	72.8	140.2
Total operating income	184.0	219.1
Operating expenses	(61.6)	(50.7)
Provisions for losses	(3.8)	(2.1)
	118.6	166.3
Fair value net losses	(11.6)	(1.8)
Operating profit being profit on ordinary activities before taxation	107.0	164.5
Tax charge on profit on ordinary activities	(9.8)	(8.1)
Profit on ordinary activities after taxation	97.2	156.4

Total operating income decreased to £184.0 million (2018: £219.1 million), principally as a result of less dividends declared in subsidiary entities. Due to a Group reorganisation in 2017 these subsidiaries did not declare any dividends in that year, as a consequence the dividends declared in 2018 represented two years earnings.

Net interest income increased by 40.9% to £111.2 million from the £78.9 million recorded in the year ended 30 September 2018. The increase principally reflects growth in the size of the average loan book, which rose by 29.6% to £5,018.4 million over the year (2018: £3,871.1 million).

Other operating income in 2019 included £68.7 million of dividends from subsidiary companies (2018: £135.0 million). Aside from this, fee income decreased to £4.1 million (2018: £5.2 million) reflecting the lending conducted during the year.

STRATEGIC REPORT (Continued)

Operating expenses increased to £61.6 million from £50.7 million reported in the previous year. The Board remains focussed on controlling operating costs through the application of rigorous budgeting and monitoring.

The Bank has applied IFRS 9 in calculating its provisions for impairment for the first time in the year. As prior year charges are not required to be restated, the 2019 charge is not strictly comparable to that for 2018. However, the charge of £3.82 million for loan impairment has increased by £1.69 million from for the previous year under IAS 39 (2018: £2.13 million). Careful management of all the Bank's loan books continues to be a strategic priority, for both retention and credit purposes. The credit performance of the books continues to be pleasing, with that of the buy-to-let book particularly strong, compared to market averages, with improvements in performance on acquired consumer portfolios year-on-year and credit metrics on the Bank's newer portfolios also strong and in line with expectations.

Yield curve movements during the period resulted in hedging instrument fair value net losses of £11.5 million (2018: £1.8 million net losses), which do not affect cash flow. The size of the movement in the period is mostly a result of market turbulence throughout the year, with the yield curve showing large fluctuations, primarily downwards, especially at month ends. Commentators have ascribed some of this to heightened political uncertainties in the UK over Brexit during the period, with these uncertainties carrying on into the new financial year.

This impacted particularly on the carrying values of swaps held for the purpose of hedging pipeline loan commitments, which cannot be included in a hedge for accounting purposes.

The fair value movements of hedged assets or liabilities are expected to be profit neutral over time, as these instruments will be held to maturity. As such, this item represents a timing difference. The Bank remains economically and appropriately hedged.

Corporation tax has been charged at the rate of 9.1%, increased from 4.9% for the previous year. This is a result of the inclusion of dividend income in the Bank's profit, which does not fall to be taxed in the company. Excluding the dividends, the effective rate increases to 25.6%, with the underlying rate of UK corporation tax applying to the Bank in the year, 19.0%, being increased by the 8.0% Bank Tax Surcharge for a proportion of the Bank's profits.

Profits after taxation of £97.2 million (2018: £156.4 million) have been transferred to consolidated equity, which totalled £786.1 million at the year end (2018: £709.3 million).

PRINCIPAL RISKS AND UNCERTAINTIES

An analysis of the Bank's exposure to risk, including financial risk, and the steps taken to mitigate these risks are set out on pages 15 to 25 and in notes 34 to 38. A discussion of critical accounting estimates is set out in note 44.

After considering the above, the Bank's liquidity and its access to funding facilities, the directors have a reasonable expectation that the Bank will have adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the Financial Statements.

OPERATIONS

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 Bank's activities. The Bank operates in accordance with group environment policies, which are described in the PBG's Annual Report, which does not form part of this Report.

EMPLOYEES

Following the group reorganisation in 2017, all employees of the Bank were transferred to another group company. The Group operates group-wide employment policies, which address diversity, employee involvement and employment of disabled persons, and these are discussed in the Annual Report of PBG.

Approved by the Board of Directors

and signed on behalf of the Board

RICHARD WOODMAN

Director

12 December 2019

PRINCIPAL RISKS AND MITIGATION

The Bank's system of risk management and governance is integrated with that of the wider Group. It is supervised by the Bank's Board of Directors, supported by its Audit Committee, Remuneration Committee and Risk and Compliance Committee. The work of the Risk and Compliance Committee is supported by its executive committees, including the Asset and Liability Committee ('ALCO'), the Conduct and Compliance Committee ('CCC'), the Credit Committee and the Operational Risk Committee ('ORC'). For each of these bodies, the membership is the same as for the equivalent bodies in PBG.

Further information on the risk framework of the Group is set out in the Annual Report and Accounts of PBG and its Pillar 3 report, which are available on its website at www.paragonbankinggroup.co.uk

Principal risks

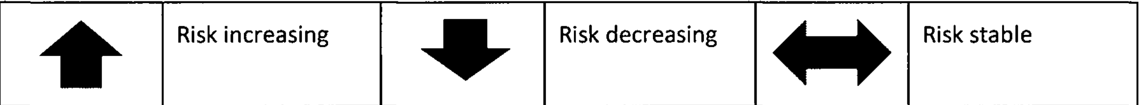
The Bank is exposed to a number of principal risks and uncertainties that arise from the operation of its business model and strategy. A summary of those risks and uncertainties which could prevent the achievement of the Bank's strategic objectives, how the Bank seeks to mitigate those risks and the change in the perceived level of each risk in the last financial year are described below.

This analysis represents the Bank's gross risk position as presented to, and discussed by, the Risk and Compliance Committee as part of its ongoing monitoring of the Bank's risk profile.

This summary should not be regarded as a complete statement of all potential risks and uncertainties faced by the Bank but rather those which the Bank believes have the potential to have a significant impact on its financial performance and future prospects.

To identify and control the risks to which it is exposed, the Group employs a risk management framework. As part of this framework, principal risks are identified and assessed within the key categories of Business Risk, Credit Risk, Conduct Risk, Operational Risk, Liquidity and Capital Risk and Market Risk.

The change in the perceived level of each risk in the last financial year is indicated using the symbols shown below:



PRINCIPAL RISKS AND MITIGATION (Continued)

<table>
<tr><th colspan="3">Business Risk</th></tr>
<tr><td colspan="3">Economic Risk</td></tr>
<tr><td>Description</td><td colspan="2">Mitigation</td></tr>
<tr><td>The potential for a deterioration in the UK's economic conditions is harder to forecast given the continuing material uncertainties as to the terms on which the UK will leave the EU.

Given that its income is wholly derived from activities within the UK, the Group could be materially affected by a severe downturn in the UK economy, which could reduce demand for the Group's loan products, increase the number of customers that default on their loans and cause security asset values to fall.</td><td colspan="2">The Bank closely monitors economic developments in the UK and overseas, with support from leading independent macro-economic advisors. This information supports the senior management's annual review of strategic objectives and business plans for each of the Bank's principal trading operations.

As a lender and acquirer of credit portfolios inevitably exposes the Bank to any material deterioration in economic conditions, the Board's defined strategy is to limit this risk by operating as a specialist lender in carefully chosen markets where its employees have significant levels of experience and expertise.

A robust stress testing framework is maintained which provides the Board with an informed understanding and appreciation of the Bank's capacity to withstand shocks of varying severities.</td></tr>
<tr><td>Change</td><td>Whilst UK economic performance has again been broadly stable in the last financial year, the near-term outlook has continued to remain uncertain given a lack of clarity as to the basis of the UK's withdrawal from and future relationship with the EU. This continuing uncertainty has led to the overall risk assessment being considered to have increased further in the last year.</td><td>⬆</td></tr>
</table>

PRINCIPAL RISKS AND MITIGATION (Continued)

<table>
<tr><td colspan="3">Concentration risk</td></tr>
<tr><th colspan="2">Description</th><th>Mitigation</th></tr>
<tr><td colspan="2">Lending to customers investing in the UK private rented sector forms a substantial part of the Group's advances and assets.

It is therefore exposed to any systemic deterioration in performance of the sector, which will be influenced by underlying factors such as house prices, supply of rental property, and demographic changes.

The buy-to-let sector has been subject to a high level of fiscal and regulatory intervention in recent years, where such changes make buy-to-let less attractive or viable to customers' businesses, the Group is exposed to adverse consequences.

Concentration risks may also arise within other business lines, affecting their performance.</td><td>The Group has a very deep understanding of the private rented sector built up over many years of successful operations in the buy-to-let market which is available to the Bank. This includes a long history of performance data through the economic cycle.

It seeks to use this expertise constructively by playing an active role through several routes, in shaping the development of policy for the private rented sector.

Given this deep specialist knowledge of the sector and its historically prudent approach to underwriting, the Bank has been well placed to respond promptly and effectively to recent regulatory changes relating to buy-to-let lending

The Bank also continues to exploit opportunities to diversify the range of its activities and income streams, consistent with its strategic objective of operating as a prudent, risk focussed specialist lender. This has been illustrated in recent years through acquisitions and diversification into new product areas.</td></tr>
<tr><td>Change</td><td>The Bank continues to have significant exposure to buy-to-let lending but, due to its specialist knowledge of the sector, it has been able to respond positively to regulatory changes in recent years. The Group's diversification strategy has also positioned it to reduce its reliance on this product line.

In the longer term, changes to the UK taxation regime and greater regulatory intervention in the sector may reduce demand and availability of buy-to-let lending products. However, the Bank continues to be confident in its ability to operate successfully in this evolving environment.</td><td>⟷</td></tr>
</table>

PRINCIPAL RISKS AND MITIGATION (Continued)

Transition risk		
Description	**Mitigation**	
The Bank has made a number of acquisitions in previous periods. While there have been no acquisitions in the current accounting period, any failure to manage effectively the transition and implementation risks resulting from previous material corporate acquisitions may impact adversely on the Bank's financial performance and its reputation.	The Group's M&A strategy is that it will only consider acquisitions in areas of business that it understands and which are complementary to its existing activities, including where applicable to the Bank. Extensive pre-acquisition due diligence is always undertaken with support from respected, high quality advisors. Formal governance arrangements are applied to any proposed acquisition and to subsequent integration projects, with regular progress reporting to the executive team and the Board. Where necessary, enhancements are made to the risk and control frameworks of acquired businesses to ensure these are aligned to those of the wider Group.	
Change	Ongoing integration activity has been successful and with no new acquisitions undertaken, transition risk has reduced.	⇩

Credit Risk

Customer Risk		
Description	**Mitigation**	
Failure to screen potential borrowers, underwrite and manage repayments effectively could expose the Bank to the risk of unexpected material losses. Recoverable amounts on loans may also be affected by adverse movements in security values such as house and commercial asset prices.	The Bank has comprehensive policies in place that set out detailed criteria which must be met before loans are approved. Credit policies incorporate limits for concentration risks arising from factors such as large exposures to counterparties, geographical areas or types of lending. The Bank uses a range of sources to inform expectations of key external factors such as interest rate movements and house price inflation which are in turn used to guide policy and underwriting. The Bank's approach to the management of credit risk and the systems in place to mitigate that risk on both originated and purchased assets are further described in note 36 to the accounts.	
Change	The Bank's impairment rate has remained very low, reflecting the maintenance of robust, proven credit disciplines, generally stable economic conditions and the credit quality of its borrowers. The potential for any credit deterioration due to changing economic conditions, particularly given current uncertainties regarding the UK's future relationship with the EU, is being monitored closely across all Group portfolios.	⇔

PRINCIPAL RISKS AND MITIGATION (Continued)

<table>
<tr><td colspan="3">Counterparty Risk</td></tr>
<tr><td colspan="2">Description</td><td>Mitigation</td></tr>
<tr><td colspan="2">The Bank is exposed to the failure of counterparties with which it places deposits, or which provide hedging agreements to mitigate interest rate and foreign exchange risk.</td><td>The Bank has a strictly controlled number of approved treasury counterparties. To be approved, counterparties must meet specific credit rating criteria.

Exposure to approved counterparties is monitored intra-day by senior management within the Treasury function with all trading performed within approved limits.

The credit quality of all treasury counterparties and the Bank's exposure to them is reported monthly to the Asset and Liability Committee ('ALCO').</td></tr>
<tr><td>Change</td><td>The credit quality of the treasury counterparties with whom the Bank transacts has been maintained during the year and this risk is therefore considered to be stable.</td><td></td></tr>
</table>

PRINCIPAL RISKS AND MITIGATION (Continued)

Conduct Risk

Customer Fair Outcomes

Description	Mitigation
The Bank provides a broad range of financial services products across a number of brands to consumers and small business customers. As a result, the Bank is exposed to potential conduct risk should it fail to deliver fair outcomes for its customers. Systemic poor customer treatment may lead to regulatory censure, reputational damage and resulting reductions in profitability.	The Bank has a formal Conduct Risk Management framework which includes a number of detailed policies and standards addressing the fair treatment of customers. At the centre of these is the Conduct Risk Policy, underpinned by additional policies and standards. This sets out the Bank's overarching approach to the management of conduct risk as part of a framework within which business areas are required to develop systems and processes to identify, measure, manage, monitor and report risks in accordance with stated risk appetites. The management of conduct risk within the Bank is tailored to the specific product and customer type concerned. Business areas dealing with consumers have dedicated quality and control teams which validate process adherence and the delivery of fair treatment for customers. This may also include a dedicated customer support team to manage customers deemed to be vulnerable. The Conduct and Compliance Committee ('CCC') has a remit which includes overseeing the fair treatment of customers. The CCC also receives items for review and / or approval, such as product governance submissions, conduct risk related policies and standards, business area incentive schemes, compliance monitoring outputs and regulatory communications. The Compliance function has a formal monitoring plan which is focussed on conduct risk and the fair treatment of customers, particularly those that are defined as vulnerable, or in financial difficulty. The plan is reviewed and approved on at least an annual basis by the RCC. Management actions to address any adverse compliance monitoring or Internal Audit reports are overseen at the CCC, ORC and RCC. The Group's approach to employee remuneration means that very few staff are included in financial incentive schemes. All schemes are required to be approved by the CCC before implementation and then reviewed by the CCC at least annually.

Change		
Change	The increasingly regulated nature of the Bank's operations and continuing changes to the regulatory conduct landscape heightens the potential risk.	⇧

PRINCIPAL RISKS AND MITIGATION (Continued)

Operational Risk

People Risk

Description	Mitigation
The Bank is exposed to the risk that the Group is unable to recruit and retain skilled senior management and key personnel at all levels. Failure to maintain the necessary skill base within the workforce could have a material impact on the Bank's ability to deliver its business plan and strategic objectives. This is a particular risk in respect of key specialist and executive positions, where the institutional knowledge of the incumbents would be hard to replicate in the short term.	The Bank manages and controls its key person dependency risk through effective succession planning, recruitment, development and retention strategies. External remuneration and reward structures are monitored to ensure it remains competitive and is able to recruit and retain key personnel. A range of employee benefits are offered on a Group basis, in addition to base salaries including a defined contribution pension scheme, Sharesave Plan and an annual profit related performance scheme for most employees. A Senior Leadership Development Programme and Manager and Team Leader Academies have been created to develop pools of strong, capable individuals with the potential to fill future managerial and specialist roles within the business. The Group has been accredited under the 'Investors in People' scheme since 1997 and has held Champion status in the scheme since May 2014. This accreditation is awarded to a very small proportion of organisations who are seen as pioneers in people management practices and role models in strategic leadership.

Change	A strong employment market and particularly buoyant demand for skilled financial services staff has again been a feature of the last financial year. This has led to continued strong competition to recruit and retain employees. Despite the increasingly competitive external environment, the Group remains confident in its ability to manage this risk.	⟺

PRINCIPAL RISKS AND MITIGATION (Continued)

<table>
<tr><td colspan="3">Systems Risk</td></tr>
<tr><td colspan="2">Description</td><td>Mitigation</td></tr>
<tr><td colspan="2">The Group is exposed to the risk that its IT infrastructure and systems are unable to support its operational needs.

This includes the risk that the Group's processes fail to offer adequate protection against the threat of cyber-crime.

Failure in Group IT systems, either in terms of capacity or security, however caused, could result in detriment to customers, regulatory censure and reputational damage, while failure to match market levels of functionality could have an adverse impact on business volumes. All of these factors could materially impact income and profitability.

This risk also includes the potential that the Group's key outsourcing arrangements with third parties could expose it to material loss or reputational damage.</td><td>The Group has a formally agreed IT strategy which ensures that priority is given to those areas which are most critical to the delivery of the Group's strategy and business plan. It maintains an ongoing programme of investment in IT infrastructure and systems. The Group also employs a robust vendor management process to select and monitor third party IT suppliers.

Over the last twelve months the Group has continued to invest in new technology and services to maintain and increase its defence in depth strategy to protect its operational capability. The implementation of a new Security Operations Centre service has added third party security expertise to support the Group's existing specialist resource.

A formal Cyber Incident Response Plan is in place to ensure the Group is well placed to deal with any issues or events. This is regularly reviewed and approved by the RCC.

There is ongoing focus on the information security management system (ISO27001:2005) to which the Group is certified, to ensure that controls, testing and user awareness are maintained and improved.

Change programmes are closely managed with robust control and testing processes to ensure that system developments meet operational requirements and are effectively implemented.</td></tr>
<tr><td>Change</td><td>The Group has continued to invest significantly in order to further enhance its operational resilience. However, the Group recognises that while it continues to develop, and maintain a secure IT infrastructure, the increased sophistication of cyber-crime attacks continues to be a significant risk for the business in common with the rest of the financial services sector.</td><td>⬆</td></tr>
</table>

PRINCIPAL RISKS AND MITIGATION (Continued)

<table>
<tr><th colspan="3">Regulatory Risk</th></tr>
<tr><th colspan="2">Description</th><th>Mitigation</th></tr>
<tr><td colspan="2">The Bank is exposed to the risk that its financial performance and reputation could suffer significantly if it fails to identify, interpret and comply with relevant regulatory and legal obligations.

The customers and market sectors to which the Bank supplies products, and the capital markets from which it obtains some of its funding, have been subject to increasing legislative and regulatory intervention over recent years.</td><td>The Group has Risk and Compliance and Legal teams who review key regulatory and legal developments to assess the impact on the Group's operations. These teams then work with business areas to provide advice on the implementation of appropriate measures to meet identified requirements. Expert external advice is also sought where necessary. Major regulatory or legal change initiatives are subject to formal change governance with progress reporting to the RCC.

All employees are required to undertake regulatory training and testing to ensure appropriate levels of competence are maintained. Those in relevant specialist roles are also required to adhere to formal regulatory training and competence regimes.

The Compliance and Financial Crime functions maintain formal second line monitoring plans. Progress against the plan and the issues identified within individual reviews are reported to the CCC and the RCC to ensure that regulatory requirements have been satisfactorily embedded, and any lessons learnt are applied across all relevant areas of the Group.

Similarly, the Financial Crime function provides independent oversight of business areas' adherence to anti-money laundering and financial crime requirements.

During 2018-19 key regulatory initiatives have included the focus on operational resilience and the impact of climate change. Work has commenced in both these areas and will develop during 2019-20 as further clarity is received around regulatory expectation.</td></tr>
<tr><td>Change</td><td>Whilst the Bank considers that it continues to have robust arrangements in place, the increasing scope and complexity of regulatory regimes heightens the potential risk arising from any failure to comply with current regulations or to respond effectively to new and emerging ones.</td><td>↑</td></tr>
</table>

PRINCIPAL RISKS AND MITIGATION (Continued)

<table>
<tr><th colspan="3">Liquidity and Capital Risk</th></tr>
<tr><td colspan="3">Funding Risk</td></tr>
<tr><th colspan="2">Description</th><th>Mitigation</th></tr>
<tr><td colspan="2">If the Bank's access to funding became restricted, either through market movements or regulatory intervention, this might result in the scaling back or cessation of some business lines.

Retail deposit taking is central to the Bank's funding and therefore changes in market conditions could impact the ability of the business to maintain the level of liquidity required to sustain normal business activity.</td><td>The Bank is authorised to accept retail deposits. As such, it is subject to regulation by the PRA, which aims to ensure that sufficient liquid assets are held, at all times, to mitigate the liquidity risk inherent in deposit taking

The Bank maintains a diversified range of both retail and wholesale medium and long term funding sources to cover future business requirements and liquidity to cover shorter term funding needs. The Bank remains well funded with sufficient liquidity to meet all its financial obligations as they fall due.

Internally, comprehensive treasury policies are in place to ensure sufficient liquid assets are maintained and that all financial obligations can be met as they fall due.</td></tr>
<tr><td>Change</td><td>The Bank remains well placed to access funding from a wide range of sources to meet its future funding requirements. Strong competition for retail deposits amongst challenger banks during the year means the overall risk is considered to have remained stable.</td><td></td></tr>
</table>

PRINCIPAL RISKS AND MITIGATION (Continued)

Capital Risk

Description	Mitigation
The changes made in the Basel III capital regime by the BCBS regarding minimum capital requirements from 2021 could impact on the Bank. The BCBS changes include increases in risk weights for residential real estate exposures where repayment is materially dependant on cash flows generated by the property, which may include certain categories of buy-to-let lending. The Bank's capital requirements would, therefore, be increased to some extent.	In order to further enhance its existing robust credit management capabilities and to mitigate the risks of the proposed BCBS changes, the Group took a strategic decision in 2016 to seek the necessary regulatory approval to implement an IRB approach for credit risk. In support of this, the Group appointed an experienced director of IRB to lead this initiative. A formal IRB project has since been initiated with support from respected external specialist advisors to enable the Group to commence its application process with the relevant regulatory authorities during the first half of the new financial year. The Group's IRB plan is well progressed, however a consultation paper produced in September 2019 highlighted a need for aspirant firms to comply with certain future regulations and requirements where the authorisation process extends beyond 2020. Whilst only a consultation at this stage, the Board has decided to ensure its IRB models are fully compliant with this requirement before making its first submissions to the PRA. The timing of the application will reflect the requirements of the Policy Statement that will result from the consultation process.

Change	During the year, the UK and European authorities developed their approach to the implementation of the Basel III changes. The impacts of their decisions were considered, and the proposed changes have been incorporated within the Group's IRB project. These developments did not change the Bank's assessment of the likely impact of these changes. Further information on the Bank's management of capital risk is given in note 34 to the accounts.	

PRINCIPAL RISKS AND MITIGATION (Continued)

Market Risk

Interest rate risk

Description	Mitigation
The Bank is exposed to the risk that changes in interest rates may adversely affect its net income and profitability. In particular, the Bank's profitability is determined by the difference between the interest rates at which it lends and those at which it borrows. Changes in market interest rates could therefore materially impact the Bank's profits as a result of significant mismatches between its assets and liabilities.	This risk is managed through Board approved risk appetite limits with comprehensive Treasury Polices in place to ensure that the risk posed by changes and mismatches in interest rates are effectively managed. The Board's risk management framework for Interest Rate Risk in the Banking Book ('IRRBB') has been enhanced over the last year to reflect the updated BCBS principles and methods expected to be used by banks for controlling such risks. Day-to-day management of interest rate risk within Board approved limits is the responsibility of Treasury with control and oversight provided by ALCO which reports to the RCC. The Bank seeks to match the structure of assets and liabilities by using appropriate financial instruments, such as interest rate swaps or cap agreements and fixed rate retail liabilities.

Change		
	The Bank's interest risk exposure profile, relative to its balance sheet has remained broadly similar and therefore associated risk levels remain generally stable compared to previous periods. The approach to managing the risks has, however, been enhanced to reflect the EBA's guidelines. Further information regarding the Bank's management of interest rate risk is given in note 38 to the accounts.	⟷

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 Bank PLC, a company registered in England and Wales with registration no: 05390593, for the year ended 30 September 2019.

DIRECTORS

The directors who served during the year and subsequently were:

Fiona J Clutterbuck

Nigel S Terrington

Richard J Woodman

John A Heron

Patrick J Newberry (resigned 31 December 2018)

Finlay F Williamson

Alan K Fletcher (resigned 31 December 2018)

Peter J Hartill

Barbara A Ridpath

Hugo R Tudor

Graeme H Yorston

The directors have no interests in the shares of the Bank. Their interest in the shares and securities of the parent company are set out in that company's accounts.

AUDITOR

The directors have taken all reasonable 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 is unaware.

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.

POLITICAL CONTRIBUTIONS

The Bank has not made any political donations or incurred and political expenditure during the year.

DIVIDENDS

An interim dividend of 3.3 pence per share was paid in the year (2018: 1.2 pence per share) and no final dividend is proposed (2018: nil).

DIRECTORS REPORT (Continued)

INFORMATION PRESENTED IN OTHER SECTIONS

Certain information required to be included in a directors' report by the Companies Act 2006 and regulations made there under 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.
- Information on events occurring after the balance sheet date is shown in note 17.
- 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 8 to the accounts.
- Information concerning the employment of disabled persons and the involvement of employees in the business is given in the strategic report.

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

RICHARD WOODMAN

Director

12 December 2019

STATEMENT OF DIRECTORS' RESPONSIBILITIES

in relation to Financial Statements

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

Company law requires the directors to prepare financial statements for the Bank in respect of each financial year. In respect of the financial statements for the year ended 30 September 2019, that law includes the Companies Act 2006 ('the Act'). As permitted by that law the directors have elected to prepare the accounts in accordance with International Financial Reporting Standards ('IFRS') as adopted by the European Union.

International Accounting Standard 1 – 'Presentation of Financial Statements' requires that financial statements present fairly for each financial year the Bank's financial position, financial performance and cash flows. This requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the International Accounting Standards Board's 'Framework for the Preparation and Presentation of Financial Statements'. In virtually all circumstances, a fair presentation will be achieved by compliance with all applicable IFRS.

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Bank and the Bank's profit or loss for the year. In preparing the financial statements the directors are also required to:

- select suitable accounting policies and apply them consistently
- make judgements and estimates that are reasonable, relevant and reliable
- state whether the financial statements have been prepared in accordance with the Act
- assess the ability of the Bank to continue as a going concern, disclosing, as applicable, matters related to going concern
- use the going concern basis of accounting unless they intend to liquidate the Bank or to cease operations or they have no realistic alternative to doing so
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information
- provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance

The directors are responsible for keeping proper accounting records for the Bank which disclose with reasonable accuracy at any time its financial position, for safeguarding the assets, for taking reasonable steps for the prevention and detection of fraud and other irregularities and for the preparation of a strategic report and directors' report which comply with the applicable requirements of the Act.

The directors are responsible for the maintenance and integrity of the Bank's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements differs from legislation in other jurisdictions.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

in relation to Financial Statements (continued)

Each of the current directors confirm that, to the best of their knowledge, the financial statements, prepared in accordance with International Financial Reporting Standards as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Bank.

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

RICHARD WOODMAN

Director

12 December 2019

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF PARAGON BANK PLC

1 Our opinion is unmodified

We have audited the financial statements of Paragon Bank PLC ("the Company") for the year ended 30 September 2019 which comprise the:

- Income Statement
- Balance Sheet
- Cash Flow Statement
- Statement of Movements in Equity
- Related notes, including the accounting policies in note 42, other than the disclosures labelled as unaudited in note 34.

In our opinion:

- the financial statements give a true and fair view of the state of the Company's affairs as at 30 September 2019 and of the Company's profit for the year then ended;
- the financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union (IFRSs as adopted by the EU); and
- the financial statements have been prepared in accordance with the provisions 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 9 February 2016. The period of total uninterrupted engagement is for the four financial years ended 30 September 2019. 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 public interest entities. No non-audit services prohibited by that standard were provided.

2 Key audit matters: including our assessment of risks of material misstatement

Key audit matters are those matters that, in our professional judgment, 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 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 AUDITOR'S REPORT TO THE MEMBERS OF PARAGON BANK PLC (CONTINUED)

<table>
<tr><th>Key audit matter</th><th>Our response</th></tr>
<tr><td>The impact of uncertainties due to the UK exiting the European Union on our audit

Risk vs 2018: ▲

Refer to the Strategic Report

Unprecedented levels of uncertainty

All audits assess and challenge the reasonableness of estimates, in particular as described in impairment allowances on loans to customers, interest receivable on loan accounts, below, and related disclosures and the appropriateness of the going concern basis of preparation of the financial statements (see below). All of these depend on assessments of the future economic environment and the Company's future prospects and performance.

Brexit is one of the most significant economic events for the UK and at the date of this report its effects are subject to unprecedented levels of uncertainty of outcomes, with the full range of possible effects unknown.</td><td>We developed a standardised firm-wide approach to the consideration of the uncertainties arising from Brexit in planning and performing our audits. Our procedures included:

• Our Brexit knowledge – We considered the directors' assessment of Brexit-related sources of risk for the Company's business and financial resources compared with our own understanding of the risks. We considered the directors' plans to take action to mitigate the risks.

• Sensitivity analysis – When addressing impairment allowances on loans to customers, interest receivable on loan accounts, and other areas that depend on forecasts, we compared the directors' analysis to our assessment of the full range of reasonably possible scenarios resulting from Brexit uncertainty and, where forecasts cash flows are required to be discounted, considered adjustments to discount rates for the level of remaining uncertainty.

• Assessing transparency – As well as assessing individual disclosures as part of our procedures on impairment allowances on loans to customers, interest receivable on loan account on our audit we considered all of the Brexit related disclosures together, including those in the strategic report, comparing the overall picture against our understanding of the risks.

Our results

As reported under Impairment allowances on loans to customers, interest receivable on loan accounts, we found the resulting estimates and related disclosures of Impairment allowances on loans to customers, interest receivable on loan accounts, and disclosures in relation to going concern to be acceptable. However, no audit should be expected to predict the unknowable factors or all possible future implications for a company and this is particularly the case in relation to Brexit.</td></tr>
<tr><td>Impairment allowances on loans to customers

Risk vs 2018: ▲

(£7.2 million; 2018: £5.4 million)

Refer to the accounting policy note and note 16 (financial disclosures).</td><td>Our audit procedures included:

— Controls testing: We performed end to end process walk-throughs to identify the key systems and controls used in the ECL processes. We tested the relevant general IT and applications controls over key systems used in the ECL process.</td></tr>
</table>

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF PARAGON BANK PLC (CONTINUED)

Subjective estimate

IFRS 9 was implemented by the Company on 1 October 2018. This new and complex standard requires the Company to recognise expected credit losses ('ECL') on financial instruments, which involves significant judgement and estimates and resulted in an increase in credit loss provisions. The quantum and timing of cashflows as well as the realisation rate are key assumptions in the provision calculation in that portfolio. The key areas where we identified greater levels of director judgement and therefore increased levels of audit focus in the Company's implementation of IFRS 9 are:

Economic scenarios – IFRS 9 requires the Company to measure ECLs on a forward-looking basis reflecting a range of future economic conditions. Significant management judgement is applied to determining the economic scenarios used and the probability weightings applied to its lending portfolios.

Significant Increase in Credit Risk ('SICR') – For the portfolios 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.

Model estimations – Inherently judgemental 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 therefore the most significant judgemental aspect of the Company's ECL modelling approach.

The effect of these matters is that, as part of our risk assessment, we determined that the impairment 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.

Disclosure quality

The disclosures regarding the Company's application of IFRS 9 are key to understanding the change from IAS 39 as well as explaining the key judgements and material inputs to the IFRS 9 ECL results.

— Test of details: Key aspects of our testing involved:

- Testing 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;

- Performing credit file reviews over individual loans in the Company's various loan portfolios on a risk assessed sample basis to assess the reasonableness of the ECL measured on certain loans; and

- Performing recalculations of the ECL measured on certain portfolios on a samples basis.

— 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 appropriateness of the Company's IFRS 9 models and key components.

— 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 also assessed key economic variables used which included agreeing samples of economic variables to external sources as well as 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 ECL impact of economic uncertainty, including Brexit.

— 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 was sufficiently clear.

Our results

The results of our testing were satisfactory and we considered the credit impairment charge, provision recognised and the related disclosures to be acceptable.

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF PARAGON BANK PLC (CONTINUED)

Interest receivable on loan accounts (£247.4 million; 2018: £177.1 million) Risk vs 2018: ◄► *Refer to the accounting policy note and note 3 (financial disclosures).* ***Subjective estimate*** 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 and estimated remaining collections ("ERCs") for acquired loan portfolios. *Originated assets:* 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 level 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 judgemental overlays by management. The cohorts of loans and advances which require the most judgement are buy-to-let products which were originated by the Company post-2010. *Acquired loan portfolios:* For the Company's acquired debt portfolio, the risk is that estimated future cash collections are not reflected by actual cash receipts. Given the nature of the Company's debt portfolios, estimation of future cash collections requires significant judgement to make assumptions about the value, probability and timing of expected future cash flows for each type of asset class within a portfolio. The effect of these matters is that, as part of our risk assessment, we determined that interest receivable on loan accounts has a high degree of estimation uncertainty, with a potential range of reasonable outcomes greater than our materiality for the financial statements as a whole, and possibly many times that amount. The financial statements disclose the sensitivities estimated by the Company.	Our procedures included: *Originated assets:* — 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 assessing the appropriateness of the cohort segmentation and the treatment of product switches; and — Sensitivity analysis: We performed sensitivity analysis over the repayment profiles by applying alternative profiles based upon the above procedures. *Acquired loan portfolios:* — Historical comparison: We critically assessed the Company's cash flow forecasts by comparing them to current and past performance of the Company's portfolios, including recent cash collections. *Both portfolios:* — Assessing transparency: We critically assessed the adequacy of the Company's disclosures about the sensitivity of the interest receivable on loan accounts to changes in key assumptions reflected in the inherent risk; and — Controls: We tested management review controls over the approval of the Company's repayment profiles; **Our results** We found the resulting estimate of interest receivable on loan accounts and the related disclosures to be acceptable (2018: acceptable).

Recoverability of investment in subsidiaries Risk vs 2018: ◄► (£422.7million; 2018: £342.7 million) *Refer to the accounting policy note and note 21 (financial disclosures).* ***Forecast based valuation*** The carrying amount of the Company's investments in subsidiaries are significant and the investment in each of the Bank's acquired businesses is at risk of recoverability due to changes in market factors since acquisition. The estimated recoverable amount of this balance is subjective due to the inherent uncertainty involved in forecasting future cash flows and deriving an appropriate discount rate to reflect the time value of money. In calculating the recoverable amount, the directors made assumptions over the following key inputs; profitability growth, the discount rate and the long-term growth rate	Our procedures included: — **Tests of detail:** We assessed the reasonableness of the carrying amount of each of the Bank's investments by comparing the Bank's cost of investment to the respective subsidiaries net asset position and/or the forecasted future cash flows that the subsidiary is expected to generate. **Our results** We found the resulting carrying amount of the investments in subsidiaries to be acceptable (2018: acceptable).

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 £4.9million (2018: £5.9million), determined with reference to a benchmark of Company profit before tax (of which it represents 4.5% (2018: 3.6%).

We agreed to report to the Audit Committee any corrected or uncorrected identified misstatements exceeding £0.24million, in addition to other identified misstatements that warranted reporting on qualitative grounds.

Our audit of the Company was undertaken to the materiality level specified above and was all performed at the Company's head office in Solihull.

4 We have nothing to report on 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 their 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 their 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").

Our responsibility is to conclude on the appropriateness of the Directors' conclusions and, had there been a material uncertainty related to going concern, to make reference to that in this audit report. 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 absence of reference to a material uncertainty in this auditor's report is not a guarantee that the Company will continue in operation.

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. The risks that we considered most likely to adversely affect the Company's available financial resources over this period were:

- availability of funding and liquidity in the event of a market wide stress scenario including the impact of Brexit, and
- impact on regulatory capital requirements in the event of an economic slowdown or recession.

As these were risks that could potentially cast significant doubt on the Company's ability to continue as a going concern, we considered sensitivities over the level of available financial resources indicated by the Company's financial forecasts taking account of reasonably possible (but not unrealistic) adverse effects that could arise from these risks individually and collectively and evaluated the achievability of the actions the Directors consider they would take to improve the position should the risks materialise.

Based on this work, we are required to report to you if we have anything material to add or draw attention to in relation to the directors' statement in Note 41 to the financial statements on the use of the going concern basis of accounting with no material uncertainties that may cast significant doubt over the Company's use of that basis for a period of at least twelve months from the date of approval of the financial statements.

We have nothing to report in this respect, and we did not identify going concern as a key audit matter.

5 We have nothing to report on the Strategic Report and the Directors' 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.

6 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 Company 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.

7 Respective responsibilities

Directors' responsibilities

As explained more fully in their statement set out in section B9, 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 other irregularities (see below), 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, other irregularities 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.

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF PARAGON BANK PLC (CONTINUED)

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

Irregularities – ability to detect

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 correspondence and discussed with the Directors and other management the policies and procedures regarding compliance with laws and regulations. We communicated identified laws and regulations throughout our team and remained alert to any indications of non-compliance throughout the audit.

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

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

Secondly, the Company is subject to many other laws and regulations where the consequences of non-compliance could have a material effect on amounts or disclosures in the financial statements, for instance through the imposition of fines or litigation or the loss of the Company's licence to operate. We identified the following areas as those most likely to have such an effect: regulatory capital and liquidity and certain aspects of company legislation recognising the financial and regulated 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.

Through these procedures, we became aware of actual or suspected non-compliance and considered the effect as part of our procedures on the related financial statement items. The identified actual or suspected non-compliance was not sufficiently significant to our audit to result in our response being identified as a key audit matter.

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 (irregularities) 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 irregularities, as these may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal controls. We are not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

8 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.

Simon Clark (Senior Statutory Auditor)

for and on behalf of KPMG LLP, Statutory Auditor

Chartered Accountants

One Snowhill
Snow Hill Queensway Birmingham
B4 6GH

12 December 2019

The Accounts

Showing the financial position, results and cash flows of the Company prepared in accordance with IFRS and UK law

INCOME STATEMENT
For the year ended 30 September 2019

	Note	2019 IFRS 9 £m	2018 IAS 39 £m
Interest receivable	4	247.38	177.08
Interest payable and similar charges	5	(136.23)	(98.20)
Net interest income		111.15	78.88
Other operating income	6	72.76	140.21
Total operating income		183.91	219.09
Operating expenses	7	(61.54)	(50.70)
Provisions for losses	16	(3.82)	(2.13)
Operating profit before fair value items		118.55	166.26
Fair value net losses	9	(11.54)	(1.75)
Operating profit being profit on ordinary activities before taxation		107.01	164.51
Tax charge on profit on ordinary activities	10	(9.79)	(8.08)
Profit on ordinary activities after taxation for the financial year		97.22	156.43

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

There were no other items of comprehensive income in the current or preceding years.

BALANCE SHEET
For the year ended 30 September 2019

	Note	2019 IFRS9 £m	2018 IAS 39 £m
Assets			
Cash – central banks	11	816.40	895.88
Cash – retail banks	11	20.83	21.67
Short term investments	12	-	-
Loans to customers	13	5,848.32	4,640.60
Derivative financial assets	18	9.72	22.40
Sundry assets	19	344.53	350.23
Deferred tax asset	20	2.51	-
Investment in subsidiary undertakings	21	1,598.65	1,558.08
Total assets		8,640.96	7,488.86
Liabilities			
Retail deposits	22	6,395.87	5,292.80
Derivative financial liabilities	18	72.30	4.30
Central bank facilities	23	994.40	1,024.40
Corporate bond	24	150.00	150.00
Sundry liabilities	25	229.37	299.51
Current tax liabilities	26	12.95	7.15
Deferred tax liabilities	20	-	1.37
Total liabilities		7,854.89	6,779.53
Called up share capital	27	552.62	552.62
Reserves	28	233.45	156.71
Total equity		786.07	709.33
Total liabilities and equity		8,640.96	7,488.86

Approved by the Board of Directors on 12 December 2019.

Signed on behalf of the Board of Directors

N S Terrington
Chief Executive

R J Woodman
Chief Financial Officer

CASH FLOW STATEMENT
For the year ended 30 September 2019

	Note	2019 £m	2018 £m
Net cash generated / (utilised) by operating activities	29	47.92	(29.83)
Net cash (utilised) by investing activities	30	(80.00)	-
Net cash (utilised) / generated by financing activities	31	(48.24)	317.49
Net (decrease) / increase in cash and cash equivalents		(80.32)	287.66
Opening cash and cash equivalents		917.55	629.89
Closing cash and cash equivalents		837.23	917.55
Represented by balances within:			
Cash	11	837.23	917.55
Short term bank borrowings		-	-
		837.23	917.55

STATEMENT OF MOVEMENTS IN EQUITY
For the year ended 30 September 2019

Year ended 30 September 2019	**Share capital**	**Profit and loss account**	**Total equity**
	£m	**£m**	**£m**
Transactions arising from			
Profit for the year	-	97.22	97.22
Other comprehensive income	-	-	-
Total comprehensive income	-	97.22	97.22
Transactions with owners			
Shares issued	-	-	-
Dividends paid	-	(18.24)	(18.24)
Net movement in equity in the year	-	78.98	78.98
Opening equity			
As previously reported	552.62	156.71	709.33
Change of accounting policy (note 41)	-	(2.24)	(2.24)
As restated	552.62	154.47	707.09
Closing equity	552.62	233.45	786.07

Year ended 30 September 2018	**Share capital**	**Profit and loss account**	**Total equity**
	£m	**£m**	**£m**
Transactions arising from			
Profit for the year	-	156.43	156.43
Other comprehensive income	-	-	-
Total comprehensive income	-	156.43	156.43
Transactions with owners			
Shares issued	-	-	-
Dividends paid	-	(6.91)	(6.91)
Net movement in equity in the year	-	149.52	149.52
Opening equity	552.62	7.19	559.81
Closing equity	552.62	156.71	709.33

NOTES TO THE ACCOUNTS
For the year ended 30 September 2019

1. GENERAL INFORMATION

Paragon Bank PLC is a company domiciled in the United Kingdom and incorporated in England and Wales under the Companies Act 2006 with company number 5390593. The address of the registered office is 51 Homer Road, Solihull, West Midlands, B91 3QJ. The nature of the Bank's operations and its principal activities are set out in the Strategic Report (not audited).

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

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

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

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

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. SEGMENTAL INFORMATION

The Bank is not currently obliged to provide information on operating segments in accordance with IFRS 8 as it has no listed debt or equity instruments.

All of the Bank's operations are conducted in the United Kingdom, all revenues arise from customers external to the Bank and the business is considered to represent a single segment. No customer contributes more than 10% of the revenue of the Bank, excluding dividends received from other Group companies.

Transactions with other Group entities are described in note 32.

3. REVENUE

	Note	2019 £m	2018 £m
Interest receivable	4	247.38	177.08
Other income	6	72.76	140.21
Total revenue		320.14	317.29

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

4. INTEREST RECEIVABLE

	2019 IFRS 9 £m	2018 IAS 39 £m
Interest receivable in respect of		
First mortgages	161.99	117.13
Secured consumer loans	16.25	17.21
Development finance	9.55	6.09
Finance leases	13.50	9.87
Other loans	4.38	0.65
Interest on loans to customers	205.67	150.95
Other interest receivable	15.70	3.98
Interest on group loan	23.16	21.91
Interest on investments	2.85	0.24
Total interest on financial assets	247.38	177.08

The above interest arises from:

	2019 IFRS 9 £m	2018 IAS 39 £m
Financial assets held at amortised cost	233.88	167.21
Finance leases	13.50	9.87
	247.38	177.08

5. INTEREST PAYABLE AND SIMILAR CHARGES

	2019 £m	2018 £m
On retail deposits	114.20	83.12
On bank loans and overdrafts	0.58	0.36
On corporate bonds	9.96	7.70
On central bank facilities	7.99	5.16
On intercompany loans	3.48	1.82
Total interest on financial liabilities	136.21	98.16
Other finance costs	0.02	0.04
Total interest payable and similar charges	136.23	98.20

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

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

6. OTHER INCOME

	2019 £m	2018 £m
Loan account fee income	4.06	5.21
Dividend income	68.70	135.00
	72.76	140.21

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

7. OPERATING EXPENSES

	Note	2019 £m	2018 £m
Auditor remuneration	8	0.39	0.22
Financial Services Compensation Scheme levy		0.73	0.57
Other administrative costs		60.42	49.91
		61.54	50.70

8. AUDITOR REMUNERATION

The analysis of fees payable to the Company's auditors (KPMG LLP) and their associates, excluding irrecoverable VAT, required by the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 is set out below.

	2019 £m	2018 £m
Audit fee of the company	0.39	0.22
Total fees	0.39	0.22
Irrecoverable VAT	-	-
Total cost to the Bank	0.39	0.22

Fees paid to the auditors and their associates for non-audit services to the Company are not disclosed because the consolidated accounts of the Group are required to disclose such fees on a consolidated basis.

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

9. FAIR VALUE NET LOSSES

	2019 £m	2018 £m
Ineffectiveness of fair value hedges (note 18)		
Portfolio hedges of interest rate risk		
Deposit hedge	(0.22)	0.21
Loan hedge	(5.57)	1.04
	(5.79)	1.25
Other hedging movements	(3.07)	0.25
Net losses on other derivatives	(2.68)	(3.25)
	(11.54)	(1.75)

The fair value net loss represents the accounting volatility on derivative instruments which are matching risk exposure on an economic basis generated by the requirements of IAS 39. Some accounting volatility arises on these items due to accounting ineffectiveness on designated hedges, or because hedge accounting has not been adopted or is not achievable on certain items. The losses and gains are primarily due to timing differences in income recognition between the derivative instruments and the economically hedged assets and liabilities. Such differences will reverse over time and have no impact on the cash flows of the Bank.

10. TAX CHARGE ON PROFIT ON ORDINARY ACTIVITIES

(a) Analysis of charge in the year

	2019 £m	2018 £m
Current tax		
UK Corporation Tax on profits of the period	12.53	6.56
Adjustment in respect of prior periods	0.39	0.75
Total current tax	12.92	7.31
Deferred tax	(3.13)	0.77
Tax charge on profit on ordinary activities	9.79	8.08

The current rate of corporation tax applicable to the Bank for the year ended 30 September 2019 was 19.0%, the rate in the year ending 30 September 2020 is expected to be 18.0% and the rate in subsequent years is expected to be 17.0%, based on currently enacted legislation.

The Bank's Corporation Tax Surcharge was introduced with effect from 1 January 2016. This subjects any taxable profits arising in the Bank to an additional 8.0% of tax to the extent these profits exceed £25.0m. The effect of the surcharge shown in note (c) below.

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

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

(b) Deferred tax credit for the year

The deferred tax credit in the income statement comprises the following temporary differences:

	2019 £m	2018 £m
Change in tax rate	(0.80)	0.41
Other timing differences	(2.36)	0.43
Deferred tax charge for the year	(3.16)	0.84
Prior period adjustment	0.03	(0.07)
Deferred tax charge (note 20)	(3.13)	0.77

The expected impact on deferred tax balances of the changes in the rate of Corporation Tax to 19.0% and 17.0% described above was initially accounted for when the changes in tax rates were enacted. In subsequent periods the tax rate at which temporary differences are expected to reverse is reassessed.

(c) Factors affecting tax charge for the year

Accounting standards require companies to explain the difference between the effective rate of tax in the accounts and the 'applicable rate', generally the domestic rate of tax levied on corporate income in the jurisdiction in which the entity operates.

The Bank operates wholly in the UK. At the current levels of profitability, it is considered appropriate to use the prevailing rate of corporation tax as the 'applicable rate' and to treat the impact of Banking Surcharge as an adjustment as shown below.

	2019 £m	2018 £m
Profit on ordinary activities before taxation	107.01	164.51
Profit on ordinary activities multiplied by the UK standard rate of corporation tax	20.33	31.25
Effects of:		
Non taxable income	(13.05)	(24.80)
Bank Corporation Tax Surcharge	2.89	0.95
Change of tax rate	(0.80)	-
Prior year charge	0.42	0.68
Tax charge for the year	9.79	8.08

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

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

(d) Factors affecting future tax charges

As practically all of the Bank's profit is subject to UK corporation tax the effective tax rate is expected to fall in line with the reductions in the standard rate described above.

The banking surcharge was introduced with effect from 1 January 2016. This subjects any taxable profits arising in the Bank to an additional 8% of tax to the extent they exceed £25.0m.

As a wholly based UK business the Bank does not expect to be significantly impacted by the OECD project on Base Erosion and Profit Shifting ('BEPS').

11. CASH AND CASH EQUIVALENTS

	2019 £m	2018 £m
Deposits with the Bank of England	816.40	895.88
Balances with central banks	816.40	895.88
Deposits with other banks	20.83	21.67
Cash and cash equivalents	837.23	917.55

'Cash and Cash Equivalents' includes current bank balances, money market placements and fixed rate sterling term deposits with London banks, and balances with the Bank of England.

Cash and cash equivalents are allocated to Stage 1 under the IFRS 9 impairment regime. The probabilities of default have been assessed to be so low as to require no significant impairment provision.

12. SHORT TERM INVESTMENTS

This amount represents fixed rate securities issued by the UK Government for which a liquid market exists, and which are held from time to time, as part of the liquidity requirement of Paragon Bank PLC.

No such securities were held at either 30 September 2019 or 30 September 2018, but the Bank held this type of investment during the year.

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

13. LOANS TO CUSTOMERS

	Note	2019 IFRS 9 £m	2018 IAS 39 £m
Loan accounts	14	5,100.47	4,398.81
Finance lease receivables	15	281.28	256.62
Loans to customers		5,381.75	4,655.43
Fair value adjustments from portfolio hedging		57.15	(23.05)
Investment in structured entities	17	409.42	8.22
		5,848.32	4,640.60

14. LOAN ACCOUNTS

Loan accounts at 30 September 2019, 1 October 2018 and 30 September 2018, which are all denominated and payable in sterling, were:

	2019 IFRS 9 £m	2018 IFRS 9 £m	2018 IAS 39 £m
First mortgage loans	4,636.12	3,959.83	3,961.53
Second charge mortgage loans	294.42	300.51	301.12
Development finance loans	81.93	97.06	97.45
Other secured commercial lending	88.00	38.71	38.71
	5,100.47	4,396.11	4,398.81

First mortgages are secured on residential property within the UK; second charge mortgage loans enjoy second charges on residential property.

Other secured commercial lending includes structured lending.

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

14. LOAN ACCOUNTS (CONTINUED)

The amounts of the loan assets above pledged as collateral under the central bank facilities described in note 23. The table also shows assets prepositioned with the Bank of England for use in future drawings.

	First Mortgages £m	Consumer Finance £m	Other £m	Total £m
30 September 2019 (IFRS 9)				
In respect of:				
Central bank facilities	1,484.49	-	-	1,484.49
Total pledged as collateral	1,484.49	-	-	1,484.49
Prepositioned with Bank of England	1,873.62	-	-	1,873.62
Other assets not pledged as collateral	1,278.01	294.42	169.93	1,742.36
	4,636.12	294.42	169.93	5,100.47
1 October 2018 (IFRS 9)				
In respect of:				
Central bank funding	1,670.06	-	-	1,670.06
Total pledged as collateral	1,670.06	-	-	1,670.06
Prepositioned with Bank of England	1,171.05	-	-	1,171.05
Other assets not pledged as collateral	1,118.72	300.51	135.77	1,555.00
	3,959.83	300.51	135.77	4,396.11
30 September 2018 (IAS 39)				
In respect of:				
Central bank funding	1,670.06	-	-	1,670.06
Total pledged as collateral	1,670.06	-	-	1,670.06
Prepositioned with Bank of England	1,171.05	-	-	1,171.05
Other assets not pledged as collateral	1,120.42	301.12	136.16	1,557.70
	3,961.53	301.12	136.16	4,398.81

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

15. FINANCE LEASE RECEIVABLES

The minimum lease payments due under these loan agreements are:

	2019 IFRS 9 £m	2018 IAS 39 £m
Amounts receivable		
Within one year	84.39	73.66
Within two to five years	213.68	198.59
After five years	25.27	20.75
	323.34	293.00
Less: future finance income	(38.42)	(33.82)
Present value	284.92	259.18

The present values of those payments, net of provisions for impairment, carried in the accounts are:

	2019 IFRS 9 £m	2018 IAS 39 £m
Amounts receivable		
Within one year	74.34	65.25
Within two to five years	188.31	175.58
After five years	22.27	18.35
Present value	284.92	259.18
Allowance for uncollectible amounts	(3.64)	(2.56)
Carrying value	281.28	256.62

None of the Bank's finance lease receivables were pledged as collateral for liabilities at 30 September 2019 or 30 September 2018.

16. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS

This note sets out information on the Bank's impairment provisioning under IFRS 9 for the loans to customers balances set out in note 13, including both finance leases, accounted for under IAS 17, and loans held at amortised cost, accounted for under IFRS 9, as both groups of assets are subject to the IFRS 9 impairment requirements.

The disclosures are set out under the following headings:

- Basis of provision
- Impairments by stage
- Movements in impairment provision in the period
- Impairments charged to income
- Economic inputs to provision calculations
- Sensitivity analysis

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').

Calculation of expected credit loss ('ECL')

For the majority of the Bank'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 Bank's most significant asset classes. The PD calculation is a function of current asset performance, customer information and future economic assumptions. The structure of the models was derived through analysis of correlation in historic data, which identified which current and historical customer attributes and external economic variables were predictive of future loss. PD measures are calculated for the full contractual lives of loans with the models deriving probabilities that, at a given future date, a loan will be in default, performing or closed. The Bank 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 Bank's potential case management activities. This evaluation includes the potential impact of economic conditions at the time of any future default or enforcement. The derivation of the significant assumptions used in these calculations is discussed below.

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

16. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

In certain asset classes a fully modelled approach is not possible. This is generally where there are few assets in the class, where there is insufficient historical data on which to base an analysis or where certain measures, such as days past due are not useful (e.g. where the loan agreement does not require regular payments of pre-determined amounts). In these cases, which represent a small proportion of the total portfolio, alternative approaches are adopted. These rely on internal credit monitoring practices and professional credit judgement.

Notwithstanding the mechanical procedures discussed above, the Bank will always consider whether the process generates sufficient provision for particular loans, especially large exposures, and will provide additional amounts as appropriate.

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

The Bank uses arrears multiples as a proxy for days past due, as this measure is commonly used in its arrears reporting. A loan will generally be one month in arrears from the point it is one day past due until it is thirty days past due.

Definitions of default

As the IFRS 9 definition of ECL is based on PD, default must be defined for this purpose. The Bank'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 Bank'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
For the year ended 30 September 2019

16. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (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 Bank'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 backward-looking definition, rather than one based on future expectations.

Credit impaired assets are identified either through quantitative measures or by operational status. Designations of accounts for regulatory capital purposes are also taken into account. Assets may also be assigned to Stage 3 if they are identified as credit impaired as a result of management review processes.

All loans which are in the process of enforcement, from the point where this becomes the administration strategy, are classified as credit impaired.

In order to harmonise IFRS 9 definitions with those used for regulatory purposes all default cases are considered to be credit impaired, including all receiver of rent cases and all cases with at least one payment more than ninety days overdue, even where such cases are being managed in the expectation of realising all of the carrying balance. In order to provide better information for users, additional analysis of credit impaired accounts has been presented below distinguishing between receiver of rent account, accounts subject to realisation / enforcement procedures and long term managed accounts, all of which are treated as credit impaired.

IFRS 9 Staging

IFRS 9 calculations and related disclosures require loan assets to be divided into three stages, with accounts which were credit impaired on initial recognition representing a fourth class.

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

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

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

16. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Impairments by stage

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

	Stage 1	Stage 2 *	Stage 3 *	POCI	Total
	£m	£m	£m	£m	£m
30 September 2019					
Gross loan book	5,251.65	112.67	24.64	-	5,388.96
Impairment provision	(2.37)	(0.82)	(4.02)	-	(7.21)
Net loan book	5,249.28	111.85	20.62	-	5,381.75
Coverage ratio	0.04%	0.73%	16.31%	-	0.13%

	Stage 1	Stage 2 *	Stage 3 *	POCI	Total
	£m	£m	£m	£m	£m
1 October 2018					
Gross loan book					
Gross loan book	4,567.66	66.79	26.37	-	4,660.82
Impairment provision	(1.31)	(0.54)	(3.54)	-	(5.39)
Net loan book	4,566.35	66.25	22.83	-	4,655.43
Coverage ratio	0.03%	0.81%	13.42%	-	0.12%

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

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

16. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Finance leases included above, analysed by staging, were:

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
30 September 2019					
Gross loan book	272.07	10.39	2.46	-	284.92
Impairment provision	(1.73)	(0.39)	(1.52)	-	(3.64)
Net loan book	270.34	10.00	0.94	-	281.28
1 October 2018					
Gross loan book	251.33	5.26	1.61	-	258.20
Impairment provision	(1.02)	(0.15)	(0.70)	-	(1.87)
Net loan book	250.31	5.11	0.91	-	256.33

In terms of the Bank'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.

Legacy assets and acquired loans which were performing on acquisition are included in the staging analysis above.

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

16. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Analysis of Stage 2 loans

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

	< 1 month arrears	> 1 <= 3 months arrears	Total
	£m	£m	£m
30 September 2019			
Gross loan book	98.58	14.09	112.67
Impairment provision	(0.52)	(0.30)	(0.82)
Net loan book	98.06	13.79	111.85
Coverage ratio	0.53%	2.13%	0.73%

	< 1 month arrears	> 1 <= 3 months arrears	Total
	£m	£m	£m
1 October 2018			
Gross loan book	48.98	17.81	66.79
Impairment provision	(0.24)	(0.30)	(0.54)
Net loan book	48.74	17.51	66.25
Coverage ratio	0.49%	1.68%	0.81%

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

16. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Analysis of Stage 3 loans

The table below analyses the accounts in Stage 3 between accounts in the process of enforcement or where full recovery is considered unlikely ('Realisations' in the table), loans being managed on a long term basis where full recovery is possible but which are considered in default for regulatory purposes and buy-to-let mortgages where a receiver of rent ('RoR') has been appointed by the Bank to manage the property on the customer's behalf. RoR accounts in Stage 3 may be fully up-to-date with full recovery possible. These accounts are included in Stage 3 as they are classified as defaulted for regulatory purposes.

	> 3 month arrears £m	RoR managed £m	Realisations £m	Total £m
30 September 2019				
Gross loan book	10.78	9.76	4.10	24.64
Impairment provision	(0.78)	(1.15)	(2.09)	(4.02)
Net loan book	10.00	8.61	2.01	20.62
Coverage ratio	7.23%	11.78%	50.98%	16.31%

	> 3 month arrears £m	RoR managed £m	Realisations £m	Total £m
1 October 2018				
Gross loan book	15.01	9.08	2.28	26.37
Impairment provision	(1.06)	(1.86)	(0.62)	(3.54)
Net loan book	13.95	7.22	1.66	22.83
Coverage ratio	7.06%	20.48%	27.19%	13.42%

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

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

16. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

	2019 IFRS 9 £m	2018 IFRS 9 £m
First mortgages	6.80	6.28
Second mortgages	4.72	5.94
Motor finance	0.97	0.93
	12.49	13.15

The RoR managed accounts are being managed to ensure the optimal resolution for landlords, tenants and lenders and this long-term, stable situation underpinned their treatment as not impaired under IAS 39, but the existence of the RoR arrangement causes the accounts to be treated as defaulted for regulatory purposes. The Bank's RoR arrangements are described in more detail below.

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

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

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

	30 September 2019		1 October 2018	
	No.	£m	No.	£m
Managed accounts				
Appointment date				
2010 and earlier	27	4.36	29	4.78
2011 to 2013	7	2.07	10	2.74
2014 to 2016	1	0.14	1	0.14
2016 and later	24	3.19	17	1.42
Total managed accounts	59	9.76	57	9.08
Accounts in the process of realisation	9	1.79	15	1.51
	68	11.55	72	10.59

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

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

16. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Movements in impairment provision by stage

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

	Total £m
At transition – 1 October 2018	5.39
Provided in period	3.30
Amounts written off	(1.48)
At 30 September 2019	7.21

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 2019 enforceable contractual balances of £2.44m were outstanding on non-POCI assets written off in the period. This will exclude those accounts where a full and final settlement was agreed and those where the contractual terms do not permit any further action. Enforceable balances will be kept under review for operational purposes but no amounts will be recognised in respect of such accounts unless further cash is received or there is a strong expectation that it will be.

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

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Loss allowance at 1 October 2018	1.31	0.54	3.54	-	5.39
New assets originated or purchased	0.78	-	-	-	0.78
Changes in loss allowance					
Transfer to stage 1	0.18	(0.16)	(0.02)	-	-
Transfer to stage 2	(0.20)	0.25	(0.05)	-	-
Transfer to stage 3	(0.37)	(0.15)	0.52	-	-
Changes due to credit risk	0.32	0.32	2.88	-	3.52
Write offs	-	-	(1.48)	-	(1.48)
PM26 Sale	-	-	-	-	-
Changes in models/parameters	0.35	0.02	(1.37)	-	(1.00)
Loss allowance at 30 September 2019	2.37	0.82	4.02	-	7.21

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

16. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Balances at 1 October 2018	4,567.66	66.79	26.37	-	4,660.82
New assets originated or purchased	1,748.69	-	-	-	1,748.69
Changes in staging					
Transfer to stage 1	21.31	(20.95)	(0.36)	-	-
Transfer to stage 2	(65.97)	67.59	(1.62)	-	-
Transfer to stage 3	(14.24)	(4.54)	18.78	-	-
Redemptions and repayments	(543.97)	(9.10)	(13.00)	-	(566.07)
Sale to PM26	(469.56)	-	-	-	(469.56)
Write offs	-	-	(1.48)	-	(1.48)
Other changes	7.73	12.88	(4.05)	-	16.56
Balance at 30 September 2019	5,251.65	112.67	24.64	-	5,388.96
Loss allowance	(2.37)	(0.82)	(4.02)	-	(7.21)
Carrying value	5,249.28	111.85	20.62	-	5,381.75

Impairments charged to income

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

	2019 IFRS 9 £m	2018 IAS 39 £m
Provided in period	3.30	1.78
Recovery of written off amounts	0.52	0.35
	3.82	2.13
Of which		
Loan accounts	0.60	0.60
Finance leases	3.22	1.53
	3.82	2.13

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 Bank uses four distinct economic scenarios chosen to represent the range of possible outcomes and allow for the impact of economic asymmetry in the calculations.

16. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

In developing its economic scenarios, the Bank 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 outlook in the central scenario at 30 September 2019 is broadly similar to that a year earlier, although both the forecast level of bank rates and consumer lending growth are reduced, reflecting a more pessimistic economic outlook. However, the house price growth forecast over the five year period is a little stronger

The central scenario is the economic forecast used within the Bank for planning purposes and represents its expectation of the most likely outcome. The upside and downside scenarios are less likely variants developed from this base case. The final scenario represents a protracted slump and is derived from the Bank of England's annual stress testing scenarios. Each scenario comprises a number of economic parameters and while models for different portfolios may not use all of the variables, the set, as a whole, is defined for the Bank and must be consistent.

The Bank defines its upside and downside scenarios by reference to the central scenario. It is therefore necessary for management to consider the relative weightings that should apply to each of these scenarios when ECLs are calculated. At 30 September 2019, the directors considered the movements already reflected in the scenarios and the levels of uncertainty in the UK political and economic climate more generally and concluded that, while the central scenario still provided an appropriate basis for planning purposes, the downside risks had increased over the twelve months. The directors therefore determined that the weighting attributed to the downside scenario should be increased, and that to the upside scenario reduced.

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 2019

	Central scenario	**Upside scenario**	**Downside scenario**	**Severe downside scenario**
Weighting applied	*40%*	*20%*	*35%*	*5%*
Economic driver				
Gross Domestic Product ('GDP') (increase)	1.7%	2.2%	1.0	(0.1)%
House Price Index ('HPI') (increase)	3.3%	5.5%	(0.1)%	(5.3)%
Bank Base Rate ('BBR')	0.8%	1.9%	0.5%	0.0%
Consumer Price Inflation ('CPI')	2.1%	1.8%	2.5%	3.1%
Unemployment (rate)	3.9%	3.5%	5.6%	8.0%
Secured lending (annual change)	3.6%	4.2%	2.7%	1.4%
Consumer credit (annual change)	6.1%	7.6%	3.8%	0.3%

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16. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

1 October 2018

	Central scenario	Upside scenario	Downside scenario	Severe downside scenario
Weighting applied	*40%*	*30%*	*25%*	*5%*
Economic driver				
Gross Domestic Product ('GDP') (increase)	1.6%	2.0%	0.9%	(0.1)%
House Price Index ('HPI') (increase)	3.0%	5.1%	(0.3)%	(5.2)%
Bank Base Rate ('BBR')	1.2%	1.7%	0.7%	0.0%
Consumer Price Inflation ('CPI')	2.1%	1.8%	2.6%	3.3%
Unemployment (rate)	3.9%	3.6%	5.7%	8.3%
Secured lending (annual change)	3.2%	3.6%	2.5%	1.5%
Consumer credit (annual change)	8.6%	10.5%	5.3%	0.6%

Sensitivity

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

Economic conditions

If the weightings of the economic scenarios were altered to weight the upside scenario at 10%, the Central scenario at 40%, the downside scenario at 45% and the severe downside at 5%, the effect would be to increase buy-to-let provisions, the most significant part of the impairment provision by £0.10m, from £2.27m to £2.37m.

Significant increase in credit risk

The most important driver of SICR is relative PD. If all PDs were increased by 10%, loans with a gross value of £0.81m would transfer from stage 1 to stage 2, and the total provision would increase by £0.07m from the effects of higher expected losses and the impact of providing for expected lifetime losses, rather than 12-month losses on the additional stage 2 cases.

Value of security

The principal assumptions impacting on loss given default are the estimated security values. If the rate of growth in house prices assumed by the model were halved, ignoring any PD effects, then the provision for the Group's first and second mortgages assets under the central scenario would increase by £0.54m.

Superseded disclosures

Further information relating to comparative disclosures under IAS 39 which are no longer relevant under IFRS 9 is included in note 33.

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17. INVESTMENT IN STRUCTURED ENTITIES

Investments in structured entities represent the Bank's investment in publicly traded, asset backed floating rate notes originally issued by Paragon Mortgages (No. 14) PLC, Paragon Mortgages (No. 25) PLC and Paragon Mortgages (No. 26) PLC, special purpose vehicle ('SPV'). In addition debt issued by Paragon Second Funding Limited was also acquired by the Bank during the year. These companies were established and controlled by entities in common control with the Bank to purchase pools of loan assets.

As Paragon Mortgages (No. 14) PLC, Paragon Mortgages (No. 25) PLC, Paragon Mortgages (No. 26) PLC and Paragon Second Funding Limited are controlled by Paragon Banking Group PLC, the Bank's ultimate parent, these entities are considered to be related parties of the Bank.

These investments are denominated in sterling and are considered to be debt investments as defined by IFRS. The underlying assets are mortgage loans made to United Kingdom borrowers. The Bank is under no obligation to make any contribution to the SPV and its maximum loss is limited to the carrying value of its investment.

The Investments consist of notes issued by SPV's which are AAA rated (or equivalent) by external agencies and participation in a syndicated debt issued by a Group entity that is rated A2 by Moody's. Given these ratings they are included in stage 1 for IFRS 9 purposes and the PD is considered to be so low that any expected loss would be immaterial.

The movements in the Bank's investment in structured entities in the year ended 30 September 2019 and the year ended 30 September 2018 were:

	2019 £m	2018 £m
Cost		
At 1 October 2018	8.22	9.02
Additions	412.22	-
Effective Interest Rate ('EIR') income	0.58	0.24
Payments received	(11.60)	(1.04)
At 30 September 2019	409.42	8.22

£1.06m (2018: £0.00m) is included in Sundry Assets (note 19) in respect of accrued interest on these Notes at the year end.

After the year end, on 11 December 2019, the Bank acquired a further £77.50m of Paragon Second Funding Limited debt for a consideration of £72.07m.

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For the year ended 30 September 2019

18. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING

Introduction

The Bank uses derivative financial instruments such as interest rate swaps for risk management purposes only. Each such derivative contract is entered into for economic hedging purposes to manage a particular identified risk (as described in notes 35 to 39) and any gains or losses arising are incidental to this objective. No trading in derivative financial instruments is undertaken.

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 Bank's hedging arrangements are fair value hedges of portfolio interest rate risk, which are used to manage the interest rate basis risk inherent in fixed rate lending and deposit taking.

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

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

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

18. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

The analysis below splits derivatives between those accounted for within portfolio fair value hedges and those which, despite representing an economic hedge, are not accounted for as hedges. There were no individual interest rate risk or cashflow hedging arrangements in place either in the year ended 30 September 2019 or the preceding year.

	2019 Assets £m	2019 Liabilities £m	2018 Assets £m	2018 Liabilities £m
Derivatives in accounting hedge relationships				
Fair value hedges				
Interest rate swaps				
Fixed to floating	0.18	(70.18)	18.59	(0.67)
Floating to fixed	7.62	(0.13)	1.90	(3.39)
	7.80	(70.31)	20.49	(4.06)
Total derivatives in accounting hedge relationships	7.80	(70.31)	20.49	(4.06)
Other derivatives				
Interest rate swaps	1.88	(1.99)	1.91	(0.18)
Currency futures	0.04	-	-	(0.06)
Total recognised derivative assets/(liabilities)	9.72	(72.30)	22.40	(4.30)

The credit risk inherent in the derivative financial assets shown above is discussed in note 36.

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

18. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

a) Fair value hedges

Background and hedging objectives

The Bank'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 and deposit taking activities. These activities would expose the Bank to movement in market interest rates if not hedged.

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 Bank 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 Bank's interest rate risk management process, described in note 38. In order to manage these exposures, they are hedged with financial derivatives and form part of the Bank'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.

This policy creates two macro hedges:

- The '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 'deposit hedge' matching fixed rate deposits with interest rate swaps which operates in the opposite direction, converting the fixed rate interest payable to floating rate amounts.

The Bank is in the process of changing the principal sterling reference rate used in its interest rate risk management framework from LIBOR to SONIA.

18. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

Where fixed rate assets or liabilities have been hedged with interest rate swaps, these currently mostly reference three-month LIBOR. As the Bank transitions away from LIBOR it is expected that all new hedging will eventually reference SONIA. For existing swaps referencing LIBOR that have a maturity beyond December 2021 (the date LIBOR is expected to become unavailable), the Bank is closely following developments. The International Swaps and Derivative Association ('ISDA'), the trade organisation for derivatives, are consulting in developing fall backs and revisions to documentation that counterparties can sign to transition to SONIA. The proposals are expected to be finalised by calendar year-end, with implementation in 2020.

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 Bank 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.

Ineffectiveness

The Bank has identified the following possible sources of hedge ineffectiveness in its portfolio hedges of interest rate risk:

- The maturity profile of the hedging instruments may not exactly match that of the hedged items, particularly where hedged items settle early.
- The use of derivatives as a hedge of interest rate additionally exposes the Bank to the derivative counterparties' credit risk, which is not matched in the hedged item. This risk is minimised by transacting only with high quality counterparties and through collateralisation arrangements (as described in note 36).
- The use of different discounting curves in measuring fair value changes in the hedged items and hedging instruments.
- Difference in the timing of interest payments on the hedged items and settlements on the hedging instruments.

These sources of ineffectiveness are minimised by the portfolio matching process, which seeks to match the terms of the items as closely as possible.

In addition to the hedging ineffectiveness described above, group profit will also be affected by the fair value movements of interest rate swap agreements which were entered in to as part of the Bank's interest rate risk hedging strategy, but failed to find a match in the hedging portfolio.

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

18. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

Hedging Instruments

The hedging portfolios at 30 September 2019 and 30 September 2018 consist of a large number of sterling denominated swaps. Settlement on all swaps is generally 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 a reference rate, LIBOR or SONIA.

The Bank pays fixed rate and receives floating when hedging exposures from fixed rate assets (in the loan hedge). Conversely, the Bank pays floating rate and receives fixed rate when hedging fixed rate deposits, in the deposit hedge.

The principal terms of the hedging instruments are set out below, analysed between the two directions of the swap.

	2019		2018	
	Deposit Hedge	Loan hedge	Deposit Hedge	Loan Hedge
Average fixed notional interest rate	0.83%	1.08%	0.75%	1.04%
Average notional margin over LIBOR	-	-	-	-
Average notional margin over SONIA	-	-	-	-
	£m	£m	£m	£m
Notional principal value				
LIBOR swaps	1,619.00	3,681.27	1,592.50	2,482.10
SONIA swaps	-	-	-	-
	1,619.00	3,681.27	1,592.50	2,482.10
Maturing				
Within one year	805.50	316.57	1,412.00	404.10
Between one and two years	449.50	420.25	80.50	174.05
Between two and five years	364.00	2,773.45	100.00	1,903.95
More than 5 years	-	171.00	-	-
	1,619.00	3,681.27	1,592.50	2,482.10
Fair value	7.49	(69.99)	(1.49)	17.92

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

18. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

Accounting impacts

Movements affecting the portfolio fair value hedges during the year are set out below.

	2019		2018	
	Deposit Hedge £m	Loan Hedge £m	Deposit Hedge £m	Loan Hedge £m
Hedging items				
Interest rate swaps				
Included in derivative financial assets	7.62	0.18	1.90	18.59
Included in derivative financial liabilities	(0.13)	(70.17)	(3.39)	(0.67)
	7.49	(69.99)	(1.49)	17.92
Notional principal value	1,619.00	3,681.27	1,592.50	2,482.10
Change in fair value used in calculating hedge ineffectiveness	7.88	(87.31)	(0.42)	11.86

	2019		2018	
	Deposit Hedge £m	Loan Hedge £m	Deposit Hedge £m	Loan Hedge £m
Hedged items				
Fixed rate deposits				
Monetary amount of risk relating to Retail Deposits	1,473.70	-	1,446.70	-
Fixed rate loans				
Monetary amount of risk relating to Loans to Customers	-	3,750.03	-	2,463.65
Accumulated amount of fair value hedge adjustments included on balance sheet (notes 13 and 22) *	(3.92)	65.55	4.18	(16.19)
Of which: amounts related to discontinued hedging relationships being amortised	-	(8.43)	(0.41)	(6.87)
Change in fair value used in recognising hedge ineffectiveness	(8.10)	81.74	0.63	(10.82)
Hedge ineffectiveness recognised				
Included in fair value gains/losses in the profit and loss account	(0.22)	(5.57)	0.21	1.04

* Under the IAS 39 rules relating to fair value hedge accounting for portfolios of interest rate risk, the change in the fair value of the hedged items attributable to the hedged risk is shown as 'fair value adjustments from portfolio hedging' next to the carrying value of the hedged assets or liabilities in the appropriate note.

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

18. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

b) Derivatives not in a hedging relationship

The Bank's other derivatives comprise:

- Interest rate swaps which are economically part of the Bank'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
- Currency futures, economically hedging exposures on lending denominated in currency, where hedge accounting has not been adopted due to the size of the exposure

The principal terms of these derivatives are set out below.

Interest rate swaps

	2019		2018	
	Pay fixed	**Pay floating**	**Pay fixed**	**Pay floating**
Average fixed notional interest rate	0.76%	0.77%	0.99%	0.80%
Average notional margin over LIBOR	-	-	-	-
Average notional margin over SONIA	-	-	-	-
	£m	**£m**	**£m**	**£m**
Notional principal value				
LIBOR swaps	268.10	554.00	370.60	362.00
SONIA swaps	-	8.00	-	8.00
	268.10	562.00	370.60	370.00
Maturing				
Within one year	33.50	424.00	151.50	359.00
Between one and two years	35.00	95.00	31.00	11.00
Between two and five years	88.60	43.00	182.60	-
More than 5 years	111.00	-	5.50	-
	268.10	562.00	370.60	370.00
Fair value	1.87	(1.99)	1.26	0.49

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

18. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

Currency futures

	2019	2018
US *Dollar* futures		
Average future exchange rate	1.22	1.32
	£m	£m
Notional principal value	5.74	5.86
Maturing		
Within one year	5.74	5.86
Between one and two years	-	-
Between two and five years	-	-
	5.74	5.86
Fair value	0.04	(0.06)

19. SUNDRY ASSETS

	Note	2019 £m	2018 £m
Current assets			
Amounts owed by Group companies		258.90	339.89
Accrued interest income		1.30	0.44
CSA assets		72.14	3.70
CRDs		11.36	6.20
Other receivables		0.83	-
Sundry financial assets	45	344.53	350.23

Cash ratio deposits ('CRDs') are non-interest-bearing deposits lodged with the Bank of England, based on the value of the Bank's eligible liabilities. These are required to comply with regulatory rules.

Credit Support Annex ('CSA') assets are deposits placed with highly rated banks to act as security for the Bank's derivative financial liabilities.

Neither of these balances is accessible by the Bank at the balance sheet date. Therefore, they are included in sundry assets rather than cash balances.

CRD, CSA and accrued interest are considered to be stage 1 assets for IFRS 9 impairment purposes. The probabilities of default of the obligor institutions (the Bank of England and major banks) has been assessed and is considered to be so low as to require no significant impairment provision.

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

20. DEFERRED TAX

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

	2019 £m	2018 £m
Net liability at 1 October 2018	(1.37)	(0.60)
Income statement credit / (charge)	3.13	(0.77)
Change in accounting policy on adoption of IFRS 9 (note 41)	0.75	-
Net asset / (liability) at 30 September 2019	2.51	(1.37)

The net deferred tax asset / (liability) for which provision has been made is analysed as follows:

	2019 £m	2018 £m
Other timing differences	2.51	(1.37)
Net deferred tax asset / (liability)	2.51	(1.37)

As stated in note 10 legislation has been introduced to reduce the standard rate of UK corporation tax to 17.0% from 1 April 2020. The temporary differences have been provided at the rate prevailing when the Bank anticipates the temporary difference to reverse. In addition, it has been assumed that the surcharge will apply when the difference reverses. In the event that the temporary differences actually reverse in different periods a credit or charge will arise in a future period to reflect the difference. The timing of reversal of temporary differences will be affected by both matters within the Bank's control and matters outside the Bank's control.

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

21. INVESTMENT IN SUBSIDIARY UNDERTAKINGS

	Shares in Group companies £m	Loans to Group companies £m	Total £m
At 1 October 2017	342.67	476.99	819.66
Investments in subsidiaries	-	-	-
Loans advanced	-	2,150.69	2,150.69
Loans repaid	-	(1,412.27)	(1,412.27)
Provision movements	-	-	-
At 30 September 2018	342.67	1,215.41	1,558.08
Investments in subsidiaries	80.00	-	80.00
Loans advanced	-	14,511.27	14,511.27
Loans repaid	-	(14,550.70)	(14,550.70)
Provision movements	-	-	-
At 30 September 2019	422.67	1,175.98	1,598.65

Investments in subsidiaries represent transactions between the Company and various of its subsidiaries.

During the year ended 30 September 2019 the Company received £68.7m in dividend income from its subsidiaries (2018: £135.0m) and £26.2m of interest on loans to Group companies (2017: £12.6m).

The Company's subsidiaries, and the nature of its interest in them, are shown in note 47.

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

22. RETAIL DEPOSITS

The Bank's retail deposits, were received from customers in the UK and are denominated in sterling. The deposits comprise principally term deposits and 120 day notice accounts. The method of interest calculation on these deposits is analysed as follows:

	2019 £m	2018 £m
Fixed rate	4,154.38	3,643.12
Variable rates	2,237.53	1,653.45
	6,391.91	5,296.57

The weighted average interest rate on retail deposits at 30 September 2019 and 30 September 2018, analysed by charging method, was:

	2019 %	2018 %
Fixed rate	2.02	1.94
Variable rates	1.43	1.36
All deposits	1.81	1.76

The contractual maturity of these deposits is analysed below.

	2019 £m	2018 £m
Amounts repayable		
In less than three months	466.64	256.80
In more than three months, but not more than one year	2,088.43	2,024.74
In more than one year, but not more than two years	1,158.02	1,010.55
In more than two years, but not more than five years	900.87	655.28
Total term deposits	4,613.96	3,947.37
Repayable on demand	1,777.95	1,349.20
	6,391.91	5,296.57
Fair value adjustments for portfolio hedging	3.96	(3.77)
	6,395.87	5,292.80

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

23. CENTRAL BANK FACILITIES

During the year, the Bank has utilised facilities provided by the Bank of England including through its Sterling Monetary Framework. These facilities enable either funding or off-balance sheet liquidity to be provided to Paragon Bank on the security of designated pools of the Bank's first mortgage assets, with the amount available based on the value of the security given, subject to a haircut.

Drawings under the FLS are used to provide off balance sheet liquidity and form part of the Bank's HQLA. Fees are charged under the FLS at 0.25% of the market value of the liquidity drawn and are repayable in June 2020.

Drawings under the Indexed Long-Term Repo Scheme ('ILTR') have a maturity of six months and a rate of interest set in an auction process. At 30 September 2019 the average rate of interest on the Bank's ILTR drawings was 0.90% (2018: 0.90%).

Drawings under the Term Funding Scheme ('TFS') have a maturity of four years and bear interest at bank base rate. The average remaining maturity of the Bank's drawings is 22 months (2018: 34 months). As these drawings are provided at rates below those available commercially, by a government agency, they are accounted for under IAS 20. The TFS is no longer available for new drawings.

The amounts drawn under these facilities are set out below.

	2019 £m	2018 £m
TFS	944.40	944.40
ILTR	50.00	80.00
On balance sheet funding	994.40	1,024.40
FLS	108.89	108.63
Total central bank facilities	1,103.29	1,133.03

Further first mortgage assets of the Bank have been pre-positioned with the Bank of England for future use in such schemes. The assets pledged in support of these drawings are set out in note 14.

The balances arising from the TFS carried in the Bank accounts are shown below.

	2019 £m	2018 £m
TFS at IAS 20 carrying value	930.45	923.47
Deferred government assistance	13.95	20.93
	944.40	944.40

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

24. CORPORATE BOND

On 20 December 2017 the Bank issued £150.0m of 6.62% Fixed Rate Reset Callable Subordinated Tier 2 Notes due 2026 at par to its parent company, PBG, to provide it with long term capital. These bonds bear interest at a fixed rate of 6.62% per annum until 9 September 2021, after which interest will be payable at a rate of fixed rate which is 5.605% over the sterling 5-year-mid market swap rate at the time. These notes are unsecured and subordinated to any other creditors of the Bank. Interest is included within Accrued interest.

25. SUNDRY LIABILITIES

	2019 £m	2018 £m
Current liabilities		
Accrued interest	40.13	29.90
Amounts owed to group companies	188.44	258.93
CSA liabilities (note 19)	-	10.24
Other accruals	0.80	0.44
Sundry financial liabilities	229.37	299.51

All of the above balances represent financial liabilities carried at amortised cost.

26. CURRENT TAX LIABILITIES

Current tax represents UK corporation tax owed.

27. CALLED-UP SHARE CAPITAL

The share capital of the Company consists of a single class of £1 ordinary shares.

Movements in the issued share capital in the year were:

	2019 Number	2018 Number
Ordinary shares		
At 1 October 2018 and 30 September 2019	552,625,034	552,625,034

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

28. RESERVES

Profit and loss account

	2019 £m	2018 £m
At 1 October 2018	156.71	7.19
Profit for the year	97.22	156.43
Dividends paid	(18.24)	(6.91)
Change of accounting policy	(2.24)	-
At 30 September 2019	233.45	156.71

An interim dividend of £0.03 per share was paid during the year (2018: £0.01 per share). No final dividend is proposed (2018: nil).

29. NET CASH FLOW FROM OPERATING ACTIVITIES

	2019 £m	2018 £m
Profit before tax	107.01	164.51
Non-cash items included in profit and other adjustments:		
Impairment losses on loans to customers	3.82	2.13
Net (increase) / decrease in operating assets:		
Loans to customers	(1,134.33)	(1,570.06)
Derivative financial instruments	12.68	(13.03)
Fair value of portfolio hedges	(80.20)	14.87
Other receivables	45.13	(720.90)
Net increase / (decrease) in operating liabilities:		
Retail deposits	1,095.34	1,681.16
Derivative financial instruments	68.00	(1.12)
Fair value of portfolio hedges	7.73	(0.67)
Other liabilities	(70.14)	418.00
Cash generated / (utilised) by operations	55.04	(25.11)
Income taxes (paid)	(7.12)	(4.72)
	47.92	(29.83)

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

30. NET CASH FLOW FROM INVESTING ACTIVITIES

	2019 £m	2018 £m
Investment in subsidiary undertakings	(80.00)	-
Net cash (utilised) by investing activities	(80.00)	-

31. NET CASH FLOW FROM FINANCING ACTIVITIES

	2019 £m	2018 £m
Dividends paid (note 28)	(18.24)	(6.91)
Movement on central bank facilities	(30.00)	324.40
Net cash (utilised) / generated by financing activities	(48.24)	317.49

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

32. RELATED PARTY TRANSACTIONS

During the year the Bank has identified the following transactions with entities in common ownership, which are related parties.

Management and administrative services were provided to the Bank by Paragon Finance PLC. Details of the amounts charged to the Bank in respect of these services are disclosed in note 7. At the balance sheet date amounts owed by Paragon Finance PLC are disclosed in note 21.

During the year the Bank purchased £195.0m floating rate notes issued by Paragon Mortgages (No 25) PLC from Paragon Finance PLC.

Floating rate notes issued by Paragon Mortgages (No. 14) PLC, Paragon Mortgages (No. 25) PLC, Paragon Mortgages (No. 26) PLC and Paragon Second Funding Limited, companies in common control with the Bank, which are therefore related parties have been acquired by the Bank. At the balance sheet date, the outstanding investment is shown in note 17 and accrued interest on the investment is shown in note 19.

During the year the Bank sold assets to the value of £469.6m to Paragon Mortgages (No. 26) PLC. The value of the loans sold is included within note 16.

During the year the Bank provided an interest bearing loan to each of Paragon Asset Finance Limited, Paragon Mortgages (2010) Limited, Paragon Finance Plc, Paragon Development Finance Limited and PBAF Acquisitions Limited which are related parties. Details of the interest charged on the loans is provided in note 4. At the balance sheet date, the outstanding loan amounts are shown in note 21 with the accrued interest due shown in note 19. The Bank also provided various management and administrative services to these companies and its subsidiaries.

During the year the Bank had an interest bearing loan from the parent company, Paragon Banking Group Plc, which is a related party. Details about the amount charged on the loan is provided in note 5. At the balance sheet date, the outstanding loan amount is shown in note 21 with £600k (2018: £573k) shown within 'accrued interest' in note 25.

Details of the Bank investments in other group entities and income derived from them are shown in note 21.

Outstanding current account balances with Group entities are shown in notes 19 and 25.

Intercompany dividends of £68.7m (2018: 135.0m) have been received during the year from direct subsidiaries of the Bank, which are related parties. Details of the income is shown in note 6.

During the year certain of the non-executive directors of the Group were beneficially interested in savings deposits made with the Bank, on the same terms as were available to members of the public. No such deposits were outstanding at the year end (2018 : £250,000), and the maximum amount outstanding during the year was £250,000 (2018 : £250,000).

NOTES TO THE ACCOUNTS - ANALYSIS
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33. DISCLOSURES UNDER IAS 39

Certain disclosures made in respect of IAS 39 based amounts are not directly comparable to IFRS 9 disclosures, but still form part of the comparative financial information. To avoid confusion, these are presented below.

(a) Ageing of IAS 39 exposures (Note 36)

The payment status of the carrying balances of the Bank's live loan assets, before provision for impairment, at 30 September 2018, split between those accounts considered as performing and those included in the population for impairment testing, is shown below. This disclosure is not required under IFRS 9, however comparative amounts are still required to be presented. Balances for immaterial asset classes are not shown. 'Asset finance loans' below includes other related loan balances. Fully provided non-live accounts shown in note 16 are excluded from the tables below.

Days past due is not a relevant measure for the development finance, structured lending or invoice discounting businesses, due to their particular contractual arrangements.

First mortgages

	2018 £m
Not past due	3,940.56
Arrears less than 3 months	17.84
Performing accounts	3,958.40
Arrears 3 to 6 months	0.52
Arrears 6 to 12 months	0.22
Arrears over 12 months	0.56
Possessions and similar cases	2.68
Impairment population	3.98
Total gross balances	3962.38
Impairment provision on live cases	(1.38)
Timing adjustments	0.53
Carrying balance	3,961.53

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For the year ended 30 September 2019

33. DISCLOSURES UNDER IAS 39 (CONTINUED)

Consumer finance

	Second charge mortgage loans £m	Motor finance loans £m	Total £m
30 September 2018			
Not past due	278.45	247.26	525.71
Arrears less than 2 months	10.50	8.55	19.05
Performing accounts	288.95	255.81	544.76
Arrears 2 to 6 months	5.73	1.12	6.85
Arrears 6 to 9 months	1.72	0.33	2.05
Arrears 9 to 12 months	1.19	0.20	1.39
Arrears over 12 months	3.68	0.47	4.15
Impairment population	12.32	2.12	14.44
Total gross balances	301.27	257.93	559.20
Impairment provision on live cases	(0.28)	(2.56)	(2.84)
Timing adjustments	0.13	1.25	1.38
Carrying balance	301.12	256.62	557.74

Arrears in the tables above are based on the contractual payment status of the customers concerned. Where assets have been purchased by the Bank, customers may already have been in arrears at the time of acquisition and an appropriate adjustment made to the consideration paid.

NOTES TO THE ACCOUNTS - ANALYSIS
For the year ended 30 September 2019

33. DISCLOSURES UNDER IAS 39 (CONTINUED)

(b) Movement in impairment provision (Note 16)

The following amounts in respect of impairment provisions under IAS 39, net of allowances for recoveries of written off assets, have been deducted from the appropriate assets in the balance sheet. This disclosure has been superseded under IFRS 9, but disclosures for comparator periods are still required.

	First mortgages	Other loans and receivables	Finance leases	Total
	£m	£m	£m	£m
At 1 October 2017	0.41	0.60	1.13	2.14
Amounts provided in the period	0.71	(0.11)	1.53	2.13
Amounts written off	-	(0.25)	(0.10)	(0.35)
Amounts recovered	-	0.04	-	0.04
At 30 September 2018	1.12	0.28	2.56	3.96

Of the above balances, the following provisions were held in respect of realised losses not charged off, which remain on the balance sheet and are provided for in full.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK MANAGEMENT
For the year ended 30 September 2019

The notes below describe the processes and measurements which the Bank uses to manage its capital position and their exposure to financial risks including credit, liquidity, interest rate and foreign exchange risk. It should be noted that certain capital measures, which are presented to illustrate the Bank's position, are not subject to audit. Where this is the case, the relevant disclosures are marked as such.

34. CAPITAL MANAGEMENT

The Bank's objectives in managing capital are:

- To ensure that the Bank has sufficient capital to meet its operational requirements and strategic objectives
- To safeguard the Bank's ability to continue as a going concern, so that it can continue to provide returns to shareholders and benefits for other stakeholders
- To provide an adequate return to shareholders by pricing products and services commensurately with the level of risk
- To ensure that sufficient regulatory capital is available to meet any externally imposed requirements
- To ensure that the Bank complies with capital adequacy rules laid down by the PRA. This is discussed further below

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

Regulatory capital

The Bank is subject to supervision by the PRA. As part of this supervision the regulator will issue individual capital guidance setting an amount of regulatory capital, defined under the international Basel III rules, implemented through the Capital Requirements Regulation and Directive ('CRD IV'), which the Bank is required to hold relative to its risk weighted assets in order to safeguard depositors against the risk of losses being incurred by the Bank.

The Bank's regulatory capital is monitored by the Board of Directors and ALCO, which ensure that appropriate action is taken to ensure compliance with the regulator's requirements. The future regulatory capital requirement is also considered as part of the Bank's forecasting and strategic planning process.

The tables below demonstrate that at 30 September 2019 the Bank's regulatory capital of £1,127.21m (2018: £1,036.22m) was comfortably in excess of the amounts required by the regulator, including £726.96m in respect of Pillar 1 and Pillar 2a capital (unaudited), which is comprised of fixed and variable elements. The CRR also requires firms to hold additional capital buffers, including a Capital Conservation Buffer of 2.5% of risk weighted assets (at 30 September 2019) (2018: 1.875%) and a Counter-Cyclical Buffer, currently 1.0% of risk weighted assets (2018: 0.5%). Firm specific buffers may also be required.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK MANAGEMENT
For the year ended 30 September 2019

34. CAPITAL MANAGEMENT (CONTINUED)

Regulatory capital (continued)

The Bank's regulatory capital differs from its equity as certain adjustments are required by the regulator. A reconciliation of the Bank's equity to its regulatory capital determined in accordance with CRD IV at 30 September 2019 is set out below.

	Note	2019 £m	2018 £m
Total equity in the Bank		786.07	709.33
Other equity in regulatory consolidation	§	332.24	328.78
		1,118.31	1,038.11
Deductions			
Investments in shares	* §	(11.16)	(8.66)
Goodwill in regulatory consolidation	† §	(149.71)	(147.28)
Prudent valuation adjustment	§ #	(0.69)	(0.88)
Add back IFRS9 transitional relief	§	20.46	-
Common Equity Tier 1 ('CET1') Capital		977.21	881.29
Other tier 1 capital		-	-
Total Tier 1 capital		977.21	881.29
Corporate bond	24	150.00	150.00
Collectively assessed credit impairment allowances	‡ §	-	4.93
Total Tier 2 capital		150.00	154.93
Total regulatory capital		1,127.21	1,036.22

* Investments by entities within the regulatory consolidation in entities outside it.

§ Not audited.

† Goodwill which arises on consolidation for regulatory purposes deducted from available capital.

‡ Included allowances in subsidiary companies within the regulatory consolidation.

Under IFRS 9 there are no collectively assessed credit impairment allowances which are eligible as tier 2 capital.

For capital purposes, assets and liabilities held at fair value, such as the Group's derivatives, are required to be valued on a more conservative basis than the market value basis set out in IFRS 13. This difference is represented by the prudent valuation adjustment above, calculated using the 'Simplified Approach' set out in the CRR.

This was first included in the Group's regulatory capital position in the year and has been included in comparative amounts for consistency.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK MANAGEMENT
For the year ended 30 September 2019

34. CAPITAL MANAGEMENT (CONTINUED)

Regulatory capital (continued)

The total risk exposure for the Bank and subsidiary entities included in its regulatory consolidation calculated under the CRD IV framework, against which this capital is held, and the proportion of these assets it represents, are calculated as shown below.

	2019 £m	2018 £m
Credit risk		
Balance sheet assets	5,920.30	5,672.14
Off balance sheet	85.46	87.83
IFRS 9 transitional relief	10.12	-
Total credit risk	6,015.88	5,759.97
Operational risk	442.69	368.80
Other risk	108.22	93.00
Total risk exposure	6,566.79	6,221.77
	%	%
Solvency ratios		
CET1 capital	14.9	14.2
Total regulatory capital	17.2	16.7

This table is not subject to Audit

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

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK MANAGEMENT
For the year ended 30 September 2019

34. CAPITAL MANAGEMENT (CONTINUED)

Regulatory capital (continued)

On a fully loaded basis (excluding the effect of IFRS 9 transitional relief) the Group's capital ratios would be:

	2019 £m	2018 £m
CET1 Capital	977.21	881.29
Add back: IFRS 9 relief	(20.46)	-
Fully loaded CET1 Capital	956.76	881.29
TRC	1,127.21	1,036.22
Add back: IFRS 9 relief	(20.46)	-
Fully loaded TRC	1,106.76	1,036.22
Total risk exposure	6,566.79	6,221.77
Add back: IFRS 9 relief	(10.12)	-
Fully loaded TRE	6,556.67	6,221.77
Fully loaded Solvency ratios	%	%
CET1	14.6	14.2
Total regulatory capital	16.9	16.7

This table is not subject to audit

The total regulatory capital at 30 September 2019 on the fully loaded basis of £1,106.76m was in excess of the Pillar 1 & 2a requirement of £725.94m on the same basis (amounts not subject to audit).

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK MANAGEMENT
For the year ended 30 September 2019

34. CAPITAL MANAGEMENT (CONTINUED)

Regulatory capital (continued)

The table below shows the calculation of the leverage ratio, based on the balance sheet assets of the Bank's regulatory group adjusted as shown below. The PRA has set a minimum leverage ratio of 3.25% for UK firms.

	2019 £m	2018 £m
Total balance sheet assets	14,295.85	14,352.02
Add; Credit fair value adjustment on loans to customers	-	24.10
Debit fair value adjustment on retail deposits	-	4.18
	14,295.85	14,380.30
Less: Derivative assets	(592.39)	(855.67)
Central bank deposits	(816.40)	(895.88)
CRDs	(11.36)	(6.20)
Accrued interest on sovereign exposure	(0.20)	(0.34)
On-balance sheet items	12,875.50	12,622.21
Less: Intangible assets	(149.71)	(147.29)
Investments	(11.16)	(8.66)
Total on balance sheet exposures	12,714.63	12,466.26
Derivative assets	592.39	855.67
Potential future exposure on derivatives	119.95	172.10
Total derivative exposures	712.34	1,027.77
Post offer pipeline at gross notional amount	903.37	817.72
Adjustment to convert to credit equivalent amounts	(739.15)	(569.21)
Off balance sheet items	164.22	248.51
Tier 1 capital	977.21	882.17
Total leverage exposure before IFRS 9 relief	13,591.19	13,742.54
IFRS 9 relief	24.96	-
Total leverage exposure	13,616.15	13,742.54
UK leverage ratio	7.19%	6.42%

This table is not subject to audit

The increase in the leverage ratio is an expected function of the Bank's development.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK MANAGEMENT
For the year ended 30 September 2019

34. CAPITAL MANAGEMENT (CONTINUED)

The fully loaded leverage ratio is calculated as follows

	2019 IFRS 9 £m	2018 IAS 39 £m
Fully loaded Tier 1 capital	956.76	881.29
Total leverage exposure before IFRS 9 relief	13,591.19	13,742.54
Fully loaded UK leverage exposure	7.05%	6.42%

This table is not subject to audit

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

35. FINANCIAL RISK MANAGEMENT

The principal financial risks arising from the Bank's exposure to financial instruments are credit risk, liquidity risk and market risk (particularly, interest rate risk and currency risk). The Board of Directors has a Risk and Compliance Committee, consisting of the Chair and the non-executive directors which is responsible for providing oversight and challenge to the Bank's risk management arrangements. The Credit Committee and ALCO are executive sub-committees of the Risk and Compliance Committee which monitor performance against the risk appetites set by the Board and make recommendations for changes in risk appetite where appropriate. They also review and, where authorised to do so, agree or amend policies for managing each of these risks, which are summarised in the relevant note.

The financial risk management policies have remained unchanged throughout the year and since the year end. The position discussed in notes 34 to 38 is materially similar to that existing throughout the year.

36. CREDIT RISK

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

Primary responsibility for retail credit risk management across the Bank lies with the Credit Committee. During the year, the Credit Committee is made up of six senior members of staff, headed by the CEO. Its key responsibilities include setting and reviewing credit policy, under the delegated authority of the Risk and Compliance Committee controlling applicant quality, tracking account performance against targets, agreeing product criteria and lending guidelines and monitoring performance and trends.

In order to control credit risk relating to counterparties to the Bank's derivative financial instruments, short-term investments and cash deposits, ALCO determines which counterparties the Bank will deal with, establishes limits for each counterparty and monitors compliance with those limits.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK MANAGEMENT
For the year ended 30 September 2019

36. CREDIT RISK (CONTINUED)

The assets of the Bank which are subject to credit risk are set out below:

	Note	**2019 £m**	**2018 £m**
Loans to group companies	21	1,175.98	1,215.41
Loans to customers	16	5,381.75	4,655.43
Investment in structured entities	17	409.42	8.22
CSA debtor	19	72.14	3.70
Cash	11	837.23	917.55
Accrued interest	19	1.30	0.44
		7,877.82	6,800.75
Derivative financial assets	18	9.72	22.40
Short term investments	12	-	-
Maximum exposure to credit risk		7,887.54	6,823.15

Loans to customers

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

The Bank's loan assets at 30 September 2019 and 30 September 2018 are analysed as follows:

	2019 £m	**2019 %**	**2018 £m**	**2018 %**
Buy-to-let mortgages	4,567.81	84.9%	3,902.18	83.8%
Owner occupied mortgages	68.31	1.3%	59.35	1.3%
Total first mortgages	4,636.12	86.2%	3,961.53	85.1%
Secured loans	294.42	5.5%	301.12	6.5%
Development finance	81.93	1.5%	97.45	2.1%
Loans secured on property	5,012.47	93.2%	4,360.10	93.7%
Motor finance loans	281.28	5.2%	256.62	5.5%
Structured lending	88.00	1.6%	38.71	0.8%
Total loans to customers	5,381.75	100.0%	4,655.43	100.0%

The Bank's underwriting philosophy is based on a combination of sophisticated individual credit assessment and the automated efficiencies of a scored decision making process. Information on each applicant is combined with data taken from a credit reference bureau to provide a complete credit picture of the applicant and the borrowing requested. Key information is validated through a combination of documentation and statistical data which collectively provides evidence of the applicant's ability and willingness to pay the amount contracted under the loan agreement.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK MANAGEMENT
For the year ended 30 September 2019

36. CREDIT RISK (CONTINUED)

In considering whether to acquire pools of loan assets or invest in loan portfolios, the Bank will undertake a due diligence exercise on the underlying loan accounts. The Bank's procedures may include inspection of original loan documents, verification of security and the examination of the credit status of borrowers. Current and historic cash flow data will also be examined. The objective of the exercise is to establish, to a level of confidence similar to that provided by the underwriting process, that the assets will generate sufficient cash flows to recover the Bank's investment and generate an appropriate return without exposing the Bank to material operational or conduct risks.

First mortgages and secured loans are secured by charges over residential properties in England and Wales, or similar Scottish securities. Motor finance loans are effectively secured by the financed vehicle.

Development finance loans are secured by the development property and various charges over the build.

Structured finance balances are effectively secured over the assets of the customer, with by security enhanced by maintaining at a level less than the amount of total amount of the security.

Despite this security, in assessing credit risk, an applicant's ability and propensity to repay the loan remain the principal factors in the decision to lend.

Loans secured on residential property

An analysis of the indexed loan to value ratio ('LTV') for those loan accounts secured on property by value at 30 September 2019 and 30 September 2018 is set out below.

	2019 First Mortgages %	2019 Secured Loans %	2018 First Mortgages %	2018 Secured Loans %
Loan to value ratio				
Less than 70%	40.3	68.0	48.5	68.4
70% to 80%	52.6	19.7	47.0	18.3
80% to 90%	6.5	8.8	3.8	8.9
90% to 100%	0.2	1.4	0.2	2.2
Over 100%	0.4	2.1	0.5	2.2
	100.0	100.0	100.0	100.0
Average loan to value ratio	69.3	65.4	67.7	65.2

The regionally indexed LTVs shown above are affected by changes in house prices, with the Nationwide house price index, for the UK as a whole, registering an annual increase of 0.2% in the year ended 30 September 2019 (2018: 2.0%).

36. CREDIT RISK (CONTINUED)

Development finance

Development finance loans do not require customers to make payments during the life of the loan, therefore arrears and past due measures cannot be used to monitor credit risk. Instead, cases are monitored on an individual basis by management and Credit Risk. The average loan to gross development value ('LTGDV') ratio for the portfolio at year end, a measure of security cover, is analysed below.

	2019	2019	2018	2018
	By value	By number	By value	By number
LTGDV	%	%	%	%
50% or less	1.3	3.2	9.9	5.7
50% to 60%	24.4	27.4	15.5	26.1
60% to 65%	65.7	56.5	68.8	64.8
65% to 70%	8.4	11.3	3.2	2.3
70% to 75%	0.2	1.6	2.6	1.1
Over 75%	0.0	0.0	0.0	0.0
	100.0	100.0	100.0	100.0

The average LTGDV cover at the year end was 61.6% (2018: 61.2%).

LTGDV is calculated by comparing the current expected end of term exposure with the latest estimate of the value of the completed development based on surveyors' reports.

At 30 September 2019 the development finance portfolio comprised 62 accounts (2018: 88) with a total carrying value of £81.93 (2018: £97.45m). The Bank's development finance portfolio is reducing as this form of lending has now been concentrated in another group company.

Structured lending

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

Summary details of the structured lending portfolio are set out below

	2019	2018
Number of transactions	8	3
Total facilities (£m)	132.50	52.50
Carrying value (£m)	88.00	38.71

36. CREDIT RISK (CONTINUED)

The maximum advance under these facilities was 80% of the underlying assets.

These accounts do not have a requirement to make regular payments, operating on revolving basis. The performance of each loan is monitored monthly on a case by case basis by the Group's Credit Risk function, assessing compliance with covenants relating to both the customer and the performance and composition of the asset pool. These assessments, which are reported to Credit Committee, are used to inform the assessment of expected credit loss under IFRS 9.

At 30 September 2019 there were no significant concerns regarding the credit performance of these facilities.

Arrears performance

The number of accounts in arrears by asset class, based on the most commonly quoted definition of arrears for the type of asset, at 30 September 2019 and 30 September 2018, compared to the industry averages at those dates published by the UK Finance ('UKF') formally Council of Mortgage Lenders ('CML') and the Finance and Leasing Association ('FLA'), was:

	2019 %	2018 %
Buy-to-let mortgages		
Accounts more than three months in arrears		
Buy-to-Let accounts including receiver of rent cases	0.03	0.01
Buy-to-Let accounts excluding receiver of rent cases	0.02	0.01
Owner-occupied accounts	0.00	0.00
UKF data for mortgage accounts more than three months in arrears		
Buy-to-Let accounts including receiver of rent cases	0.42	0.42
Buy-to-Let accounts excluding receiver of rent cases	0.37	0.38
Owner-occupied accounts	0.81	0.88
All mortgages	0.73	0.79
Secured loans		
Accounts more than two months in arrears	5.89	6.01
FLA data for secured loans	8.40	9.40
Car loans		
Accounts more than two months in arrears	1.27	0.93
FLA data for point of sale hire purchase	2.70	2.50

As a significant proportion of the loans in the Bank were advanced in the last three years, the arrears statistics will not be strictly comparable to the industry data at this stage. Where revised data at 30 September 2018 has been published by the FLA or UKF, the comparative industry figures above have been amended.

The Bank calculates its headline arrears measure for buy-to-let mortgages, shown above, based on the numbers of accounts three months or more in arrears, but excluding those cases in possession and receiver of rent cases designated for sale. This is consistent with the methodology used by the CML in compiling its statistics for the buy-to-let mortgage market as a whole.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK MANAGEMENT
For the year ended 30 September 2019

36. CREDIT RISK (CONTINUED)

The figures shown above for secured loans include purchased portfolios which generally include a proportion of cases in arrears at the time of purchase and where this level of performance is allowed for in the discount to current balance represented by the purchase price.

Investment in structured entities

Investments in structured entities represent publicly traded Mortgage Backed Floating Rate Notes issued by another Paragon Group company to a purchase pool of residential mortgage assets. The investments are denominated in sterling and the underlying loans are made to UK borrowers. Cash generated by the assets is distributed to investors in accordance with a specified priority of payments. The Bank has no obligation to make further contributions to the company concerned.

The management has considered the position of the underlying assets and concluded that they will generate sufficient cash flows to repay the amount of the investment.

Derivative financial assets

In order to control credit risk relating to counterparties to the Bank's derivative financial instruments and cash deposits, ALCO determines which counterparties the Bank will deal with, establishes limits for each counterparty and monitors compliance with those limits. Such counterparties are typically highly rated banks. Where a derivative counterparty fails to meet the required criteria they are obliged under the terms of the instruments to set aside a cash collateral deposit.

Short term investments

The Bank may hold short term investments as part of the liquidity buffer which it is required to hold by the PRA and Board risk appetite. These investments may only be placed in treasury bills and gilts issued by the UK government and as such the credit risk is judged to be minimal.

Cash and cash equivalents

The Bank's cash balances are held in sterling at highly rated London banks and at the Bank of England, in current accounts and as short fixed term deposits and money market placements. The Bank has a policy on large exposures to mitigate any concentration risk in respect of its cash deposits. Credit risk on these balances, and the interest accrued thereon, is considered to be immaterial.

Loans to group companies

The Bank's loans to group companies support the ongoing finance operations of its subsidiaries and investment in loan assets acquired by the subsidiaries.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK MANAGEMENT
For the year ended 30 September 2019

37. LIQUIDITY RISK

Liquidity risk is the risk that the Bank might be unable to satisfy any payment which is required to be made out of cash available to it at the time. The Bank is subject to regulation by the PRA which aims to ensure that sufficient liquid assets are held to mitigate the liquidity risk inherent in deposit taking. The Bank also seeks to manage the maturities of the deposits it accepts and the likely terms of the loans it offers to reduce liquidity risk.

The total undiscounted amounts, inclusive of estimated interest, which would be payable in respect of the Bank's retail deposit borrowings, should those balances remain outstanding until the contracted repayment date are set out below.

	2019 £m	2018 £m
30 September 2019		
Payable on demand	1,783.89	1,294.35
Payable in less than three months	482.70	281.90
Payable in less than one year but more than three months	2,151.45	2,098.57
Payable in less than one year or on demand	4,418.04	3,674.82
Payable in one to two years	1,210.05	1,068.77
Payable in two to five years	982.39	720.78
Payable in over five years	-	-
	6,610.48	5,464.37

Amounts payable in respect of the 'accrued interest' shown in note 25 fall due within one year. The cash flows described above will include those for interest on retail deposits accrued at 30 September 2019 and 30 September 2018 disclosed in note 25.

In order to reduce the liquidity risk inherent in the retail deposit balances, the PRA requires that the Bank, like other regulated banks, maintains a buffer of liquid assets to ensure it has sufficient available funds at all times to protect against unforeseen circumstances. The amount of this buffer is calculated using Individual Liquidity Guidance ('ILG') set by the PRA based on the Internal Liquidity Adequacy Assessment Process ('ILAAP') undertaken by the Bank. The ILAAP determines the liquid resources that must be maintained in the Bank to meet its Overall Liquidity Adequacy Requirement ('OLAR') and to ensure that it can meet its liabilities as they fall due. It is based on an analysis of its business as usual forecast cash requirements but also considers their predicted behaviour in stressed conditions.

At 30 September 2019 and 30 September 2018, the liquidity buffer comprised the following on and off balance sheet assets, all held within the Bank.

	Note	2019 £m	2018 £m
Short term investments	12	-	-
Balances with central banks	11	646.40	724.88
Total on balance sheet liquidity		646.40	724.88

The above analysis does not include off balance sheet funding of £108.89m (2018: £108.63m) in respect of primary liquidity representing short dated UK Treasury bills held as a result of drawings under the FLS.

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK MANAGEMENT
For the year ended 30 September 2019

37. LIQUIDITY RISK (CONTINUED)

Borrowings

The Bank issued £150.0m of tier 2 debt in December 2017 with an optional call date in December 2022 and a final maturity of September 2026. Amounts expected to be payable, including interest, are set out below.

The total undiscounted amounts, inclusive of estimated interest, which would be payable in respect of the borrowings of the Bank, should those balances remain outstanding until the contracted repayment date, or the earliest date on which repayment can be required, are set out below.

	Central Bank Facilities	Corporate Debt	Total
	£m	£m	£m
30 September 2019			
Payable in less than one year	55.30	9.93	65.23
Payable in one to two years	702.20	9.93	712.13
Payable in two to five years	244.90	29.79	274.69
Payable in over five years	-	169.86	169.86
	1,002.40	219.51	1,221.91
30 September 2018			
Payable in less than one year	87.30	9.93	97.23
Payable in one to two years	10.00	9.93	19.93
Payable in two to five years	958.30	29.79	988.09
Payable in over five years	-	179.79	179.79
	1,055.60	229.44	1,285.04

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK MANAGEMENT
For the year ended 30 September 2019

37. LIQUIDITY RISK (CONTINUED)

The cash flows which are expected to arise from derivative contracts in place at the year end, estimating future floating rate payments and receipts on the basis of the yield curve at the balance sheet date are as follows:

	2019 Total cash inflow / (outflow) £m	2018 Total cash inflow / (outflow) £m
On derivative assets		
Payable in less than one year	(0.16)	(2.26)
Payable in one to two years	2.94	3.76
Payable in two to five years	1.80	20.12
Payable in over five years	0.01	(0.36)
	4.59	21.26
On derivative liabilities		
Payable in less than one year	(12.51)	(4.07)
Payable in one to two years	(19.00)	(1.12)
Payable in two to five years	(40.14)	0.19
Payable in over five years	(0.46)	0.03
	(72.11)	(4.97)
	(67.52)	16.29

NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK MANAGEMENT
For the year ended 30 September 2019

38. INTEREST RATE RISK

The Bank manages interest rate risk, the risk that margins will be adversely affected by movements in market interest rates, through its lending, deposit taking and borrowing activities. As certain of the Bank's financial assets and liabilities bear interest at rates which float with market rates and others are fixed, either for a term or for their whole lives, a movement in market rates can change the net interest margin on the Bank's activities unless the exposure is managed.

The Bank has fixed and floating rate loan assets, together with fixed and floating rate savings deposit and manages mismatches using interest rate swap agreements to ensure any exposure remains appropriate to the Banks risk appetite.

The Bank's ALCO monitors the interest rate risk exposure on the Bank's loan assets.

The Bank's retail deposits either bear variable interest rates or are fixed rate liabilities which are hedged in accordance with the Bank's risk management strategy. The interest rates paid on the Bank's variable rate deposits are determined by reference to, inter alia, returns achievable in the Bank's lending markets and the rates being charged on similar products in the market.

The Bank's loan assets are predominantly hedged fixed rate assets. The interest rates charged on the Bank's variable rate loan assets are determined by reference to, inter alia, the Bank's funding costs and the rates being charged on similar products in the market.

Generally these factors ensure the matching of changes in interest rates on the Bank's loan assets and borrowings and any exposure arising on the interest rate resets is relatively short term.

To assess the Bank's exposure to interest rate movements the notional impact of a 1% change in UK interest rates on the equity of the Bank at 30 September 2019, and the notional annualised impact of such a change on the operating profit of the Bank, based on the year-end balance sheet have been calculated.

On this basis a 1% increase in UK interest rates would reduce the Bank's equity at 30 September 2019 by £0.00m (2018: £0.00m) and decrease profit before tax by £6.00m (2018: increase profit before tax by £2.18m).

This calculation allows only for the direct effects of any change in UK interest rates. In practice such a change might have wider economic consequences which would themselves potentially affect the Bank's business and results.

The Banks use of derivatives and hedging to manage interest rate risk is described in more detail in note 18.

39. CURRENCY RISK

The asset finance business has a limited amount of lending denominated in US dollars and may contract to purchase assets for leasing in currency. These balances are hedged through the Bank by the purchase of currency derivatives and/or appropriate currency balances.

As a result of these arrangements the Bank has no material exposure to foreign currency risk, and no sensitivity analysis is presented for currency risk.

The Bank's use of financial derivatives to manage currency risk is described further in note 18.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

39. CURRENCY RISK (CONTINUED)

The notes set out below describe the accounting basis on which the Bank prepares its accounts, the particular accounting policies adopted by the Bank 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.

40. BASIS OF PREPARATION

The financial statements have been prepared in accordance with International Financial Reporting Standards ('IFRS') as adopted by the EU. In the financial years reported upon this means that, in the Bank's circumstances, the financial statements accord also with International Financial Reporting Standards as approved by the International Accounting Standards Board.

The particular accounting policies adopted have been set out in note 42 and the critical accounting judgements and estimates which have been required in preparing these financial statements are described in note 43 and 44 respectively

Adoption of new and reviewed reporting standards

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

- IFRS 9 – 'Financial Instruments' (together with consequential changes to IFRS 7 - 'Financial Instruments: Disclosures')
- IFRS 15 – 'Revenue from Contracts with Customers'

The effect on the Bank's accounting of the adoption of these standards is discussed in note 41.

Comparability of information

IFRS 9 does not require that the balance sheet information at 30 September 2018 and the profit and loss information for the year ended on that date is restated on the adoption of the Standard. The information presented for those periods in these financial statements is derived in accordance with IAS 39 'Financial Instruments: Recognition and Measurement' ('IAS 39'), and therefore may not be directly comparable with the balance sheet at 30 September 2019 and the profit and loss account for the year then ended which are prepared under IFRS 9.

In order to aid users of the accounts additional comparative balance sheet amounts at 1 October 2018, immediately following transition, have been provided where relevant. These are marked as 2018 IFRS 9.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

40. BASIS OF PREPARATION (CONTINUED)

Standards not yet adopted

At the date of authorisation of these financial statements IFRS 16 – 'Leases', which has not been applied in these financial statements, was in issue but not yet effective.

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

IFRS 16

IFRS 16 will replace the standards currently governing the accounting for operating and finance leases and will come in to force with effect from the Bank's financial statements for the year ending 30 September 2020. The Bank has not early adopted IFRS 16 and will adopt IFRS 16 for the year ending 30 September 2020 using the modified retrospective approach.

The standard will address accounting by lessees and lessors, but the provisions for lessor accounting are little changed from those in IAS 17 and so the accounting for the Bank's finance lease receivables will be largely unaffected. The Bank has no leases where it is the lessee.

41. CHANGES IN ACCOUNTING STANDARDS

The Bank is required to adopt IFRS 9 (and the consequent changes to IFRS 7) and IFRS 15 for the first time in preparing its financial statements for the year ended 30 September 2019.

IFRS 9 – Overview

IFRS 9 'Financial Instruments' replaces IAS 39 'Financial Instruments: Recognition and Measurement' ('IAS 39') and addresses the recognition, classification and measurement of financial assets and liabilities.

IFRS 9 – Classification

IFRS 9 changes the classification requirements for financial assets and liabilities. In order for financial assets to be carried at amortised cost under the new standard, they must be carried in a business model whose objective is to collect the contractual cash flows from the assets and where those cash flows comprise solely payments of principal and interest ('SPPI'). Further information on this judgement is given in note 43.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

41. CHANGES IN ACCOUNTING STANDARDS (CONTINUED)

In accordance with the new rules:

- Cash balances, loans to customers (other than finance leases), intercompany balances and investments in structured entities, which were classified as 'loans and receivables' under IAS 39 are classified as 'financial assets measured at amortised cost' under IFRS 9 and continue to be measured on the amortised cost basis
- Retail deposits and external borrowings, which were classified as 'other financial liabilities' under IAS 39 are classified as 'financial liabilities measured at amortised cost' and continue to be measured on the amortised cost basis
- Derivative financial assets and liabilities, which were carried at fair value under IAS 39 are classified as 'financial assets or liabilities at fair value through profit and loss' under IFRS 9 and continue to be measured on the same basis

The amortised cost and fair value measurement methodologies remain broadly the same in IFRS 9 as they were in IAS 39 and no measurement changes in the accounts of the Bank have arisen as a result of these classification changes.

The Bank's financial asset and financial liability balances measured in accordance with IFRS 9 and the preceding standard, IAS 39, at the transition date (1 October 2018) are set out below:

	Post-transition £m	Pre-transition £m
Financial Assets		
Cash – central banks	895.88	895.88
Cash – retail banks	21.67	21.67
Loans to customers	4,652.44	4,655.43
Investment in structured entities	8.22	8.22
Derivative financial assets	22.40	22.40
Loans to Group companies	339.89	339.89
Sundry financial assets	10.34	10.34
	5,950.84	5,953.83
Financial Liabilities		
Retail deposits	5,292.80	5,292.80
Derivative financial liabilities	4.30	4.30
Central bank facilities	1,024.40	1,024.40
Balances owed to Group companies	408.93	408.93
Other financial liabilities	40.57	40.57
	6,771.00	6,771.00

The only changes arising from a change in measurement on transition to IFRS 9 relate to impairment provisions on the Bank's loans to customers. These are discussed further below.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

41. CHANGES IN ACCOUNTING STANDARDS (CONTINUED)

IFRS 9 – Impairment

IFRS 9 changes the basis of impairment provision for all financial assets from an incurred loss to an expected credit loss ('ECL') basis. Therefore, the provisioning is dependent on an assessment of the probability of future default and the loss which might be incurred at that time. This introduces significant additional areas of estimation to the accounting.

This introduces a number of new concepts and changes to the approach required by IAS 39. 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. This has the effect of recognising losses on loans earlier than at present, as IAS 39 requires provisions to be made only at the point where a loss has actually occurred and there is objective evidence of credit impairment.

The Standard also requires that companies calculate impairment under a variety of differing economic scenarios and combine these on a weighted average basis to arrive at the final provision, rather than base calculations on a central forecast, as is generally the case under IAS 39.

IFRS 9 requires loan assets to be divided into three 'stages', with accounts which were credit impaired on initial recognition representing a fourth class.

The three classes comprise: those where there has been no Significant Increase in Credit Risk ('SICR') since advance or acquisition (Stage 1); those where there has been a SICR (Stage 2); and loans which are credit impaired (Stage 3). It is an important feature of the standard that SICR is not defined solely by the performance of the account, but also by other information available about the customer both internally and externally, such as credit bureau information.

- 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. These accounts would be largely unprovided for under IAS 39, although some cases with adverse qualitative indicators might have been addressed by a collective emergence provision. Such provisions under IAS 39 were designed to cover assets where a loss event had occurred before the reporting date, but this event had not yet affected performance
- 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. This is likely to lead to an increase in provision in general, though the IAS 39 emergence provision would have also addressed some of this risk

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

41. CHANGES IN ACCOUNTING STANDARDS (CONTINUED)

- For credit impaired assets, provisions will be made on the basis of lifetime expected credit losses, taking account of forward-looking economic assumptions and a range of possible outcomes. Under IAS 39, provisions were based on the asset's carrying value and the present value of the estimated future cash flows. Despite IAS 39 not explicitly taking account of alternative economic scenarios, where loans had attracted a provision under IAS 39, the IFRS 9 provision on transition was, in most cases, broadly similar to the closing IAS 39 position

  Credit impaired assets are identified either through quantitative measures or by operational status. In determining indicators of credit impairment regard is also taken of definitions used for regulatory capital purposes. Assets may also be assigned to Stage 3 if they are identified as credit impaired as a result of management review processes

- For assets which were purchased or originated as credit impaired ('POCI') accounts (i.e. considered as credit impaired at the point of first recognition) the required treatment is largely similar under IAS 39 and IFRS 9. This classification also includes credit impaired assets recognised in corporate acquisitions under IFRS 3. Purchased performing accounts are not classified as POCI, but are first recognised in Stage 1

Under IAS 39 the Bank treated all loan accounts as live where they remained open on its administration system. IFRS 9 requires a firm to consider the prospect of future recovery in its write off approach and the Bank has adopted a revised accounting policy for write offs following transition.

Accounts are now written off for accounting purposes when standard enforcement processes have been completed, subject to any amount retained in respect of expected salvage receipts. This change has no effect on the net carrying value, only on the amounts reported as gross loan balances and accumulated impairment provisions, but provides a more informative value for the coverage ratio.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

41. CHANGES IN ACCOUNTING STANDARDS (CONTINUED)

All accounts which would have been written off for accounting purposes prior to the transition date under the new policy have been written off at transition. All of these cases were fully provided and therefore this has had no impact on reserves.

As disclosed in the transition report, the introduction of IFRS 9 resulted in an increase in the Bank's impairment provision of £2.99m at the transition date, 1 October 2018. The carrying value of loans to customers reduced from £4,655.43m to £4,652.44m a reduction of 0.06%.

The movement in impairment provisions in the Bank's accounts between the balance disclosed under IAS 39 and the opening balance under IFRS 9 is set out below.

	£m
Impairment on loans to customers	
At 30 September 2018 under IAS 39	3.96
IFRS 9 transition adjustments	2.99
Change in write-off definition	(1.56)
At 1 October 2018 under IFRS 9	5.39

The reduction due to write off definitions is principally attributable to part redeemed loan balances which remained live on the administration systems of the Bank and were therefore treated as live for accounting purposes. Under IFRS 9 these balances may be defined as written off, and the Bank's IFRS 9 write off policy considers them to be so, as this provides users with a more useful measure of provision cover.

The increase in impairment on transition will be allowed as a deduction for the purposes of UK Corporation Tax under the Change in Accounting Practices Regulations. This is spread over the ten years following transition for loan assets and is allowable in the 2019 tax computations for finance leases. A deferred tax asset of £0.75m has been recognised on transition.

Cash balances and the sundry financial asset balances shown in note 19 are classified as financial assets accounts for at amortised cost and are therefore subject to the impairment provisions of IFRS 9. However, these assets are principally UK sovereign exposures (including exposures to the Bank of England) and exposures to highly rated banks. The ECLs on these counterparties are considered to be minimal. The value, tenor and potential for default of the other exposures is such that any potential IFRS 9 provision is insignificant.

Intercompany debtors are classified as financial assets accounted for at amortised cost and are therefore subject to the impairment provisions of IFRS 9. However, having considered the Group's overall funding position, is it considered that the probability of default is low. Any potential IFRS 9 provision is considered to be insignificant.

FRN notes held by the Bank are rated as AAA with external rating agencies while the debt issued by a Group company is rated at A2 by Moodys. Given the underlying performance of the entities and the high grade rating assessments the probability of default is low. Any potential IFRS 9 provision would be insignificant.

Derivative financial assets are carried at fair value, which includes the consideration of credit risk, as they were under IAS 39.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

41. CHANGES IN ACCOUNTING STANDARDS (CONTINUED)

IFRS 9 – Hedge accounting

The hedge accounting requirements of IFRS 9 do not specifically address portfolio fair value hedges of interest rate risk ('macro hedges') which IAS 39 deals with directly. A separate financial reporting standard is to be developed in this area. IFRS 9 allows the option to continue to apply the existing hedge accounting requirements of IAS 39 until this is implemented.

As the Bank's hedging arrangements are either macro hedges, which are not specifically addressed by the new standard, or bespoke cash flow hedges, which would not be affected by the change of standard, the Bank has decided to defer application of these rules until the full new hedge accounting regime is in place.

It thus continues to apply the hedge accounting requirements of IAS 39 and all hedging arrangements in place at 30 September 2018 continue to be recognised on 1 October 2018 after IFRS 9 transition.

However, the consequential changes to IFRS 7 (see below) do apply to these financial statements and the Bank's disclosures in respect of hedge accounting and derivatives have been revised and expanded.

IFRS 7 – Disclosure

At the point of adoption of IFRS 9, entities are also required to adopt amendments to IFRS 7 – 'Financial Instruments: Disclosures' made by IFRS 9 in July 2014. The principal amendments affecting the Bank's accounts are those concerning the reporting of impairment, taking account of the IFRS 9 measurement requirements for impairment, the reporting of credit risk and the reporting of hedging strategies and outcomes.

This has, therefore, required significant amendments to the disclosures presented as notes 35 (credit risk), 14 to 16 (loans and impairment) and 18 (derivatives and hedging) in these accounts compared to those presented for the year ended 30 September 2018. When new notes address impairment, no comparative amounts are required to be disclosed, but for other new requirements, comparative amounts under the new standard at 30 September 2018 are shown.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

41. CHANGES IN ACCOUNTING STANDARDS (CONTINUED)

Summary

The overall impacts of the changes above on consolidated equity at 30 September 2018 are set out below.

		£m	£m
Equity at 30 September 2018			709.33
IFRS 9			
Impairment	(note 16)	(2.99)	
Deferred tax thereon	(note 20)	0.75	
		(2.24)	
Total adjustments			(2.24)
Equity at 1 October 2018			707.09

All these amendments impacted retained earnings. None of these changes have any impact on the Bank's cash flow reporting.

42. ACCOUNTING POLICIES

The particular policies applied by the Bank in preparing these financial statements with the IFRS regime are described below.

As comparative financial information relating to the year ended 30 September 2018 and earlier periods has not been restated for IFRS 9, as permitted by that standard, the accounting policies applied differ to those used in the accounts for the year ended 30 September 2019. Where this is significant both policies are shown.

(a) **Accounting convention**

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

(b) **Basis of consolidation**

The Bank is exempt under Section 400 of the Companies Act 2006 from the obligation to prepare group financial statements, being a wholly-owned subsidiary undertaking of Paragon Banking Group PLC.

42. ACCOUNTING POLICIES (CONTINUED)

(c) **Going concern**

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

Accounting standards require the directors to assess the Bank's ability to continue to adopt the going concern basis of accounting. In performing this assessment, the directors consider all available information about the future, the possible outcomes of events and changes in conditions and the realistically possible responses to such events and conditions that would be available to them, having regard to the 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting' published by the Financial Reporting Council in September 2014.

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

After performing this assessment, the directors concluded that it was appropriate for them to continue to adopt the going concern basis in preparing the Annual Report and Accounts.

(d) **Cash and cash equivalents**

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

(e) **Short term investments**

Short term investments are held as part of the liquidity requirement of Paragon Bank PLC. As such they are measured at their fair value which corresponds to their market value at the balance sheet date.

(f) **Loans to customers**

Year ended 30 September 2019 under IFRS 9

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

Loans advanced are valued at inception at the initial advance amount, which is the fair value at that time, inclusive of procuration fees paid to brokers or other business providers and less initial fees paid by the customer. Loans acquired from third parties are initially valued at the purchase consideration paid or payable. Thereafter, all loans to customers are valued at this initial amount less the cumulative amortisation calculated using the 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.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

42. ACCOUNTING POLICIES (CONTINUED)

Where financial assets are credit-impaired at initial recognition the EIR is calculated on the basis of expected future cash receipts allowing for the effect of credit risk. In other cases, the expected contractual cash flows are used.

Year ended 30 September 2018 under IAS 39

Loans to customers are considered to be 'loans and receivables' as defined by IAS 39 – 'Financial Instruments: Recognition and Measurement'. They are therefore accounted for on the amortised cost basis.

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

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.

(g) **Finance lease receivables**

Finance lease receivables are included within 'Loans to Customers' at the total amount receivable less interest not yet accrued, unamortised commissions and provision for impairment.

Income from finance lease contracts is governed by IAS 17 – 'Leases' and accounted for on the actuarial basis.

(h) **Impairment of loans to customers**

Year ended 30 September 2019 under IFRS 9

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.

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

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

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

42. ACCOUNTING POLICIES (CONTINUED)

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 Bank 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 Bank 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 loan portfolios acquired at a discount, the discounts take account of future expected impairments and such assets are treated as POCI. For these assets, the Bank recognises all changes in future cash flows arising from changes in credit quality since initial recognition as a loss allowance with any changes recognised in profit or loss.

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.

Year ended 30 September 2018 under IAS 39

Loans and receivables are reviewed for indications of possible impairment throughout the year and at each balance sheet date in accordance with IAS 39. Where loans exhibit objective evidence of impairment (a 'loss event') the carrying value of the loans is reduced to the net present value of their expected future cash flows, including the value of the potential realisation of any security (net of sales costs) discounted at the original EIR.

Within its buy-to-let portfolio the Bank 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. 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 attract an impairment provision. Properties in receivership are eventually either returned to their landlord owners or sold.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

42. ACCOUNTING POLICIES (CONTINUED)

Loss events reflect both loans that display delinquency in contractual payments of principal or interest or, for buy-to-let loans in receivership but up to date at the balance sheet date, properties where the receiver adopts a sale strategy, where a shortfall may or may not arise.

In addition to loans where loss events are evident, loans are also assessed collectively, grouped by risk characteristics and account is taken of any impairment arising due to events which are believed to have taken place but have not been specifically identified at the balance sheet date. Collective impairment provisions are calculated for each key portfolio based on recent historical performance, with adjustments for expected changes in losses based on management's judgement. In the receiver of rent portfolio collective provisions are also established for cases where the present strategy might not be sustainable.

For loan portfolios acquired at a discount, the discounts take account of future expected impairments. An impairment charge is only recognised in the income statement if the total receipts from an acquired portfolio are below the original purchase price. Changes to expected cash flows from acquired portfolios are reflected by discounting the future expected cash flows by the original effective interest rate, with any change from the prevailing carrying value being recognised in the income statement.

For financial accounting purposes provisions for impairments of loans to customers when first recognised in the income statement are held in an allowance account. These balances are released to offset against the gross value of the loan when it is written off to profit and loss on the administration system. After this point a salvage balance may be held in respect of any further recoveries expected on the loan.

(i) **Investment in structured entities**

Investments in structured entities are intended to be held to maturity and are therefore accounted for on the amortised cost basis. The return from such investments is calculated on the EIR basis.

(j) **Amounts owed by or to group companies**

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

(k) **Investments in subsidiaries**

The Bank's investments in subsidiary undertakings are valued at cost less provision for impairment.

(l) **Retail deposits**

Retail deposits are carried in the balance sheet on the amortised cost basis. The initial fair value recognised represents the cash amount received from the customer.

Interest payable to the customer is expensed to the income statement as interest payable over the deposit term on an EIR basis.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

42. ACCOUNTING POLICIES (CONTINUED)

(m) 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 income statement as interest payable over the term of the borrowing on an EIR basis.

(n) Central bank facilities

Where central bank facilities are provided at a below market rate of interest, and therefore fall within the definition of government assistance as defined by IAS 20 – 'Accounting for Government Grants and Disclosure of Government Assistance' the liability is initially recognised at the value of its expected cash flows discounted at a market rate of interest for a comparable commercial borrowing. Interest is recognised on this liability on an EIR basis, using the imputed market rate to determine the EIR.

The remaining amount of the advance is recognised as deferred government assistance and released to the profit and loss account through interest payable over the periods during which the arrangement affects profit.

(o) Derivative financial instruments

All derivative financial instruments 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 income statement, except where such amounts are permitted to be taken to equity as part of the accounting for a cash flow hedge.

(p) 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 Bank has made this election and the accounting policy below has been determined in accordance with IAS 39.

For all hedges, the Bank documents the relationship between the hedging instruments and the hedged items at inception, as well as its risk management strategy and objectives for undertaking the transaction. The Bank 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.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

42. ACCOUNTING POLICIES (CONTINUED)

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 or retail deposit liabilities) 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 income statement at the same time as the hedged item affects the income statement. Where a cash flow hedge relationship is terminated, or deemed ineffective, the amount taken to equity will remain there until the hedged transaction occurs, or is no longer expected to take place.

(q) **Taxation**

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

The Bank holds a provision for uncertain tax positions at the balance sheet date based on a global assessment of the expected amount that will ultimately be payable.

Tax relating to items taken directly to equity is also taken directly to equity.

(r) **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.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

42. ACCOUNTING POLICIES (CONTINUED)

(s) **Revenue**

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

(t) **Other income**

Other income, which is accounted for in accordance with IFRS 15, includes:

- Event-based administration fees charged to borrowers (other than the initial fees included in amortised cost), which are credited when the related service is performed
- Fees charged to third parties for account administration services, which are credited as those services are performed
- Commissions receivable on the sale of insurances, as agent of the third-party insurer, which are taken to profit at the point at which the Bank becomes unconditionally entitled to the income
- Broker fees receivable on the arrangement of loans funded by third parties, on an agency basis, which are taken to profit at the point of completion of the related loan

(u) **Dividends**

In accordance with IAS 10 – 'Events after the balance sheet date', dividends payable on ordinary shares are recognised in equity once they are appropriately authorised and are no longer at the discretion of the Bank. Dividends declared after the balance sheet date, but before the authorisation of the financial statements remain within shareholders' funds.

However, such dividends are deducted from regulatory capital from the point at which they are announced, and capital disclosures are prepared on this basis.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

43. CRITICAL ACCOUNTING JUDGEMENTS

The most significant judgements which the directors have made in the application of the accounting policies set out in note 42 relate to:

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

Under IFRS 9, the directors are required to assess where a credit obligation has suffered a Significant Increase in Credit Risk ('SICR'). The directors' assessment is based primarily on changes in the calculated 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.

More information on the definition of SICR adopted is given in note 16.

(b) Definition of default

In applying the impairment provisions of IFRS 9 and 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 Bank'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 Bank's definition of default adopted is given in note 16.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

43. CRITICAL ACCOUNTING JUDGEMENTS (CONTINUED)

(c) Classification of financial assets

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

- The company's 'business mode' – 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 Bank has considered its products and concluded that, as standard lending products, they fall within the SPPI criteria.

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

The use of amortised cost accounting is also restricted to assets which a company holds within a business model whose object is to collect cash flows arising from them, rather than seek to profit by disposing of them (a 'Held to Collect' model). The Bank's strategy is to hold loan assets until they are repaid or written off. Loan disposals are rare, and the Bank 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 Bank has classified its customer loan assets as carried at amortised cost.

The Bank's policy is to hold the FRN's acquired and included in 'investment in structured entities', for liquidity purposes and has no intentions to sell them at any point, as such, has catergorised the business model for these assets as Held to Collect. The FRNs provide cash returns in the form of LIBOR linked interest and principal at nominal value. These cash flows are considered as SPPI and the Bank carries its investments in structured entities at amortised cost.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

44. CRITICAL ACCOUNTING ESTIMATES

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

(a) Impairment losses on loans to customers

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

Internal information used will include number of months arrears, qualitative information, such as possession by a first charge holder on a second charge mortgage or where a buy-to-let case is under the control of a receiver of rent, the receiver's present and likely future strategy for the property (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 Bank must derive a set of scenarios which are internally coherent. The Bank addresses these requirements using four distinct economic scenarios chosen to represent the range of possible outcomes.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

44. CRITICAL ACCOUNTING ESTIMATES (CONTINUED)

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 Bank's approach to account management given a particular scenario.

(b) **Effective interest rates**

In order to determine the EIR applicable to loans and borrowings an estimate must be made of the expected life of each asset or liability and hence the cash flows relating thereto, including those relating to early redemption charges. For purchased loan accounts this will involve estimating the likely future credit performance of the accounts at the time of acquisition. 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 (in the case of borrowings) on customer behaviour.

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

- A reduction of the assumed average lives of loans secured on residential property by three months would reduce balance sheet assets by £4.9m (2018: £3.11m).
- An increase of the assumed average lives of loans secured on residential property by three months would increase balance sheet assets by £4.3m (2018: £3.12m)
- An increase of 50% in the number of five year fixed rate buy-to-let loan assets assumed to redeem before the end of the fixed rate period, generating additional early redemption charges would increase balance sheet assets by £3.29m

45. FINANCIAL ASSETS AND FINANCIAL LIABILITIES

The Bank's financial assets and financial liabilities are valued on one of two bases, defined by IFRS 9:

- Financial assets and liabilities carried at fair value through profit and loss ('FVTPL')
- Financial assets and liabilities carried at amortised cost

IFRS 7 – 'Financial Instruments: Disclosures' requires that where assets are measured at fair value these measurements should be classified using the fair value hierarchy set out in IFRS 13 – 'Fair Value Measurement'. This hierarchy reflects the inputs used, and defines three levels.

- Level 1 measurements are unadjusted market prices
- Level 2 measurements are derived from directly or indirectly observable data, such as market prices or rates
- Level 3 measurements rely on significant inputs which are not derived from observable data

As quoted prices are not available for level 2 and 3 measurements, the valuation is derived from cash flow models based, where possible, on independently sourced parameters. The accuracy of the calculation would therefore be affected by unexpected market movements or other variances in the operation of the models or the assumptions used.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

45. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

The Bank had no financial assets or liabilities in the year ended 30 September 2019 or the year ended 30 September 2018 carried at fair value and valued using level 3 measurements.

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

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

a) Assets and liabilities carried at fair value

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

	Note	2019 £m	2018 £m
Financial assets			
Derivative financial assets	18	9.72	22.40
Short term investments	12	-	-
		9.72	22.40
Financial liabilities			
Derivative financial assets	18	72.30	4.30
		72.30	4.30

All of these financial assets and financial liabilities are required to be carried at fair value by IFRS 9, and the introduction of the new standard has had no impact on their classification, valuation basis or valuations.

Derivative financial assets and liabilities

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

The principal inputs to these valuation models are LIBOR and SONIA sterling benchmark interest rates.

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

45. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

In order to determine the fair values, the management applies valuation adjustments to observed data where that data would not fully reflect the attributes of the instrument being valued, such as particular contractual features or the identity of the counterparty. The management reviews the models used on an ongoing basis to ensure that the valuations produced are reasonable and reflect all relevant factors. These valuations are based on market information and they are therefore classified as level 2 measurements. Details of these assets are given in note 18.

Short term investments

The short-term investments described in note 12 are freely traded securities for which a market price quotation is available and are classified as level 1 measurements.

b) Assets and liabilities carried at amortised cost

The fair values for financial assets and financial liabilities held at amortised cost, determined in accordance with the methodologies set out below are summarised below.

	Note	2019 Carrying amount	2019 Fair value	2018 IAS 39 Carrying amount	2018 Fair value
		£m	£m	£m	£m
Financial assets					
Cash	11	837.23	837.23	917.55	917.55
Loans to customers	16	5,381.75	5,534.38	4,655.43	4,734.33
Investment in structured entities	17	409.42	409.42	917.55	917.55
Loans to group companies	19	258.90	258.90	339.89	339.89
Sundry financial assets	19	85.63	85.63	10.34	10.34
		6,972.93	7,125.56	6,840.76	6,919.66
Financial liabilities					
Retail deposits		6,391.91	6,408.95	5,296.57	5,301.68
Amounts owed to group companies		338.44	338.44	408.93	408.93
Other financial liabilities		40.93	40.93	40.58	40.58
		6,771.28	6,788.32	5,746.08	5,751.19

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

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

45. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

Cash and investment in structured entities

The fair values of cash and cash equivalents and investments in structured entities which are carried at amortised cost are considered to be not materially different from their book values. In arriving at that conclusion market inputs have been considered but because all the assets mature within three months of the year end and the interest rates charged on financial liabilities reset to market rates on a quarterly basis, little difference arises.

As these valuation exercises are not wholly market based, they are considered to be level 2 measurements.

Loan assets

To assess the likely fair value of the Bank's loan assets in the absence of a liquid market, the directors have considered the estimated cash flows expected to arise from the Bank's investments in its loans to customers based on a mixture of market based inputs, such as rates and pricing and non-market based inputs such as redemption rates. Given the mixture of observable and non-observable inputs these are considered to be level 3 measurements.

Retail deposits

To assess the likely fair value of the Bank's retail deposit liabilities, the directors have considered the estimated cash flows expected to arise based on a mixture of market based inputs, such as rates and pricing and non-market based inputs such as withdrawal rates. Given the mixture of observable and non-observable inputs, these are considered to be level 3 measurements.

46. ULTIMATE PARENT COMPANY

The smallest and largest group into which the Bank is consolidated, and the Bank's immediate and ultimate parent company and ultimate controlling party is Paragon Banking Group PLC, a company registered in England and Wales.

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

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

47. DETAILS OF SUBSIDIARY UNDERTAKINGS

Subsidiary undertakings of the Bank at 30 September 2019, where the share capital is held directly by the Bank or by its subsidiaries are shown below:

Company	Holding	Principal Activity
Direct subsidiaries of Paragon Bank PLC		
Paragon Finance Plc	100%	Residential mortgage and asset administrator
Mortgage Trust Limited	100%	Residential mortgages
Paragon Mortgages (2010) Limited	100%	Residential mortgages
Paragon Mortgages Limited	100%	Residential mortgages
Paragon Asset Finance Limited	100%	Holding company and portfolio administration
Paragon Development Finance Limited	100%	Development finance
Direct and indirect subsidiaries of Paragon Asset Finance Limited		
City Business Finance Limited	100%	Asset finance
Paragon Commercial Finance Limited	80%	Asset finance
Paragon Business Finance PLC	100%	Asset finance
Paragon Technology Finance Limited	100%	Asset finance
PBAF (No. 1) Limited	100%	Holding company
Premier Asset Finance Limited	100%	Asset finance broker
Specialist Fleet Services Limited	100%	Asset finance and contract hire
PBAF Acquisitions Limited	100%	Residential mortgages
Capital Professions Finance Limited	100%	Non-trading
Collett Transport Services Limited	100%	Non-trading
Fineline Holdings Limited	100%	Non-trading
Fineline Media Finance Limited	100%	Non-trading
Homer Management Limited	100%	Non-trading
Lease Portfolio Management Limited	100%	Non-trading
State Securities Holdings Limited	100%	Non-trading
State Security Limited	100%	Non-trading
Direct subsidiaries of Paragon Mortgages Limited		
Paragon Second Funding Limited	100%	Residential mortgages and loan and vehicle finance
Paragon Options PLC	100%	Non-trading
Direct subsidiaries of Mortgage Trust Limited		
Mortgage Trust Services PLC	100%	Residential mortgages and asset administration
First Flexible No. 6 PLC	100%	Residential mortgages
Direct subsidiaries of Paragon Development Finance Limited		
Paragon Development Finance Services Limited	100%	Portfolio administration

NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the year ended 30 September 2019

47. DETAILS OF SUBSIDIARY UNDERTAKINGS (CONTINUED)

The financial year end of all of the Bank's subsidiary companies is 30 September. They are all registered in England and Wales and they all operate in the UK.

The remaining 20% of the equity of Paragon Commercial Finance Limited is subject to a call option agreed as part of the acquisition of the company by PBAF. No material minority interest attaches to this holding.

All of the entities listed in this note are included in the consolidated accounts of Paragon Banking Group PLC.

The registered office of each of the entities listed in this note is the same as that of the Bank (note 1), except that the registered office of State Security Limited is Burlington House, Botleigh Grange Office Campus, Grange Drive, Hedge End, Southampton, SO30 2AF.

E. Useful Information

Information which may be helpful to shareholders and other users of the Annual Report and Accounts

This section includes

E1 Glossary	A summary of abbreviations used in the Annual Report and Accounts.
E2 Contacts	Names and addresses of the Bank's advisers.

E1 GLOSSARY

ALCO	Asset and Liability Committee
BBR	Bank Base Rate
BEPS	Base Erosion and Profit Shifting
CCC	Compliance and Conduct Committee
CCoB	Capital Conservation Buffers
CCyB	Counter-Cyclical Buffers
CEO	Chief Executive Officer
CET1	Core Equity Tier 1
CPI	Consumer Price Index
CRD IV	The current EU Capital Requirements Regulation and Directive Regime
CRDs	Cash Ratio Deposits
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation – EU Regulation 575/2013
CSA	Credit Support Annex
EBA	European Banking Authority
EIR	Effective Interest Rate
EPS	Earnings per Share
ERC	Estimated Remaining Collections
EU	European Union
FCA	Financial Conduct Authority
FLA	Finance and Leasing Association
FLS	Funding for Lending Scheme
FRC	Financial Reporting Council
FRN	Floating Rate Note
FSCS	Financial Services Compensation Scheme
FVTPL	Fair Value Through Profit and Loss
GDP	Gross Domestic Product
HPI	House Price Index
HQLA	High Quality Liquid Assets
IAS	International Accounting Standard(s)
IFRS	International Financial Reporting Standard(s)
ILAAP	Internal Liquidity Adequacy Assessment Process
ILG	Individual Liquidity Guidance
ILTR	Indexed Long Term Repo Scheme
IRB	Internal Ratings Based

E1 GLOSSARY (Continued)

IRRBB	Interest Rate Risk in the Banking Book
ISA	Individual Savings Account
ISDA	International Swaps and Derivatives Association
ISO27001:2005	International Organization for Standardization 27001:2005, 'Information Security Management Systems'
KPMG	KPMG LLP, the Bank's auditor
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LIBOR	London Interbank Offered Rate
Ltd	Limited (company)
LTGDV	Loan to Gross Development Value
LTIP	Long-term Incentive Plan
LTV	Loan to Value
M&A	Merges and Acquisitions
NIM	Net Interest Margin
NPS	Net Promoter Score
NSFR	Net Stable Funding Ratio
OBR	Office of Budget Responsibility
OCI	Other Comprehensive Income
OLAR	Overall Liquidity Adequacy Requirement
ORC	Operational Risk Committee
PD	Probability of Default
PLC	Public Limited Company
PM25	Paragon Mortgages (No.25) PLC
PM26	Paragon Mortgages (No.26) PLC
POCI	Purchased or Originated Credit Impaired (assets)
RICS	Royal Institution of Chartered Surveyors
RoR	Receiver of Rent
RWA	Risk Weighted Assets
SA	Standardised Approach
Schedule 7	Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008
SICR	Significant Increase in Credit Risk
Sharesave	All Employee Share Option
SONIA	Sterling Overnight Interbank Average Rate

E1 GLOSSARY (Continued)

SPPI	Solely Payments of Principal and Interest
SPV	Special Purpose Vehicle company
TFS	Term Funding Scheme
The Act	The Companies Act 2008
The Bank	Paragon Bank PLC
PBG	Paragon Banking Group PLC
The Group	PBG and all of its subsidiary and parent undertakings
The Plan	The Paragon Pension Plan
TRC	Total Regulatory Capital
UK	United Kingdom
UKF	UK Finance

E2 CONTACTS

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