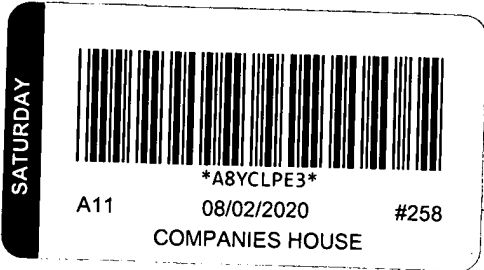


**PARAGON MORTGAGES (No.26) PLC**

**Report and Financial Statements**

**Year ended 30 September 2019**



## **STRATEGIC REPORT**

### **BUSINESS REVIEW AND PRINCIPAL ACTIVITIES**

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

The Company was incorporated on 14 December 2018.

On 3 July 2019 the Company issued floating rate notes and used the proceeds to purchase mortgage loans from Paragon Mortgages 2010 Limited, a fellow group company of the Group. During the year the Company operated in the United Kingdom, the principal activity of the Company is the provision of first mortgage loans. The directors are not aware, at the date of this report, of any likely major changes in the Company's activities in the next year.

As shown in the Company's profit and loss account on page 13, the Company's net interest income was £2,138,000. The loss after tax for the year was £848,000.

The balance sheet on page 14 of the Financial Statements shows the Company's financial position at year end. Loans to customers was £578,785,000; as a result, the balance outstanding under the asset backed loan notes at 30 September 2019 was £626,947,000. Cash held by the Company at 30 September 2019 was £64,097,000.

No interim dividend was paid during the year. No final dividend is proposed.

The Company has entered into derivative contracts in order to provide an economic hedge against its exposure to fixed rate loans to customers. Although these instruments provide an economic hedge the prescriptive nature of the requirements of International Accounting Standard 39 – 'Financial Instruments: Recognition and Measurement' ('IAS 39') means that hedge accounting cannot always be achieved. This has led to the Company recognising a fair value net loss of £2,919,000 in the year due to the ineffectiveness of the hedge relationship. This represents a timing difference and cumulative gains and losses recognised will tend to zero over time.

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

### **PRINCIPAL RISKS AND UNCERTAINTIES**

The assets of the Company are located entirely in the United Kingdom and its results are therefore impacted by the economic environment within the UK. A material downturn in economic performance could increase the numbers of customers who default on loans and / or cause the values of the properties over which the Company enjoys security to fall. The likelihood of this occurring has become more difficult to forecast given the continuing material uncertainties regarding the UK's withdrawal from the European Union.

The Company is a securitisation company and has been structured so as to avoid, in as far as is possible, all forms of financial risk with its outstanding loan notes match-funded to maturity. An analysis of the Company's exposure to risk, including financial risk, and the steps taken to mitigate these risks are set out in note 7, a discussion of critical accounting judgements is set out in note 5 and a discussion of critical accounting estimates is set out in note 6.

### **FUTURE PROSPECTS**

After considering the above, the directors have a reasonable expectation that the Company will have adequate resources to continue in operational existence for the foreseeable future, this is further discussed in note 4.

**STRATEGIC REPORT (CONTINUED)**

**ENVIRONMENT**

The Group recognises the importance of its environmental responsibilities, monitors its impact on the environment, and designs and implements policies to reduce any damage that might be caused by the Group's activities. The Company operates in accordance with group policies, which are described in the Group's Annual Report, which does not form part of this Report.

**EMPLOYEES**

The Company has no employees. All operational services are provided by employees of the Group. The Group's employment policies are described in its Annual Report, which does not form part of this Report.

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



**Jennifer Jones**

per pro MaplesFS UK Corporate Director No.1 Limited

Director

23 January 2020

## **DIRECTORS' REPORT**

The directors present their Annual Report prepared in accordance with Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 and the audited Financial Statements of Paragon Mortgages (No.26) PLC, a company registered in England and Wales with registration no: 11727898, for the period ended 30 September 2019.

### **CORPORATE GOVERNANCE**

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

### **DIRECTORS**

The directors during the year and subsequently were:

MaplesFS UK Corporate Director No.2 Limited (appointed 14 December 2018)

MaplesFS UK Corporate Director No.1 Limited (appointed 14 December 2018)

J P Giles (appointed 14 December 2018)

J L Jones (appointed 14 December 2018)

### **DIRECTORS' INDEMNITIES**

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

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

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

### **AUDITOR**

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.

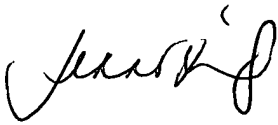
**DIRECTORS' REPORT (CONTINUED)**

**INFORMATION PRESENTED IN OTHER SECTIONS**

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

- Commentary on the likely future developments in the business of the Company is included in the Strategic Report.
- A description of the Company's financial risk management objectives and policies, and its exposure to risks arising from its use of financial instruments are set out in note 7 to the accounts.
- Disclosure on any dividends paid during the year is included in the Strategic Report.

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



Jennifer Jones

per pro Maples FS UK Corporate Director No.1 Limited

Director

23 January 2020

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

**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 each financial year. Under that law the directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). The financial statements are required by law to give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of their profit or loss for that period.

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets, for the Company's systems of internal control and 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 Companies Act 2006.

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



Pandora Sharp

Company Secretary

23 January 2020

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

## **1 Our opinion is unmodified**

We have audited the Financial Statements of Paragon Mortgages (No. 26) PLC ('the Company') for the year ended 30 September 2019 which comprise the:

- Profit and Loss Account
- Balance Sheet
- Statement of Movements in Equity
- Related notes, including the accounting policies in note 4.

In our opinion, the Financial Statements:

- the financial statements give a true and fair view of the state of the Company's affairs as at 30 September 2019 and of its loss for the year then ended;
- the financial statements have been properly prepared in accordance with UK accounting standards, including Financial Reporting Standard 101 – 'Reduced Disclosure Framework'; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

## **Basis for opinion**

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

We were appointed as auditor by the shareholders on 14 January 2020. 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 Group in accordance with, UK ethical requirements including the FRC Ethical Standard as applied to listed public interest entities. No non-audit services prohibited by that standard were provided.

## **2 Key audit matters: 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 AUDITORS' REPORT  
TO THE MEMBERS OF PARAGON MORTGAGES (No.26) PLC (CONTINUED)**

Key audit matter	Our response
<p><b>The impact of uncertainties due to the UK exiting the European Union on our audit</b> Risk ▲</p> <p><i>Refer to the Strategic Report</i></p> <p><b>Unprecedented levels of uncertainty</b></p> <p>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.</p> <p>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.</p>	<p>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:</p> <ul style="list-style-type: none"> <li>• <b>Our Brexit knowledge</b> – 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.</li> <li>• <b>Sensitivity analysis</b> – 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.</li> <li>• <b>Assessing transparency</b> – 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.</li> </ul> <p><b>Our results</b></p> <p>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.</p>



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

<p><b>Impairment allowances on loans to customers</b></p> <p>Risk ▲ (£3k;)</p> <p><i>Refer to the accounting policy note 4 and note 14 (financial disclosures).</i> <b>Subjective estimate</b></p> <p>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:</p> <p><b>Economic scenarios</b> – 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.</p> <p><b>Significant Increase in Credit Risk ('SICR')</b> – 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.</p> <p><b>Model estimations</b> – 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.</p> <p>The effect of these matters is that, as part of our risk assessment, we determined that the impairment of loans to customers has a high degree of estimation uncertainty, with a potential range of reasonable outcomes greater than our materiality for the financial statements as a whole, and possibly many times that amount.</p> <p><b>Disclosure quality</b> 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.</p>	<p>Our audit procedures included:</p> <ul style="list-style-type: none"> <li>— 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.</li> <li>— Test of details: Key aspects of our testing involved: <ul style="list-style-type: none"> <li>- 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;</li> <li>- Performing credit file reviews over individual loans in the Company's loan portfolios on a risk assessed sample basis to assess the reasonableness of the ECL measured on certain loans; and</li> <li>- Performing recalculations of the ECL measured on portfolios on a samples basis.</li> </ul> </li> <li>— Our financial risk modelling expertise: We involved our own financial risk modelling specialists in evaluating the IFRS 9 model. 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 model and key components.</li> <li>— 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.</li> <li>— Assessing transparency: We evaluated whether the disclosures appropriately reflect and address the uncertainty which exists when determining the Company's overall ECL. In addition, we challenged whether the disclosure of the key judgments and assumptions made was sufficiently clear.</li> </ul> <p><b>Our results</b> The results of our testing were satisfactory and we considered the credit impairment charge, provision recognised and the related disclosures to be acceptable.</p>
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**INDEPENDENT AUDITORS' REPORT  
TO THE MEMBERS OF PARAGON MORTGAGES (No.26) PLC (CONTINUED)**

<p><b>Interest receivable on loan accounts</b> (£5,539k) Risk ◀▶ <i>Refer to page 13 (profit and loss account) and the accounting policy note 4.</i> <b>Subjective estimate</b> 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. 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.</p>	<p><b>Our procedures included:</b> <b>Historical comparison:</b> 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 <b>Sensitivity analysis:</b> We performed sensitivity analysis over the repayment profiles by applying alternative profiles based upon the above procedures. <b>Assessing transparency:</b> 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 <b>Controls:</b> We tested management review controls over the approval of the Company’s repayment profiles; <b>Our results</b> We found the resulting estimate of interest receivable on loan accounts and the related disclosures to be acceptable.</p>
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**3 Our application of materiality and an overview of the scope of our audit**

Materiality for the Company financial statements as a whole was set at £4.83 million, determined with reference to a benchmark of Company’s total assets (of which it represents 0.75%).

We agreed to report to Those Charged with Governance any corrected or uncorrected identified misstatements exceeding £0.24 million, 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.

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

### **4 We have nothing to report on going concern (continued)**

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 4 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 on page 5 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.

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

## ***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.

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

Whilst the company is subject to many other laws and regulations, we did not identify any others where the consequences of non-compliance alone could have a material effect on amounts or disclosures in the financial statements.

These limited procedures did not identify actual or suspected non-compliance.

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

24 January 2020

**PROFIT AND LOSS ACCOUNT**

**PERIOD ENDED 30 SEPTEMBER 2019**

	Note	2019 £000
Interest receivable		
Loans to customers		5,539
Other		62
		<hr/> 5,601
Interest payable and similar charges	8	(3,463)
Net interest income		<hr/> 2,138
Other operating income		109
Total operating income		<hr/> 2,247
Operating expenses		(347)
Provisions for losses		(3)
		<hr/> 1,897
Fair value net loss	10	(2,919)
Operating loss, being loss on ordinary activities before taxation	11	<hr/> (1,022)
Tax on loss on ordinary activities	12	174
Loss on ordinary activities after taxation	19	<hr/> <hr/> (848)

All activities derive from continuing operations.

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

**BALANCE SHEET**

**30 SEPTEMBER 2019**

	Note	2019 £000	2019 £000
<b>ASSETS EMPLOYED</b>			
<b>FIXED ASSETS</b>			
Financial assets	13		578,785
<b>CURRENT ASSETS</b>			
Debtors falling due within one year	16	1,231	
Cash at bank		64,097	
		<u>          </u>	65,328
			<u>644,113</u>
<b>FINANCED BY</b>			
<b>EQUITY SHAREHOLDERS' DEFICIT</b>			
Called up share capital	18	12	
Profit and loss account	19	(848)	
		<u>          </u>	(836)
<b>CREDITORS</b>			
Amounts falling due within one year	20	5,699	
Amounts falling due after more than one year	20	639,250	
		<u>          </u>	644,949
			<u>644,113</u>

These Financial Statements were approved by the Board of Directors on 23 January 2020.

Signed on behalf of the Board of Directors



per pro MaplesFS UK Corporate Director No.1 Limited

Director

STATEMENT OF MOVEMENTS IN EQUITY

PERIOD ENDED 30 SEPTEMBER 2019

	Share capital £000	Profit and loss account £000	Total equity £000
<i>Total comprehensive income for the year</i>			
Loss for the period	-	(848)	(848)
Other comprehensive income	-	-	-
	<hr/>	<hr/>	<hr/>
Total comprehensive income for the period	-	(848)	(848)
<i>Transactions with owners</i>			
Issue of shares	12	-	12
	<hr/>	<hr/>	<hr/>
Net movement in equity in the year	12	(848)	(836)
Opening equity	-	-	-
	<hr/>	<hr/>	<hr/>
Closing equity	12	(848)	(836)
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

## NOTES TO THE ACCOUNTS

### PERIOD ENDED 30 SEPTEMBER 2019

#### 1. GENERAL INFORMATION

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

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

#### 2. BASIS OF PREPARATION

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

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

##### 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')

The effect on the Company's accounting of the adoption of these standards is discussed in note 3.

##### Comparability of information

IFRS9 does not require that the balance sheet information at 30 September 2018 and the profit and loss information for the year ended on 30 September 2018 to be 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.

#### 3. CHANGES IN ACCOUNTING STANDARDS

The Company is required to adopt IFRS 9 (and the consequent changes to IFRS 7) 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. The Group published a report on its transition to IFRS 9 on 22 March 2019 which is available from the investor section of the Group's website at [www.paragonbankinggroup.co.uk](http://www.paragonbankinggroup.co.uk).



NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

3. CHANGES IN ACCOUNTING STANDARDS (CONTINUED)

**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 4.

In accordance with the new rules:

Cash balances and loans to customers, 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

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 Company have arisen as a result of these classification changes.

**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.

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

3. CHANGES IN ACCOUNTING STANDARDS (CONTINUED)

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

Under IAS 39 the Company 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 Company 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.

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.

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

The introduction of the IFRS 9 impairment regime had no impact on the financial assets of the Company.

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

3. 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 Company'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 Company 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 Company'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 Company'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.

4. ACCOUNTING POLICIES

**Accounting convention**

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

**Going concern**

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

As a result of the transaction documents governing the Company's mortgage backed floating rate note borrowings described in note 21 the Company will continue to trade in the same way as it did in the year ended 30 September 2019 until either:

- All of the A1, A2, B, C, D, Z, and S notes are repaid from principal cash flows arising from the Company's mortgage portfolio;
- The call option described in note 21, exercisable for the first time in May 2023 is exercised; or
- The final repayment date for the notes in May 2045 is reached.

The directors have reviewed the balance sheet performance of the company and consider that it is unlikely that any of these events will occur during the year ending 30 September 2020.

Before this point, repayments of the principal liabilities of the Company, the mortgage backed floating rate notes described in note 20, are limited to available principal cash received on the Company's loan portfolio until the final repayment date. Therefore, the directors have a reasonable expectation that the Company has adequate resources to continue in operational existence until this point, satisfying all liabilities as they fall due.

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

## NOTES TO THE ACCOUNTS

## PERIOD ENDED 30 SEPTEMBER 2019

## 4. ACCOUNTING POLICIES (CONTINUED)

**Loans to customers**

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

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

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

**Impairment of loans and receivables**

The carrying values of all loans to customers, whether accounted for under IFRS 9 or IAS 17, are reduced by an impairment provision based on their expected credit loss ('ECL'), determined in accordance with IFRS 9. These estimates are reviewed throughout the year and at each balance sheet date.

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

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

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

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

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

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

4. ACCOUNTING POLICIES (CONTINUED)

**Impairment of loans and receivables (continued)**

Within its buy-to-let portfolio the Company utilises a receiver of rent process, whereby the receiver stands between the landlord and tenant and will determine an appropriate strategy for dealing with any delinquency. This strategy may involve the immediate sale of any underlying security or the short or long term letting of the property to cover arrears and principal shortfalls. Such cases are automatically considered to have an SICR, but where a letting strategy is adopted by the receiver, a tenant is in place and arrears are reduced or cleared, the account will not necessarily be considered to be credit impaired. Properties in receivership are eventually either returned to their landlord owners or sold.

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

**Cash at bank**

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

**Current tax**

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

**Deferred taxation**

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

**Borrowings**

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

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

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

4. ACCOUNTING POLICIES (CONTINUED)

**Derivative financial instruments**

Derivative instruments utilised by the Company comprise currency swaps and interest rate swaps. All such instruments are used for hedging purposes to alter the risk profile of the existing underlying exposure of the Company in line with the Company's risk management policies (note 7).

The Company does not enter into speculative derivative contracts.

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

**Hedging**

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

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

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

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

**Amounts owed by or to group companies**

The balances owed by or to other group companies are carried at the current amount outstanding less any provision.

**Revenue**

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

**Fee and commission income**

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

**NOTES TO THE ACCOUNTS**

**PERIOD ENDED 30 SEPTEMBER 2019**

**4. ACCOUNTING POLICIES (CONTINUED)**

**Deferred purchase consideration**

Under the Mortgage sale agreement profits from the company are paid up to the companies which originated the loans by way of deferred purchase consideration. Deferred purchase consideration is recognised in the period in which it becomes payable and is paid when sufficient cash resources allow. Paragon Mortgages (2010) Limited, to whom deferred purchase consideration is paid, is a fellow group company.

**Disclosures**

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

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

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

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

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

## NOTES TO THE ACCOUNTS

## PERIOD ENDED 30 SEPTEMBER 2019

## 5. CRITICAL ACCOUNTING JUDGEMENTS

The most significant judgements which the directors have made in the application of the accounting policies set out in note 4 relate to:

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

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

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

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

**Definition of default**

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

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

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

More information on the Group's definition of default adopted is given in note 14.

**Classification of financial assets**

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

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

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

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

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

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



## NOTES TO THE ACCOUNTS

## PERIOD ENDED 30 SEPTEMBER 2019

## 6. CRITICAL ACCOUNTING ESTIMATES

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

**Impairment losses on loans to customers**

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

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

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

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

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

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

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

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

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

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

**Effective interest rates**

In order to determine the EIR applicable to loans and borrowings an estimate must be made of the expected life of each loan and hence the cash flows relating thereto. For purchased accounts this will involve estimating the likely future performance of the accounts at the time of acquisition. These estimates are based on historical data and reviewed regularly. For purchased accounts historical data obtained from the vendor will be examined.

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

6. CRITICAL ACCOUNTING ESTIMATES (CONTINUED)

**Effective interest rates (continued)**

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

**Fair values**

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

7. FINANCIAL RISK MANAGEMENT

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

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

**Credit risk**

The Company's credit risk is primarily attributable to its loans to customers. The maximum credit risk at 30 September 2019 approximates to the carrying value of loans to customers (note 14). There are no significant concentrations of credit risk due to the large number of customers included in the portfolios.

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

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

At 30 September 2019 53.7% of the Company's mortgage loans by value had a loan-to-value ('LTV') ratio of 70% or less. The weighted average LTV was 66.9%. LTV for each account is calculated by comparing the current balance to the most recent valuation of the mortgaged property, indexed as appropriate.

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

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

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

## NOTES TO THE ACCOUNTS

## PERIOD ENDED 30 SEPTEMBER 2019

## 7. FINANCIAL RISK MANAGEMENT (CONTINUED)

**Liquidity risk**

The Company's assets are principally financed by asset backed loan notes issued through the securitisation process. Details of the Company's borrowings are given in notes 20 and 21. Securitisation effectively eliminates the Company's liquidity risk by matching the maturity profile of the Company's funding to the profile of the assets to be funded.

**Interest rate risk**

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

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

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

**Currency risk**

The Company has no material exposure to foreign currency risk.

**Use of derivative financial instruments**

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

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

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

**Fair values of financial assets and financial liabilities**

Derivative financial instruments are stated at their fair values in the accounts. The Group uses a number of techniques to determine the fair values of its derivative assets and liabilities, for which observable prices in active markets are not available. These are principally present value calculations based on estimated future cash flows arising from the instruments, discounted using a risk adjusted interest rate. The principal inputs to these valuation models are SONIA benchmark interest rates for the currencies in which the instruments are denominated, sterling and euros. In order to determine the fair values the management applies valuation adjustments to observed data where that data would not fully reflect the attributes of the instrument being valued, such as particular contractual features or the identity of the counterparty. The management reviews the models used on an ongoing basis to ensure that the valuations produced are reasonable and reflect all relevant factors. Details of these assets are given in note 15.

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

8. INTEREST PAYABLE AND SIMILAR CHARGES

	2019 £000
Asset backed loan notes	3,421
Interest rate swaps	(94)
Subordinated loan interest	112
Interest on fee letter	24
Interest payable to related parties	-
	<u>3,463</u>

9. DIRECTORS AND EMPLOYEES

Directors' fees from the Company during the year is stated in note 11.

The Company had no employees in the current or preceding year. All administration is performed by employees of the related companies under the servicing agreement described in note 22. One director of the Company is employed by Paragon Finance PLC, a related party, and their remuneration is disclosed within the financial statements of that company, which do not form part of this Report.

10. FAIR VALUE NET LOSS

The fair value net loss of £2,919,000 represents the accounting volatility on derivative instruments which are matching risk exposure on an economic basis. Some accounting volatility arises on these items due to accounting ineffectiveness on designated hedges, or because hedge accounting has not been adopted or is not achievable on certain items. The loss is primarily due to timing differences in income recognition between the derivative instruments and the economically hedged assets and liabilities.

11. OPERATING LOSS, BEING LOSS ON ORDINARY ACTIVITIES BEFORE TAXATION

	2019 £000
Operating loss is after charging:	
Directors' fees	2
Auditor remuneration - audit services	12
	<u>14</u>

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

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

12. TAX ON LOSS ON ORDINARY ACTIVITIES

a) Tax credit for the period

	2019 £000
Current tax	
Corporation tax	-
Total current tax	<u>-</u>
Deferred tax (note 17)	
Origination and reversal of timing differences	(194)
Rate change	20
Total deferred tax	<u>(174)</u>
Tax credit on loss on ordinary activities	<u>(174)</u>

b) Factors affecting the tax credit for the period

	2019 £000
Loss before tax	(1,022)
UK corporation tax at 19% based on the loss for the period	(194)
Effects of:	
Change in rate of taxation on deferred tax balances	20
Tax credit for the year	<u>(174)</u>

The current rate of corporation tax applicable to the Company for the year ended 30 September 2019 is 19.0%. Legislation has been enacted that will reduce this to 17% with effect from 1 April 2020.

Therefore, the effective rate of corporation tax is expected to be 18% for the year ended 30 September 2020 and 17% thereafter. The deferred tax liability reflects the rate at which temporary differences are expected to reverse.

13. FINANCIAL ASSETS

	2019 IFRS9 £000
Loans to customers (note 14)	578,785
Derivative financial assets (note 15)	-
	<u>578,785</u>

## NOTES TO THE ACCOUNTS

## PERIOD ENDED 30 SEPTEMBER 2019

## 14. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS

This note sets out information on the Company's impairment provisioning under IFRS 9 for the loans to customers balances set out in note 13, loans held at amortised cost, accounted for under IFRS 9, subject to the IFRS 9 impairment requirements.

The disclosures are set out under the following headings:

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

**Basis of provision**

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

*Calculation of expected credit loss ('ECL')*

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

PD on both a twelve month and lifetime basis is estimated based on statistical models for the Company's most significant asset classes. The PD calculation is a function of current asset performance, customer information and future economic assumptions. The structure of the models was derived through analysis of correlation in historic data, which identified which current and historical customer attributes and external economic variables were predictive of future loss. The Company utilised all reasonably available information in its possession for this exercise.

LGD for each account is derived by calculating a value for exposure at the point of default (which will include consideration of future interest, account charges and receipts) and reducing this for security values and costs of recovery. These calculations allow for the Company's potential case management activities. This evaluation includes the potential impact of economic conditions at the time of any future default or enforcement. The derivation of the significant assumptions used in these calculations is discussed below.

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

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

## NOTES TO THE ACCOUNTS

## PERIOD ENDED 30 SEPTEMBER 2019

## 14. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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

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

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

In all cases accounts which are more than one month in arrears, where this is a meaningful measure, are considered to have an SICR.

The Company 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 Company's definitions of default for its various portfolios are aligned to its internal operational procedures and the regulatory definitions of default used internally. In particular the Company's receiver of rent cases are defined as defaulted for modelling purposes as the behaviour of the case after that point is significantly influenced by internal management decisions.

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

*Credit Impaired loans*

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

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

During the year the Company revised certain of its default definitions for regulatory purposes. Where appropriate, IFRS 9 definitions have been amended to harmonise with the new definition and hence the staging at 1 October 2018.

As a result of this harmonisation 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.

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

14. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

*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.

**Impairments by stage**

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

	Stage 1	Stage 2 *	Stage 3 *	Total
	£000	£000	£000	£000
<i>30 September 2019</i>				
Gross loan book	577,226	1,562	-	578,788
Impairment provision	(2)	(1)	-	(3)
<b>Net loan book</b>	<u>577,224</u>	<u>1,561</u>	<u>-</u>	<u>578,785</u>
<b>Coverage ratio</b>	<u>0.00%</u>	<u>0.06%</u>	<u>0.00%</u>	<u>0.00%</u>

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



NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

14. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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

*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.

	<b>&lt; 1 month arrears</b>	<b>&gt; 1 &lt;= 3 months arrears</b>	<b>Total</b>
	<b>£000</b>	<b>£000</b>	<b>£000</b>
<i>30 September 2019</i>			
Gross loan book	1,138	424	1,562
Impairment provision	-	(1)	(1)
<b>Net loan book</b>	1,138	423	1,561
<b>Coverage ratio</b>	0.01%	0.17%	0.06%

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

14. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Movements in impairment provision by stage

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

	<b>Total £000</b>
At 14 December 2018	-
New assets purchased	3
Recovered in period	-
Amounts written off	-
<b>At 30 September 2019</b>	<u>3</u>

Accounts are considered to be written off for accounting purposes when standard enforcement processes have been completed, subject to any amount retained in respect of expected salvage receipts. This has no effect on the net carrying value, only on the amounts reported as gross loan balances and accumulated impairment provisions. At 30 September 2019 enforceable contractual balances of £nil were outstanding on assets written off in the period. This will exclude those accounts where a full and final settlement was agreed and those where the contractual terms do not permit any further action. Enforceable balances will be kept under review for operational purposes but no amounts will be recognised in respect of such accounts unless further cash is received or there is a strong expectation that it will be.

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

	<b>Stage 1 £000</b>	<b>Stage 2 * £000</b>	<b>Stage 3 * £000</b>	<b>Total £000</b>
Loss allowance at 14 December 2018	-	-	-	-
New assets originated or purchased	3	-	-	3
Changes in loss allowance				
Transfer to stage 1	-	-	-	-
Transfer to stage 2	-	-	-	-
Transfer to stage 3	-	-	-	-
Changes due to credit risk	(1)	1	-	-
Write offs	-	-	-	-
Assets recognised	-	-	-	-
Changes in models/parameters	-	-	-	-
<b>Loss allowance at 30 September 2019</b>	<u>2</u>	<u>1</u>	<u>-</u>	<u>3</u>

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

14. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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

	Stage 1	Stage 2 *	Stage 3 *	Total
	£000	£000	£000	£000
Balances at 14 December 2018	624,151	1,374	-	625,525
New assets originated or purchased	-	-	-	-
Changes in staging				
Transfer to stage 1	494	(494)	-	-
Transfer to stage 2	(674)	674	-	-
Transfer to stage 3	(120)	-	120	-
Redemptions and repayments	(43,848)	3	(120)	(43,965)
Assets derecognised	-	-	-	-
Write offs	-	-	-	-
Other changes	(2,777)	5	-	(2,772)
Balance at 30 September 2019	577,226	1,562	-	578,788
Loss allowance	(2)	(1)	-	(3)
Carrying value	577,224	1,561	-	578,785

**Impairments charged to income**

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

	2019 IFRS 9 £000
Provided in period	3
Recovery of written off amounts	-
	<u>3</u>

**Economic impacts**

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

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

14. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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

The central scenario is the economic forecast used within the Company 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 Company and must be consistent.

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
<i>Weighting applied</i>	40%	20%	35%	5%
<b>Economic driver</b>				
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%

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

15. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING

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

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

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

The analysis below splits derivatives between those accounted for as part of the portfolio fair value and those which, despite representing an economic hedge, do not qualify for this treatment. There were no individual interest rate risk hedging arrangements in place either in the period ended 30 September 2019.

	<b>2019</b>	<b>2019</b>
	<b>Assets</b>	<b>Liabilities</b>
	<b>£000</b>	<b>£000</b>
<b>Other derivatives</b>		
Interest rate swaps	-	(2,825)
Total recognised derivative assets / (liabilities)	<u>-</u>	<u>(2,825)</u>

The credit risk inherent in the derivative financial assets shown above is discussed in note 7.

## NOTES TO THE ACCOUNTS

## PERIOD ENDED 30 SEPTEMBER 2019

## 15. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

**Fair value hedges***Background and hedging objectives*

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

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

This position arises naturally where fixed rate loans are funded with floating or variable rate borrowings but may also arise where retail deposit funding is used. Where possible the Company takes advantage of natural hedging between fixed rate assets and deposits, but it is unlikely that a precise match for value and tenor of the instruments could be achieved leaving unmatched items on both sides. This is referred to as repricing risk and controlled within limits under the Company's interest rate risk management process, described in note 38. In order to manage these exposures, they are hedged with financial derivatives and form part of the Company's portfolio hedging arrangements. Repricing risk is monitored regularly to ensure mismatches or gaps remain within limits set by policy.

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

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

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

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

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

Where fixed rate assets or liabilities have been hedged with interest rate swaps, these currently mostly reference three-month LIBOR. As the Company 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 Company 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.

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

15. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

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

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

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

*Hedging Instruments*

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

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

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

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

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

15. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

**Derivatives not in a hedging relationship**

The Company's other derivatives comprise:

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

The principal terms of this derivatives are set out below.

*Interest rate swaps*

	<b>2019 Pay Fixed</b>
Average fixed notional interest rate	-
Average notional margin over SONIA	0.73%
	<b>£000</b>
Notional principal value	
SONIA swaps	486,780
	<hr/> 486,780 <hr/>
Maturing	
Within one year	
Between one and two years	-
Between two and five years	486,780
	<hr/> 486,780 <hr/>
Fair value	<hr/> (2,825) <hr/>



NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

16. DEBTORS

	<b>2019</b>
	<b>£000</b>
Amounts falling due within one year:	
Amounts owed by group companies	12
Other debtors (note 22)	1,018
Deferred tax (note 17)	174
Prepayments and accrued income	27
	<u>1,231</u>

17. DEFERRED TAX

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

	<b>2019</b>
	<b>£000</b>
Balance at 14 December 2018	-
Profit and loss credit (note 12)	194
Rate change (note 12)	(20)
Balance at 30 September 2019	<u>174</u>
The net deferred tax liability for which provision has been made is analysed as follows:	
Other timing differences	<u>174</u>

18. CALLED UP SHARE CAPITAL

	<b>2019</b>
	<b>£</b>
Allotted:	
49,999 ordinary shares of £1 each (25p called up and paid)	12,500
1 ordinary shares of £1 each (fully paid)	1
	<u>12,501</u>

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

19. RESERVES

	<b>Profit and loss</b>
	<b>account</b>
	<b>£000</b>
At 14 December 2018	-
Loss for the financial period	(848)
At 30 September 2019	<u>(848)</u>

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

20. CREDITORS

	<b>2019</b>
	<b>£000</b>
Amounts falling due within one year:	
Other creditors (note 22)	1,896
Accruals and deferred income	3,803
	<u>5,699</u>
	<u>2019</u>
	<u>£000</u>
Amounts falling due after more than one year:	
Asset backed loan notes	626,947
Derivative financial liabilities (note 15)	2,825
S VFN Notes	9,478
	<u>639,250</u>

A maturity analysis and further details of the asset backed loan notes are given in note 21.

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

21. BORROWINGS

The mortgage backed floating rate notes are secured over a portfolio comprising fixed and variable rate mortgage loans secured by first charges over residential properties in the United Kingdom. The notes are subject to mandatory redemption in part on each interest payment date in an amount equal to the principal received or recovered in respect of the mortgage. As a result of this structure, cash received in respect of loan assets is not immediately available for distribution. At 30 September 2019, the amount of restricted cash and investments held within the Company was £64,097,000. The maturity date of the notes matches the maturity date of the underlying assets. It is likely that a substantial proportion of these notes will be repaid within five years.

The Company has the option to repay all of the notes at an earlier date (the 'call date'), or at any interest payment date thereafter, at the outstanding principal amount.

Interest is payable at a fixed margin above:

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

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

The margin has a step-up to a higher rate from May 2023.

Notes in issue at 30 September 2019 were:

Notes	Maturity date	Call date	Principal outstanding 2019	Note margin 2019
			£m	
'A1'	May 2045	Aug 2024	383.5	1.05%
'A2'	May 2045	Aug 2024	151.5	1.20%
'B'	May 2045	Aug 2024	24.7	1.90%
'C'	May 2045	Aug 2024	18.6	2.25%
'D'	May 2045	Aug 2024	20.1	2.60%
'Z'	May 2045	Aug 2024	20.1	3.60%
'S'	May 2045	Aug 2024	10.2	4.00%
'SVFN'	May 2045	Aug 2024	9.5	4.00%

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

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

The Class S VFN Notes represents the Amortised Cost Adjustment.

There are no amounts of committed but undrawn facilities at 30 September 2019.

NOTES TO THE ACCOUNTS

PERIOD ENDED 30 SEPTEMBER 2019

22. RELATED PARTY TRANSACTIONS

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

**Transactions with Paragon Mortgages (2010) Limited (PM2010)**

The Company owed £nil to PM2010, a company under common control as defined by IAS 24, at the balance sheet date in relation to deferred purchase consideration, and £6,000 (2018: £nil) for mortgage fees and insurance which is included in other creditors.

The Company was owed £513,000 from PM2010 relating to monies received by the servicer, that are yet to be passed onto the Company, which is included in other debtors.

**Transactions with Paragon Finance PLC (PF)**

During the year PF, a company under common control as defined by IAS 24, acted as servicer of the mortgages for the Company and earned £75,000 in servicing fees. At the balance sheet date, the Company owed £75,000 to PF in relation to servicing fees, which is included in accruals and deferred income.

At the balance sheet date PF was owed £1,864,000 from the Company in relation to payments made on behalf of the Company, which is included in other creditors.

At the balance sheet date PF held the following notes as disclosed in notes 20 and 21:

Notes	Maturity date	Call date	Principal notes held 2019
			£m
'A1'	May 2045	Aug 2024	19.2
'A2'	May 2045	Aug 2024	7.6
'B'	May 2045	Aug 2024	24.7
'C'	May 2045	Aug 2024	18.6
'D'	May 2045	Aug 2024	20.1
'Z'	May 2045	Aug 2024	20.1
'S'	May 2045	Aug 2024	10.2
'SVFN'	May 2045	Aug 2024	9.5

During the year PF earned £88,000 in Class A1 note interest, £38,000 in Class A2 note interest, £165,000 in Class B note interest, £140,000 in Class C note interest, £169,000 in Class D note interest, £219,000 in Class Z note interest, £121,000 in Class S note interest, and £112,000 in Class S VFN note interest. At the balance sheet date, the Company owed £88,000 in Class A1 note interest, £38,000 in Class A2 note interest, £165,000 in Class B note interest, £140,000 in Class C note interest, £169,000 in Class D note interest, £219,000 in Class Z note interest, £121,000 in Class S note interest, and £112,000 in Class S VFN note interest, which are included in accruals and deferred income.

**NOTES TO THE ACCOUNTS**

**PERIOD ENDED 30 SEPTEMBER 2019**

**22. RELATED PARTY TRANSACTIONS (CONTINUED)**

**Transactions with Paragon Bank PLC (PB)**

During the year PB, a company under common control as defined by IAS 24, acted as servicer of the mortgages for the Company and earned £236,000 (2018: £nil) in servicing fees. At the balance sheet date, the Company owed £236,000 (2018: £nil) to PB in relation to servicing fees, which is included in accruals and deferred income.

The Company owed £26,000 (2018: £nil) for mortgage fees and insurance which is included in other creditors.

The Company was owed £505,000 (2018: £nil) from PB relating to monies received by the servicer, that are yet to be passed onto the Company, which is included in other debtors.

At the balance sheet date PB held the following notes as disclosed in notes 20 and 21:

<b>Notes</b>	<b>Maturity date</b>	<b>Call date</b>	<b>Principal notes held 2019</b>
			<b>£m</b>
'A2'	May 2045	Aug 2024	144.0

During the year PB earned £714,000 (2018: £nil) in Class A2 note interest. At the balance sheet date, the Company owed £714,000 (2018: £nil) to PB in Class A note interest which is included in accruals and deferred income.

**23. ULTIMATE PARENT COMPANY**

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

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

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