Paragon Banking Group PLC

Preliminary announcement

For the year ended 30 September 2023

RNS Announcement
Paragon Banking Group PLC
6 December 2023

Strong financial performance in volatile environment

Paragon Banking Group PLC ('Paragon' or 'the Group'), the specialist lender and banking group, today announces its full year results for the year ended 30 September 2023

Nigel Terrington, Chief Executive of Paragon said:

"The Group's performance for 2023 again demonstrates the strength of our business model, with underlying profits up 25.4%, loan book growth of 4.7% and retail deposits increasing 24.3% to £13.3 billion, outperforming the market, providing strong liquidity and supporting growth.

The Group's diversification strategy and focus on specialist markets across buy-to-let and our commercial divisions provides resilience. Our digitalisation programme continues at pace, providing better user experience for our customers and intermediaries, along with delivering operational efficiencies.

We have today announced a further £50.0 million share buy-back for the 2024 financial year. Reflecting the sustained performance of the Group, strength of our capital ratios and liquidity level, since 2015, the Group has returned over £948.5 million to shareholders via share buybacks and dividends.

Whilst the external environment remains dynamic with high interest rates and inflation, the Group remains well placed to continue supporting its customers in its chosen specialist markets. The strength of the business model and through-the-cycle experience of the management team provides strong foundations to capitalise on opportunities and continue to deliver strong returns for shareholders."

Financial highlights

- Underlying profit before fair value items increased by 25.4% to £277.6 million (2022: £221.4 million) *
- Reflecting the unwinding of non-cash accounting fair value gains reported in 2022, statutory profit before tax fell by 52.2% to £199.9 million (2022: £417.9 million including £4.6 million of one-off gains)
- Underlying EPS increased 34.8% to 94.2p (2022: 69.9p) *, reported EPS fell 46.8% to 68.7p (2022: 129.2p) reflecting fair value unwinds
- Underlying cost:income ratio improved further to 36.6% (2022: 39.4%)
- Cost of risk at 12 basis points (2022: 10 basis points) continues to reflect high quality customer base
- Capital ratios remain strong: CET1 ratio 15.5% (2022: 16.3%)
- Net interest margin widened by 40 basis points year-on-year to 309 basis points
- Underlying Return on Tangible Equity increased to 20.2% (2022: 16.0%)
- Tangible Net Asset Value per share at 30 September 2023 of £5.79 (2022: £5.33)

- Total dividend up 30.8% to 37.4p (2022: 28.6p), in line with policy
- £100.0 million share buyback programme completed in the 2023 financial year with a further £50.0 million announced for the 2024 financial year

* Appendix A

Operational highlights

- Total new lending of £3.01 billion (2022: £3.21 billion):
    - Mortgage Lending advances totalled £1.88 billion (2022: £1.91 billion)
    - Commercial Lending advances totalled £1.13 billion (2022: £1.30 billion)
- Enhanced customer retention of over 80% at product maturity and new advances support net loan book growth of 4.7% to £14.9 billion (2022: £14.2 billion)
- Buy-to-let three-month plus arrears 0.34% (2022: 0.15%), remaining significantly below the industry average
- Buy-to-let portfolio loan-to-value ratio at 62.8% (2022: 57.9%), providing substantial security cover
- Retail deposits increased 24.3% to £13.3 billion (2022: £10.7 billion), outperforming the market, supporting growth and providing strong liquidity
- Further progress on delivery of digitalisation strategy, with benefits already available to customers and intermediaries, helping to drive operational efficiencies
- Continuing engagement with PRA on IRB application process

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The Group will be holding a results presentation for sell-side analysts on Wednesday 6 December 2023 at 9:30am, at UBS, 5 Broadgate, London EC2M 2QS.

This will be webcast live at: https://secure.emincote.com/client/paragon/full-year-results-2023

The presentation material will be available on the Group's corporate website at www.paragonbankinggroup.co.uk/investors from 7:00am on the same day, with a webcast replay available from 2:00pm.

Cautionary statement

Your attention is drawn to the cautionary statement set out at the end of this announcement.

Introduction

The Group has reported strong results for 2023, with the loan book growing by 4.7% from its 2022 level and net interest margin widening to over 3%. This growth has been delivered whilst maintaining the strong capital and liquidity that underpins the Group's lending and savings propositions. Gross new lending advances again exceeded £3 billion, while the net increase of £2.6 billion in the deposit base supports growth and materially enhances liquidity.

The increasing influence of digitalisation is seen across the business, with our asset finance portal generating material application flows in the year, and the buy-to-let mortgage maturities portal underpinning stronger year-on-year customer retention at product maturity. Most recently, a post-completion portal has been put in place for buy-to-let customers and further functionality is being developed across the business, with delivery planned for 2024. The value of these enhancements is clear both from the response of our customers and from improved operational efficiency.

2023 has seen the Group make further progress with its climate change initiatives, which are discussed in more detail in the third edition of its Responsible Business Report. Developments in the year included enhanced analysis of the Group's lending on a financed emissions basis, a significant step towards the compilation of an associated transition plan, and the completion of a decarbonisation assessment of the head office building, which contributes to over 30% of the Group's operational carbon footprint.

The Group's people have responded extremely well to the effects of the volatile macroeconomic environment seen during 2023, rising to the various challenges, ensuring good outcomes for customers, and continuing to support the extensive change programmes in progress, as the Group develops its hybrid working approach in an increasingly digitalised environment.

The strong financial performance for the year supports a 30.8% increase in the Group's dividend to 37.4 pence per share. The Group completed a £100.0 million share buy-back programme in the financial year and has announced its intention to conduct a further buy-back of up to £50.0 million during the coming financial year. The full details of the PRA's approach to implementing Basel 3.1 in the UK are still not certain, and the regulator has recently delayed implementation to July 2025. Sufficient capital continues to be available to address the potential impacts of the Basel 3.1 regime. The Group also continues to progress its application for IRB accreditation for its buy-to-let mortgage assets.

Financial performance

Underlying operating profits (excluding fair value and gains on asset sales in 2022) increased by 25.4% year-on-year, to £277.6 million. The principal driver remained net interest income, which benefitted from a growing book and wider margins.

The average net loan book in Mortgage Lending rose by 4.4% to £12.6 billion from its 2022 level, with the average value of the Commercial Lending book increasing by 11.5% to £1.9 billion. The net interest margin rose to 309 basis points from the 269 basis points recorded in the previous year. These positive rate and volume influences saw net interest income increase by 20.9% to £448.9 million (2022: £371.2 million).

Interest income recognition follows the EIR approach set out in IFRS 9, which requires management judgments to be made about the future behaviour of customer accounts, in order to spread income over the expected life of a loan. For the Group's buy-to-let portfolio, these judgements centre on the likely behaviour of customers after their fixed rate period ends and the rates of reversionary interest which will apply at that point. The lack of recent historical precedent for the current economic environment makes these judgements complex. The aggregate EIR debtor position on the Group's balance sheet at 30 September 2023 totalled £20.5 million (including the impact of discounts on acquired loans), representing 14 basis points of the gross loan book.

Other income was little changed year-on-year, at £17.1 million (2022: £17.2 million, excluding the one-off impact of gains on a disposal of loans).

Operating expenses totalled £170.4 million and include costs associated with the closure of a Group subsidiary and an operational restructuring. While these are one-off in nature, they are considered immaterial and therefore no adjustment has been made to underlying results. The 8.4% increase in costs excluding these one-off items reflects the impact of inflationary pressures in the year, particularly in professional services, together with the Group's continued investment in its digitalisation plans.

The underlying cost: income ratio improved from 39.4% for the 2022 financial year to 36.6% in 2023, with cost discipline and the delivery of operational synergies remaining key areas of focus.

Impairment charges rose by £4.0 million to £18.0 million (2022: £14.0 million), reflecting the impact on customers of higher interest rates and the broader inflationary environment. The charge represents a cost of risk of 12 basis points. A more stable economic outlook, together with enhancements to the Group's SME lending impairment models have been the main drivers in supporting the reduction of overlays from £15.0 million at 30 September 2022 to £6.5 million at the year end, with a greater proportion of the expected loss being recognised by the modelled provisions. Impairment coverage ratios at 30 September 2023 stand at 45 basis points before judgemental overlays (2022: 37 basis points) and 49 basis points including the overlays (2022: 44 basis points).

As noted in the 2022 accounts, the rapid increase in interest rate expectations during 2022 generated a material fair value gain on derivatives hedging the new business pipeline. These gains reverse to zero over the lives of the related loan assets, and 2023 saw £77.7 million of this unwind.

The following table details the reconciliation between statutory and underlying profits for the 2022 and 2023 financial years.

Underlying profit reconciliation	**2023** **£ million**	**2022** **£ million**
Underlying profit before tax	277.6	221.4
Gains on asset sales	-	4.6
Fair value movements	(77.7)	191.9
Statutory profit before tax	**199.9**	**417.9**

Trading performance

New business flows for the year were in line with expectations, although the volatile interest rate environment resulted in substantial variations in application flows on an intra-period basis, with the sharp movements in rate expectations influencing demand and customer confidence.

In Mortgage Lending, £1.88 billion of new buy-to-let advances, coupled with stronger customer retention at product maturity, resulted in 4.7% growth in the net loan book across the year. Credit quality remains strong, with buy-to-let three-month plus arrears standing at 34 basis points (2022: 15 basis points), which continues to be significantly better than industry averages, and a weighted average indexed loan-to-value ratio of 62.7% (2022: 57.8%) providing substantial security cover.

The annualised redemption rate for the buy-to-let portfolio as a whole was 9.0% in 2023 (2022: 9.8%) with the legacy variable rate book, which is more impacted by increases in variable rates, amortising at 14.7% and the post-2010 new book seeing redemptions of 7.0%.

The net loan book for the Commercial Lending division grew by 4.8% in the year. Development finance grew by 3.9% to £0.75 billion, motor finance grew by 13.9% to £0.30 billion and SME lending grew 5.0% to £0.76 billion. The structured lending division saw net repayments of 5.4%, taking the year end drawn balance to £0.17 billion.

High interest rates (both spot rates and swap rates) in the final quarter of the financial year resulted in subdued demand for the Group's property-focussed offerings. In the buy-to-let book, these lower flows, coupled with disciplined management of lending margins and a swifter turnround of offers, resulted in the year end pipeline decreasing to £0.6 billion (2022: £1.3 billion). The development finance pipeline also reduced, to £0.5 billion from £0.7 billion a year before.

Capital and funding

Since the authorisation of Paragon Bank in 2014, the Group has used retail deposits to fund the majority of its lending growth and the systematic refinancing of its legacy wholesale facilities. This process continued through 2023, with the deposit book growing to £13.3 billion. Wholesale funding will continue to be used tactically, when pricing is attractive, and to manage duration. However, savings deposits are expected to provide the principal source for the Group's financing requirements over the coming years, supporting the further growth of its business and the repayment of its £2.75 billion TFSME drawing by October 2025.

Around 94% of our savings deposits are FSCS covered, and the product mix remains skewed to term deposits rather than easy access accounts, with term deposits comprising 65.5% of the portfolio (2022: 58.1%).

The success of the Group's savings growth has seen Paragon Bank's twelve-month average Liquidity Coverage Ratio ('LCR') increasing to 193.8% in 2023, compared to 146.2% during 2022. With savings deposits expected to be the Group's primary source of funds for the planned repayments of its TFSME borrowings, savings inflows and, hence, the LCR are likely to remain at more elevated levels in the near term. Once the TFSME funding is repaid we would expect the LCR to move back towards historic levels.

The CET1 and total capital ratios at the year end were 15.5% and 17.5% respectively and remain comfortably above regulatory requirements (2022: 16.3% and 18.3%). These requirements increased in the year, with the Bank of England increasing the UK CCyB rate to 2.0% (2022: 0.0%).

The Group continues to pursue an IRB accreditation, initially for its buy-to-let portfolio, and has been in active dialogue with the PRA for much of 2023. The Group is currently awaiting feedback regarding its most recent submissions.

Business model developments

The most notable developments seen in 2023 relate to the Group's continued digitalisation plans, which involve a phased re-platforming of its operational systems together with enhancements to customer and intermediary-facing portals, improving the user experience, and helping to drive operational efficiencies.

The buy-to-let mortgage maturities portal introduced in 2022 underpinned a material improvement in customer retention, with over 80% of professional landlords with maturing fixed-rate accounts taking switch products at maturity, up from over 70% in 2022. Similarly, the roll-out of the SME lending broker portal and enhanced automated support for decision-making in that business has been a catalyst for increased application volumes and more effective handling of cases.

The new financial year is scheduled to see further progress on the Group's digitalisation journey, with more systems moving from on-site hardware to cloud-based hosting, and additional functionality being developed for both the lending and savings businesses. The majority of the cost of these developments is included in operating expenses at the point it is incurred, with just £1.6 million of software capitalised in the year and held on the balance sheet (2022: £1.7 million).

The Group's operating model was reviewed during the year – focusing on the implications of hybrid working and critically examining the Group's management structure. The review was facilitated by a third-party consultancy which provided relevant peer and emerging trend insight to inform the Group's analysis of best practice. The process concluded during September 2023, resulting in a restructuring that will see 53 people leaving the business. Costs associated with this exercise totalled £2.6 million and were fully expensed in 2023.

2023 also saw the closure of the Group's mortgage brokerage subsidiary, TBMC, following a review of buy-to-let distribution strategy. This closure resulted in the writing off of goodwill and other intangible assets, together with other costs, totalling £2.0 million.

People

The Group's 1,500 employees are its most important asset. The outcome of the 2023 engagement survey was therefore particularly pleasing, with 88% of employees sharing their views, more than in any previous survey. The overall engagement score of 90% was our highest level for eight years, a result well above the average for the sector. Employees scored the Group particularly well on areas such as delivering good outcomes for customers, risk culture and positively influencing climate, alongside organisational integrity, wellbeing, development opportunities and employee voice.

A formal employee code of conduct has been in place throughout the year, with 100% of the Group's people attesting that they understood the code's expectations during 2023. The Group has a thriving Equality, Diversity and Inclusion ('EDI') network, sponsored at ExCo level, and a strong People Forum, which has regular engagement with the Chair of the Board, and the executive and non-executive directors.

Sustainability

During 2023 the Group joined PCAF (the Partnership for Carbon Accounting Financials) and in its 2023 Annual Report presents a PCAF Scope 3 financed emissions balance sheet, which measures the emissions attributable to its lending on an industry standard basis. Establishing a reliable benchmark forms a key element in planning the Group's transition path to net zero, so this represents an important milestone in that process.

Progress is also represented by work to enhance understanding of the potential impacts, over time, on the Group's buy-to-let portfolio of the UK Government's evolving proposals for Minimum Energy Efficiency Standards ('MEES') for residential property, and by the extension of attributable emissions reporting to include elements of the Group's Commercial Lending operations.

The majority of the emissions included in the Group's operational footprint arise from its thirty-year old head office in Solihull. During the year a full decarbonisation report on this building was completed, with the identified enhancement works planned to be completed over the coming three years, well ahead of the Group's operational net zero target date of 2030.

Outlook

The high interest rate, high inflation economic background has led to both market-wide reductions in demand and challenges on customer affordability. In this environment the Group's focus on specialist products, a robust credit approach, high levels of customer retention and margin maintenance has delivered strong results in 2023 and these strategies will continue into 2024 and beyond.

The Group's buy-to-let business represents its most mature and well-established division. Overall, the buy-to-let market slowed significantly in 2023, but the more specialist sector in which the Group operates has been materially more resilient. Having delivered stable and steady growth for many years, the combination of its strong franchise, longevity of data, planned delivery of IRB in fine-tuning capital requirements and increasingly digitalised operations combine to provide opportunities to maintain and accelerate this progress.

The continuing development of the Group's Commercial Lending division is also being driven by technological initiatives, embedding those recently introduced and rolling-out further elements of the Group's digitalisation plans. Capacity exists for each of the division's existing business lines to grow, and this is also an area where incremental capabilities can be strategically added over time, either organically or through acquisition. Operating at wider margins than the buy-to-let business, future growth in this segment will be a core component in the structure of the Group's margins going forward.

Savings deposits continue to form the core of the Group's funding, with 2023 having seen significant growth at attractive costs. The Group's TFSME drawings begin to mature in October 2025, therefore growth in savings at a greater rate than that for loan balances, potentially together with tactical access to wholesale markets, should be anticipated in the coming year. With a strong retail focus and 94% of deposits covered by the FSCS, the Group's savings proposition delivers a reliable, scalable and cost-effective means of financing the growth of the business.

Overall, the Group remains well placed to continue to support customers in its chosen specialist markets. The strength of the business model provides a strong foundation to capitalise on opportunities and deliver strong returns to shareholders.

MANAGEMENT REPORT

This section reviews the activities of the Group in the year under these headings

Business review	Funding	Capital	Financial results	Operations
Lending and performance for each business line	*Deposit taking and other sources of finance*	*Regulatory capital, liquidity and distributions*	*Results for the year*	*Systems, people, sustainability and risk*
Section 1	Section 2	Section 3	Section 4	Section 5

1 BUSINESS REVIEW

The Group reports its results analysed between two segments, Mortgage Lending and Commercial Lending, based on types of customers, products and the internal management structure. New business advances in the year and year end loan balances are summarised below, analysed by segment:

	Advances in the year		Net loan balances at the year end	
	2023 £m	2022 £m	2023 £m	2022 £m
Mortgage Lending	1,879.9	1,910.0	12,902.3	12,328.7
Commercial Lending	1,128.7	1,304.7	1,972.0	1,881.6
	3,008.6	3,214.7	14,874.3	14,210.3

The Group's total loan balance increased by 4.7% in the year, as it pursued its strategic objective of managed, targeted growth in challenging market conditions.

Total advances decreased 6.4% year-on-year, although the pattern of movements was not consistent between the Group's specialist markets, with the complex economic situation seen in the year impacting different business lines to varying degrees.

MANAGEMENT REPORT (Continued)

1 BUSINESS REVIEW

1.1 MORTGAGE LENDING

The Group's Mortgage Lending division principally provides buy-to-let mortgages secured on UK residential property to specialist landlords. The Group has been active in this market for over a quarter of a century, through a wide range of economic environments. This gives the Group deep data and an unparalleled understanding of this form of mortgage and of the requirements of the specialist landlords who form its customer base.

During the period the Group also offered a limited volume of loans to non-specialist landlords, although this activity has been increasingly non-core in recent years. The segment also includes legacy assets from discontinued product lines, including residential first and second charge mortgage loans.

The Group's focus on the specialist buy-to-let market facilitates detailed, case-by-case underwriting, where its unique approach to managing property risk and building customer relationships differentiate it from both mass market and other specialist lenders.

Housing and mortgage market

The levels of economic uncertainty in the UK economy over the year, coupled with the higher interest rate environment has significantly impacted the housing market. Activity substantially reduced year-on-year, with transactions for the year ended September 2023 reported by HMRC, at 1,085,000, 11.5% lower than the 1,226,000 in the previous year. In part this reflects a hiatus in the mortgage market in September and October 2022 when many lenders withdrew products as a response to the volatility in financial markets following the September 2022 mini-budget, but subsequent pressure on mortgage affordability has kept business levels depressed.

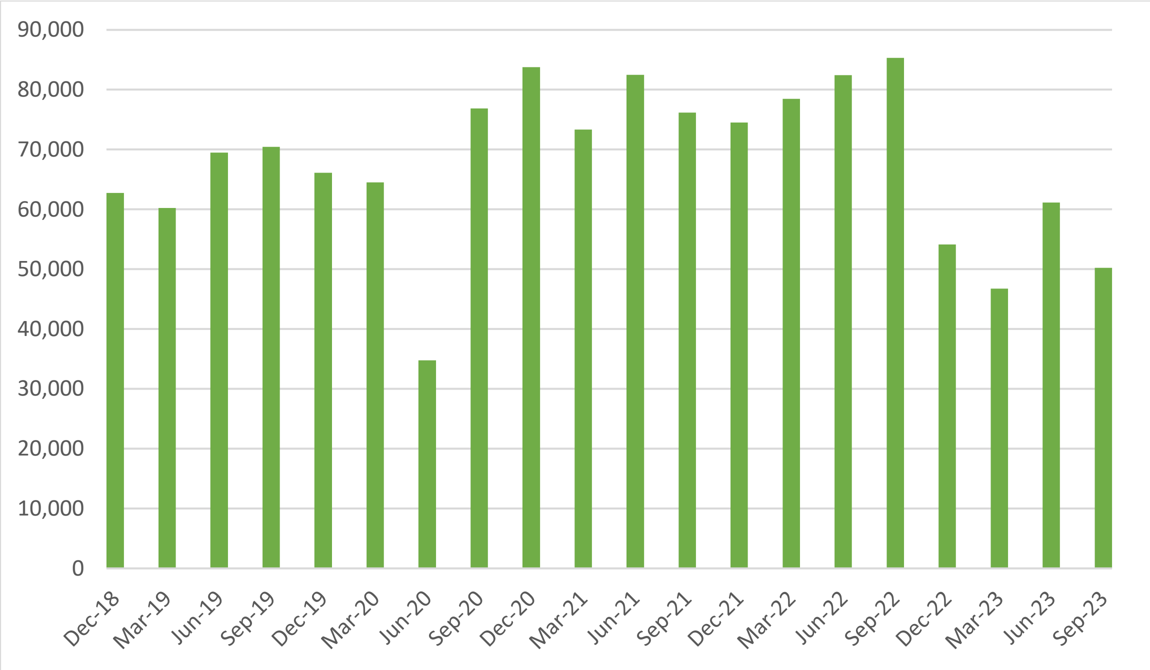
In its September 2023 Residential Market Survey, RICS reported continuing weak demand, although their members' outlook was less negative than earlier in the year, attributable to the impact of interest rates and more general economic uncertainty on affordability.

This weakening of demand put downward pressure on house prices, with the Nationwide House Price Index recording a year-on-year fall of 5.3% to September 2023 (2022: increase of 9.5%), although prices had broadly stabilised towards the end of the year. This was a smaller fall than some had predicted and returns house prices to February 2022 levels, although the impact of inflation over the period means that in real terms house prices fell by 12.6% in the year. Nationwide predicts the market to remain subdued in the short term, with RICS forecasting further house price falls over a twelve month horizon.

In response to the level of activity in the housing market, new mortgage lending was extremely weak in the year, with volumes in all four quarters less than any in recent years, other than the June 2020 quarter impacted by Covid. The Bank of England reported new approvals of £212.2 billion for the year ended 30 September 2023, a reduction of 33.8% on the record £320.8 billion reported for the previous financial year. Lending for new purchases and for remortgages were equally impacted, with volumes for both transaction types falling by around 18%, although the value of mortgages refinanced with their existing lender increased by 23%.

1 BUSINESS REVIEW

Quarterly Bank of England UK mortgage approval data for the last four financial years is set out below.



At 30 September 2023 the UK Finance ('UKF') survey of mortgage market arrears and possessions reported arrears levels building, potentially in response to rising interest rates, particularly towards the year end. Possession numbers rose through the year but remain far below the pre-Covid levels of early 2020.

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

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

While it is clear that the changing economic environment and regulatory landscape has caused some landlords to step away from the PRS, the Group's experience is that this reaction is concentrated amongst some smaller non-specialist amateur landlords, while its specialist customers remain committed to the sector.

The experience of the Group's customers, their level of involvement and the diversification of their income streams across properties make them less vulnerable to cash flow shocks in the event of a downturn and better able to cope when faced with an adverse economic situation impacting them or their tenants.

MANAGEMENT REPORT (Continued)

1 BUSINESS REVIEW

According to data from the 2021 census carried out in England and Wales, the PRS provides homes for around 20.3% of households in those countries, increased from 16.7% in the 2011 census. Data from the ONS Labour Force Survey suggest that across the UK at 30 June 2023, 22.1% of households were renting privately, a figure that has been gradually rising over recent years. With the economic environment creating constraints on income and mortgage affordability, it is likely that reliance on the sector will increase.

This can be seen in the lettings market data published in the RICS September 2023 UK Residential Market Survey. This reported continuing strong tenant demand coupled with a serious shortage of new instructions from landlords, which was pushing rents upwards, with RICS members expecting rent rises of around 5% in the next twelve months.

Research published by Zoopla suggested that, on average, rents for new tenancies across the UK had increased by 10.3% year-on-year, with the highest increases in Scotland, at 12.8%, despite what is perceived as more restrictive regulation in the Scottish PRS.

The UK Government is proposing reform of the PRS through its Renters (Reform) Bill, which was introduced into Parliament in May 2023. The Group has monitored the development of the legislation to date and is largely comfortable with the reforms, which balance the needs of tenants and landlords. However, there are concerns over the impact of the level of new regulation being applied to landlords. The Group would also urge the UK Government to ensure that the introduction of the new framework is adequately resourced to prevent disruption to both tenants and landlords. Overall, the Group does not believe its business model will be significantly impacted by the new legislation, and considers that its customer base may be better prepared to face these changes than some other parts of the PRS.

Around three quarters of properties in the PRS are funded through buy-to-let mortgages, but buy-to-let mortgage activity in the year was even more subdued than for mortgages more generally, with new advances reported by UKF, at £36.8 billion for the year ended 30 September 2023, being 32.4% lower than for the previous year (2022: £54.5 billion). While this was mostly led by a fall in activity for new house purchases, which were down by 36.6%, remortgaging was also impacted, falling by 30.5%. However, some of the downward pressure on remortgaging will be attributable to the relative unattractiveness of fixed rates available, coupled with the potential for affordability issues.

There is also evidence of increasing numbers of borrowers transferring to new products offered by their existing lender, which are not recorded as new cases in the data. Information published by UKF showed that around two thirds of landlords refinancing their mortgage in the year ended 30 September 2023 switched to a new product with the same lender, rather than remortgaging with a new provider, compared to around half in the preceding year.

This mixed outlook for the sector was borne out by the Group's own independently commissioned research amongst landlords and mortgage intermediaries.

MANAGEMENT REPORT (Continued)

1 BUSINESS REVIEW

In the Group's quarterly survey of buy-to-let landlords for the quarter ended 30 September 2023, 71% of landlords reported that they were experiencing increased tenant demand, with 48% reporting significant increases. Rental yields also continued to move upwards, with 70% of respondents having made rent increases over the year. Landlord confidence had also increased, year-on-year for rental expectations and for their own businesses, where the survey reported net optimism for the first time in a year. This was particularly the case amongst the larger landlords who form the Group's targeted customer base.

Expectations for capital gains, however, had fallen year-on-year and landlords remained relatively pessimistic generally. Reported confidence, across all metrics measured, covering their own business, the sector and the UK economy more generally, had declined significantly in the last quarter of the financial year.

Amongst specialist mortgage intermediaries, the Group's half-yearly insight survey, published in August 2023, showed that the vast majority of intermediaries were confident or very confident about the prospects for their firms and the mortgage industry. However, over 40% cited a lack of confidence in the outlook for buy-to-let, although this was still an improvement in the year. The principal issues that were concerning the respondents were the level of interest rates, and the impact of the cost of living on affordability.

The UKF analysis of arrears and possessions also provided analysis of buy-to-let cases, showing a similar position to the wider mortgage market, with arrears moving upwards, and that trend accelerating towards the end of the period.

Overall, this data indicates that the buy-to-let mortgage market remains generally robust, even in the face of economic pressures, albeit with a degree of caution on its future prospects. It therefore underpins the strength of the Group's proposition, particularly given its focus on the specialist landlord.

The Business Mortgage Company ('TBMC')

During the year the Group conducted a review of its TBMC mortgage brokerage business. This concluded that changes in market dynamics had meant that this operation was no longer contributing materially to the Group's strategic objectives and the decision was taken to close the operation. Costs of £2.0 million relating to the closure, including writing off remaining intangible balances, were expensed in the year.

By the end of the year the closure process had been largely completed, with remaining cases processed in an orderly fashion. The Group thanks TBMC's employees, business partners and customers for their support over the years and wishes them well for the future.

MANAGEMENT REPORT (Continued)

1 BUSINESS REVIEW

Mortgage Lending activity

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

	2023 £m	2022 £m
Originated assets		
Specialist buy-to-let	1,857.6	1,869.5
Non-specialist buy-to-let	22.3	39.5
Total buy-to-let	1,879.9	1,909.0
Owner-occupied	-	1.0
	1,879.9	1,910.0

Total mortgage originations in the Group decreased by only 1.6%, despite the constriction seen in the housing and mortgage markets more generally resulting in an increased market share of new lending. This is partly due to the Group's pipeline hedging policy, which enabled the mortgage offers which were in process at the start of the year to be satisfied, at a time when many lenders had to withdraw offers as a result of rising market interest rates. The Group's focus within the mortgage sector remained tightly on the specialist buy-to-let product, lending to larger landlords, those operating through corporate structures and those with complex properties, with other products ancillary to this activity.

New lending on specialist buy-to-let mortgages decreased by 0.6%, significantly outperforming the market, with the specialist sector showing itself to be resilient and eager to take advantage of opportunities created by the economic environment. These specialist completions, at £1,857.6 million formed 98.8% of the Group's new mortgage business. Non-specialist buy-to-let lending remains modest in comparison, with advances continuing to decline.

The majority of the Group's mortgage lending products offer fixed rates for an initial period, with many customers choosing a new product, either with the Group or elsewhere, at the end of this fixed period. A market shift in 2017 saw five-year fixes become the dominant product and those loans are now reaching the end of the five-year period. The Group has well-established retention procedures to address accounts as their fixed rates expire, which were enhanced as part of its digitalisation programme during the previous year. Over 80% of the specialist landlord customers whose products matured in the year remained with the Group at the year end.

In response to the uncertainties over the future of interest rates, the Group launched a new suite of track-to-fixed rate products, allowing customers to delay fixing their interest rate. The early launch of this alternative, compared to the market, helped support both advances and retentions.

The new business pipeline, being the loans passing through the underwriting process, stood at £594.6 million at the year-end, with the reduction from the previous year partly reflecting the tightening of the market in the period, but partly reflecting an enhanced approach to managing the pipeline (2022: £1,256.0 million).

1 BUSINESS REVIEW

Specialist intermediaries are the principal source of the Group's buy-to-let applications, and it continues to strategically focus on ensuring that the service offered to them is excellent. The Group's regular intermediary insight surveys in the year showed 95% were satisfied with the ease of obtaining a response from the Group (2022: 89%), delivering an NPS at offer stage of +60 (2022: +40). 75% of intermediaries dealing with the Group rated its service as good or better than that provided by other lenders (2022: 67%). Paragon Mortgages was also named as Best Professional Buy-to-Let Lender at the 2022/23 Your Mortgage awards, its tenth victory in that category, highlighting the effectiveness of its service proposition.

The Group's long-term programme of reengineering its mortgage business continued through the year. All systems and operational processes are being thoroughly reviewed and refined to align them with the Group's strategy for the division and the overarching plan of digitalising the business. The value of the work completed to improve the redemption and retention process in the previous period is demonstrated by results in this area in the current year.

The current year saw the completion of another major phase of the project, with the first release of a new landlord portal launched in May 2023. This market-leading new portal offers a better user experience and increased self-serve opportunities, and will continue to be enhanced. The overall project continues and will deliver additional service upgrades and new opportunities for interaction between the Group and its customers and business partners as further phases are rolled out.

Environmental impacts

The Group understands the potential for climate change to impact its mortgage business and seeks to mitigate risk through careful consideration of the properties on which it will lend. It also continues to develop systems and refine data to allow its overall position to be measured and the behaviour of its security portfolio under climate-related stresses to be better understood.

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

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

MANAGEMENT REPORT (Continued)

1 BUSINESS REVIEW

The Group's new buy-to-let lending volumes on energy-efficient properties, which have increased by 8.7% in the year, are set out below.

	2023	2022
	£m	£m
EPC rated A or B	184.1	169.0
EPC rated C	720.5	663.2
Total rated A to C	904.6	832.2
Percentage with available data (England and Wales)	*99.9%*	*99.6%*

The Group's latest analysis identified EPC grades for 94.6% by value of its mortgage book in England and Wales at 30 September 2023 (2022: 92.8%). Of these 99.2% were graded E or higher (2022: 98.9%) with 41.5% rated A, B or C (2022: 39.3%). The year-on-year movements are principally a result of the balance of new business, with almost half of the Group's advances in the year in England and Wales, 49.5% (2022: 45.1%) having one of the top three grades.

While the Group monitors EPC performance it is also conscious of the need to avoid unintended consequences by focussing lending on this. Although upgrading existing properties is beneficial to overall emissions, the demolition and replacement of properties may be less so.

The Group also monitors the potential physical risks to security values arising from climate change. This includes assessing a property's flood risk as part of the underwriting process. In addition, the exposure relating to the current mortgage book is monitored using specialist bureau data. This addresses the risk of flooding from rivers, seas or surface water. This showed that 3.0% of properties securing buy-to-let mortgages, where data was available, were at 'higher' risk (2022: 3.0%).

98% of landlords surveyed in the Group's research said that they were aware of the EPC rules affecting their properties. 79% of landlords stated they had no properties with EPC grades less than E, and 64% confirmed they would upgrade any property not meeting the standard rather than seek to sell it.

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

MANAGEMENT REPORT (Continued)

1 BUSINESS REVIEW

Performance

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

	2023	2022
	£m	£m
Post-2010 assets		
First charge buy-to-let	9,679.5	8,536.4
First charge owner-occupied	22.5	28.0
Second charge	75.8	104.4
	9,777.8	8,668.8
Legacy and acquired assets		
First charge buy-to-let	3,040.6	3,549.6
First charge owner-occupied	5.2	8.4
Second charge	78.7	101.9
	12,902.3	12,328.7

At 30 September 2023, the total net mortgage portfolio was 4.7% higher than at the start of the financial year, reflecting strong lending and retention performance. The balance of post-2010 buy-to-let lending grew by 12.8% and now represents 75.8% of the division's total loan assets (2022: 69.2%).

The annualised redemption rate on buy-to-let mortgage assets, at 9.0% (2022: 9.8%), has continued at a relatively low level. This is despite the potential impact of rising rates on customers whose interest charges are linked to reference rates, and the increasing numbers of five-year products now reaching the end of their fixed rate periods. As described above, the Group has adopted a number of strategic initiatives to retain customers with maturing fixed rate products.

Arrears on the buy-to-let book increased in the year to 0.34% (2022: 0.15%), with the payment performance of the Group's customers remaining strong, despite the growing economic pressures in the UK. Arrears on post-2010 lending were at 0.06% (2022: 0.09%). These arrears remain very low compared to the national buy-to-let market, highlighting the strength of the Group's credit standards. UKF reported arrears of 0.69% across the buy-to-let sector at 30 September 2023, sharply increased year-on-year (2022: 0.41%), though still less than the arrears seen in the wider mortgage market.

The Group's buy-to-let underwriting is focussed on the credit quality and financial capability of its customers, underpinned by a robust assessment of the available security. Relying on a detailed and thorough assessment of the value and suitability of the property as security, this approach to valuation, including the use of a specialist in-house valuation team, provides significant security in the face of economic stress.

The loan-to-value coverage in the Group's buy-to-let loan book, at 62.8% (2022: 57.9%), represents significant security, despite the falls in house prices in the year. Levels of interest cover and stressed affordability in the portfolio remain substantial, leaving customers well placed to develop their businesses going forward; indeed, on a simple weighted average basis, the Group's landlord customers now have around £9.0 billion of equity in their mortgaged properties.

1 BUSINESS REVIEW

Arrears on the closed second charge mortgage lending portfolios increased to 23.48% (2022: 21.33%) as the books continue to run off. These arrears levels remain higher than the average for the sector, which reflects the ageing of the balances, with the continuing upward trend reflecting the redemption of performing accounts. This book contains a significant number of accounts which are currently making full monthly payments, but which had missed payments at some point in the past, inflating the arrears rate. Credit performance is considered to be in line with expectations and the Group benefits from substantial security on these assets, with an average loan-to-value ratio of 52.3% (2022: 50.6%) providing a significant mitigant to credit risk.

For accounting purposes, 6.5% of the segment's gross balances were considered as having a significant increase in credit risk ('SICR') at the year end (2022: 16.4%), including 1.2% which were credit impaired (2022: 1.1%). This resulted from the more stable economic situation and some fine tuning of ECL models which enabled a more accurate identification of increased credit risk in performing accounts, counterbalanced, to some extent, by an increased number of arrears cases. However, the nature of the cases involved meant that provision coverage was stable, at 33 basis points (2022: 31 basis points), although coverage on fully performing accounts had reduced from 6 basis points at 30 September 2022 to 4 basis points at the year end, a result of the decreased level of overlay required.

The Group's receiver of rent process for buy-to-let assets helps to reduce the level of losses by giving direct access to the rental flows from the underlying properties, while allowing tenants to stay in their homes. At the year end, 564 properties were managed by a receiver on the customer's behalf, an increase of 18.7% over the year (2022: 475 properties), with receivers appointed on a number of additional portfolios during the year, while older cases continue to be resolved. Almost all these cases currently relate to pre-2010 lending, with cases being addressed on a long-term basis to ensure good outcomes for customers and their tenants, as well as for the Group.

Outlook

In the face of a difficult operating environment the division performed strongly in the year and the work carried out in the year to enhance retentions and develop new products means that it enters the new financial year with a robust proposition, with further improvements to its processes and systems progressing towards launch. These will ensure the Group maintains its reputation for providing an effective and responsive service to its customers and their brokers.

The Group's underwriting standards, credit performance and administration policies mean that the division is well placed to deliver value to shareholders whatever direction the UK economy takes, while ensuring that any issues of vulnerability amongst customers or their tenants are appropriately addressed.

MANAGEMENT REPORT (Continued)

1 BUSINESS REVIEW

1.2 COMMERCIAL LENDING

The Group's Commercial Lending division includes four key specialist business streams lending to, or through, commercial organisations, mostly on a secured basis. This division had been a major source of growth within the Group before the impact of Covid and remains a focus for growth going forward.

The four business lines address:

- Development finance, funding smaller, mostly residential, property development projects
- SME lending, providing leasing for business assets and unsecured cash flow lending for professional services firms, amongst other products
- Structured lending, providing finance for niche non-bank lenders
- Motor finance, focussed on specialist parts of the sector

Each of these businesses is led by a specialist management team with a strong understanding of their market. The principal competitors for each are small banks and non-bank lenders. The Group operates principally in markets where the largest lenders have little presence, creating both a credit availability issue for customers and significant opportunities for the Group.

The Group's strategy for Commercial Lending is to target niches (either product types or customer groups) where its skill sets and customer service culture can be best applied, and its capital effectively deployed to optimise the relationship between growth, risk and return.

MANAGEMENT REPORT (Continued)

1 BUSINESS REVIEW

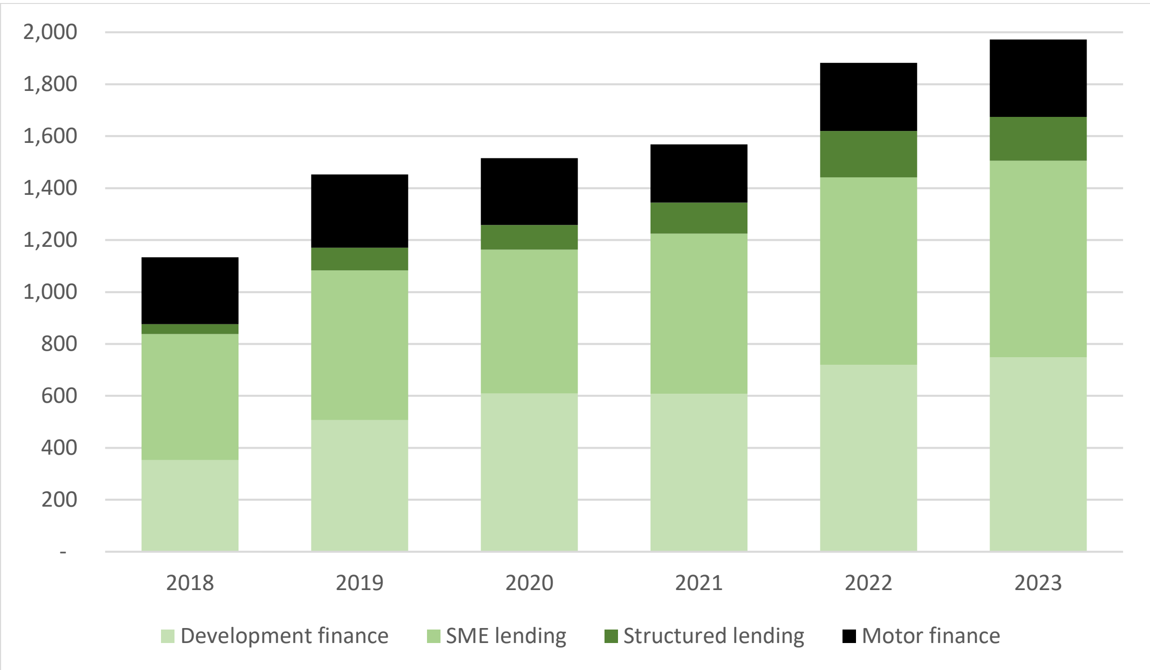
Commercial Lending activity

New lending in the Commercial Lending segment fell by 13.4% in the year as the UK slowed and customers felt the impact of the interest rate environment. Performance varied between business lines with development finance, where economic and political uncertainty increased caution amongst developers, particularly affected.

The new lending activity in the segment during the year is set out below, analysed by principal business line. As the structured lending business comprises revolving credit facilities, the net movement in the period is shown.

	2023 £m	2022 £m
Development finance	528.1	632.2
SME lending	447.9	446.4
Structured lending	(9.5)	59.9
Motor finance	162.2	166.2
	1,128.7	1,304.7

Despite this slowdown the overall Commercial Lending portfolio continued to grow, with total exposure increasing by 4.8% in the year to £1,972.0 million (2022: £1,881.6 million). The increase in the portfolio over the last five years, and its impact on the Group's diversification strategy is illustrated by the chart below.



1 BUSINESS REVIEW

Development finance

Activity levels across the development finance market have been significantly depressed during the year. Political uncertainty at the start of the year, coupled with caution over the future directions of interest rates, build costs and property values over the period, reduced developers' appetite to launch new projects, and led to increased issues arising on those projects which have been progressed.

The Group reported lower levels of enquiries and pipeline at the end of the previous financial year and this trend has largely continued through the year, with advances falling 16.5%. At the 2023 year end developers remained cautious, with undrawn amounts on live facilities at 30 September 2023, at £404.1 million, being 27.3% lower than those a year earlier (2022: £556.0 million), while the post-offer pipeline fell to £97.3 million (2022: £136.8 million).

The business extended its green financing option during the year, with the amount of funding available increased to £200.0 million. This product provides beneficial terms for projects to develop energy-efficient properties, those with an EPC A grade, and by 30 September 2023, £155.0 million of new lending facilities had been agreed under this initiative, with drawings in the year of £51.4 million and the first major project completed. This type of development will be an area of focus for the Group going forward, as customers increasingly factor these discounts into their project planning.

The Group's development finance lending was originally centred on London, but has broadened, year-on-year, with the proportion of the portfolio located in London and South-East England falling to 45.8% from 56.8% at 30 September 2022. Activity increased particularly in South-West England, with funding provided for a number of major projects.

The Group's investment in systems for this business has continued to show benefits during the year, with systems introduced in July 2022 enhancing process efficiency and customer service as they have bedded in. This drive towards digitalisation will continue, providing a solid platform for the future of the business and supporting the transition over time to an IRB approach to capital management.

In spite of the disruption seen in the sector during the year and the consequent impact on new business levels, long-term fundamentals of the business remain sound. The Group has a strong presence in the purpose-built student accommodation market, where evidence suggests there is a significant shortfall in high quality provision and, following the year end, the business expanded its product range to cover 'Build-to-Rent' projects, providing a wider range of options for its developer customers.

There is wide-spread agreement that the UK provides fewer new homes than necessary, offering significant opportunities for smaller developers to expand and for the Group to support them. The Group's proposition is strong and attractive and continues to provide healthy returns for the capital invested and opportunities for growth.

1 BUSINESS REVIEW

SME lending

The Group's SME lending business has a focus toward construction equipment and similar wheeled plant, and therefore is exposed to UK sentiment around capital investment. The political uncertainties of the period and the rising interest rate environment serve to increase levels of caution around committing to major capital projects, so the business has been faced with a testing operating environment for most of the year.

Despite this, asset leasing volumes increased by 3.4% year-on-year to £286.4 million excluding government-backed balances (2022: £276.9 million). While this is less than the 8% increase in new leasing business, excluding cars and high value items, in the year to 30 September 2023 reported by the Finance and Leasing Association ('FLA'), the FLA data has sharp variations between asset classes. The FLA reported no year-on-year increase in new leases of plant and machinery, while new leases of construction plant showed a decline. Investment in operating leases has also continued with £15.3 million of assets acquired in the period (2022: £14.5 million).

Lending under the UK Government-sponsored Recovery Loan Scheme, ('RLS') to support SMEs potentially affected by the Covid pandemic continued in the year. The reduction in the guarantee from December 2021, and the general emergence from Covid saw a marked drop-off in take-up of the scheme. During the year £7.9 million was advanced under the RLS (2022: £32.2 million), of which the majority, £6.9 million, was asset leasing business.

The Group continues to closely monitor the government-guaranteed portfolio for any adverse indications, particularly in view of the performance issues with such loans reported by other lenders, which have principally focussed on Bounce Back Loans Scheme ('BBLS') lending. However, it has not yet encountered such problems in its own portfolio.

Short-term lending to professional services firms outside government supported schemes increased by 9.5% to £137.7 million (2022: £125.8 million). These loans are often used to spread the impact of tax and other significant liabilities, and in previous periods the availability of tax deferrals, and government-guaranteed loans under Covid-related schemes to firms had seriously depressed demand. However, the underlying requirement for this form of finance remains for the longer-term, and performance has continued to move back towards pre-Covid levels.

The Group's investment in technology within the SME lending operation has continued to deliver improvements in internal efficiency and service to brokers and customers, providing an important point of differentiation against competitors. Agile and modular delivery enables individual improvements to go into the live system as they are completed, providing incremental enhancements, on an ongoing basis. During the year these included enhanced automated support for decisioning, enabling more efficient processing of applications.

The new broker portal launched in the previous financial year continues to provide benefits as its use is rolled out and further product lines added. Take-up has continued to grow with over 70% of standard SME lending applications now being received through the portal. This interface is designed as an additional service to brokers, with the division's business support team remaining fundamental to ensuring brokers and customers receive the standard of service they require.

MANAGEMENT REPORT (Continued)

1 BUSINESS REVIEW

The portal has facilitated a step-change in the operation's ability to handle smaller value loans efficiently, leading to an increased level of applications for such products, reducing the size of the average advance, which reduces risk in the portfolio.

In a survey conducted by the Group, 75% of users were satisfied with the new portal, with 79% considering it to be as good as or better than other lenders' offerings. Feedback from the survey is being used to drive further enhancements to the portal.

More widely, the division's ongoing broker satisfaction survey reported that 78% of respondents were likely to do further business with the Group (2022: 81%), with 86% reporting that the service they had received was as good or better than that received from other lenders (2022: 88%). The overall NPS amongst brokers for the year was +25, significantly positive. This was also recognised when the Group won the Leasing World 2023 Gold Award as SME Specialist of the Year. The strength of the Group's relationships with the broker community are key to the success of the business going forward.

The Group monitors the potential impact on climate of the industries it does business with, and supports UK SMEs with green propositions, such as the installation of solar power or infrastructure for recycling, as they transition their businesses towards net zero. These types of initiatives are expected to increase going forward as such considerations are prioritised by customers.

The FLA Outlook Survey for the third quarter of 2023, released in November 2023, showed almost all of its members expected a broadly similar economic situation for the coming year, with almost half anticipating some decline in business investment. 82% anticipated a worsening arrears position and 89% expected a higher level of corporate insolvencies, although a majority in both cases felt the increases would be small. Despite these fears, most members had become more optimistic for future business levels, with three quarters expecting at least some increase in lending levels in the next twelve months.

The Group's own quarterly research among SME leaders, conducted towards the end of the financial year also reported a mixed picture. Just over half of SMEs were confident of the prospects for their own business with the remainder unsure or negative, with similar results for their views on the sector more generally. Substantial numbers reported declining cashflows and turnover in recent months, although a larger number said these had improved, with a majority expecting improvements in the short term. Despite this, the number of SMEs expecting to make capital investments in their business in the near future was far greater than those who had made such investments in the previous six months.

Overall, the outlook for the SME sector remains uncertain, with contradictory data and a real prospect of additional headwinds building going forward. Some SMEs are clearly becoming more confident, especially for the longer term, but significant numbers still have a neutral or more negative outlook.

The prospects for SMEs in the UK are clearly more stable than at the previous year end, although the economic pressures of high interest rates and rising costs continue to present risks. However, the division has robust resources in place to manage any decline in portfolio performance and has enhanced its technology further to support recoveries. The division's investment in systems and its expert team ensure that it is well placed to support those SMEs who feel ready to invest to take advantages of the opportunities that will present themselves.

1 BUSINESS REVIEW

Structured lending

In response to the challenging economic conditions, activity in the structured lending business was broadly stable in the year. Drawn balances fell marginally from £178.7 million at 30 September 2022 to £169.0 million at the end of September 2023, although the total amount of the outstanding facilities increased by 6.9% to £235.7 million (2022: £220.5 million). All facilities continued to be managed in line with their agreements.

These facilities generally fund non-bank lenders of various kinds, providing the Group with increased product diversification and are constructed to provide a credit buffer in the event of default in the ultimate customer population. The Group's experienced account managers receive regular reporting on the performance of the security assets, and maintain a high level of contact with clients to safeguard its position. To date the Group has recorded no losses on any of its structured lending facilities.

Further facilities to the value of £40.0 million came on stream after the year end, and the Group continues to examine additional opportunities which would broaden the range of products and industries supported, diluting the concentration risk inherent in this form of lending. In the current economic climate these evaluations have a significant focus on the viability of the underlying customer activity.

Motor finance

The Group's motor finance business is a focussed operation targeting propositions not addressed by mass-market lenders, including specialist makes and vehicle types, such as light commercial vehicles, motorhomes and caravans, including static caravans. During the year the business marked the fifth anniversary of its entry into the leisure vehicle market by increasing its maximum lease term for motorhomes. The Group has facilitated over £130 million of motorhome finance since entering this growing market in 2018.

Lending in the year was broadly stable at £162.2 million (2022: £166.2 million). Car finance volumes reported by the FLA fluctuated significantly in the period, with amounts particularly depressed towards the end of the year. The FLA's data showed new business up 4% overall for the year ended 30 September 2023, although the amount of used car business, which represents a significant part of the Group's portfolio, fell by 6%.

The Group's cautious expansion of lending to finance battery-powered electric vehicles ('BEVs'), including light commercial vehicles, continued in the year. £7.8 million of new loans were made in the year, an increase of 30.0% (2022: £6.0 million), reflecting the continuing growth in this market. With the business focusing on used vehicles, the proportion of BEV lending will lag the growth in new registrations, however progress continues to be made, with almost 5% of new lending relating to such vehicles. The Group is well placed to support the green aspirations of its customers, as electric vehicles become a more widely viable and popular option and increasing numbers enter the used car market.

1 BUSINESS REVIEW

Performance

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

	2023 £m	2022 £m
Asset leasing	586.0	532.5
Professions finance	52.2	60.9
CBILS, BBLS and RLS	67.2	88.0
Invoice finance	31.7	25.7
Unsecured business lending	20.4	14.6
Total SME lending	757.5	721.7
Development finance	747.8	719.9
Structured lending	169.0	178.7
Motor finance	297.7	261.3
	1,972.0	1,881.6

The economic pressures in the UK had generated an increased number of issues on development finance projects by the year end, mostly relating to increased build costs or delays. Accounts are regularly monitored and graded on a case-by-case basis by the Credit Risk function and by 30 September 2023 there were twelve accounts identified as being at risk (2022: none) with one additional long-standing legacy case (2022: one).

These accounts have been carefully examined and projections stressed for the purposes of the Group's IFRS 9 provisioning, generating an additional impairment charge. Security across the portfolio more generally remains strong. The average loan to gross development value for the portfolio at the year end was 63.1% (2022: 62.1%), which gives the Group a substantial buffer if any project encounters problems. No write-offs were recognised on projects completed in the year.

Credit performance in the division's originated finance leasing portfolios has been generally strong, despite the adverse headwinds in the UK economy. Arrears in leasing at 0.23% remained minimal (2022: 0.08%) and motor finance arrears improved to 1.08% (2022: 1.58%). Despite this, the Group has reviewed its potential responses to credit issues across the operation and is ready to support any customers encountering problems.

Whilst some lenders have reported significant issues with their CBILS, BBLS and RLS lending related to either credit quality or fraud, with over 10% of loans under these schemes resulting in default, the Group has not yet seen any serious impacts on its lending on such products. These portfolios contained only £3.3 million of Stage 2 accounts at gross carrying value at 30 September 2023, and only £1.1 million of credit impaired cases. The Group's total claims made up to 30 September 2023 under the government guarantee were £3.4 million, only 2.6% of the £131.1 million advanced since the schemes began, with £3.3 million of this balance already recovered at the year end. The majority of the Group's government-backed lending was to its existing customers, which contributed to the credit quality of this lending and has enabled it to avoid the issues seen elsewhere.

1 BUSINESS REVIEW

In the structured lending business the Group carefully monitors the performance of the underlying asset pool on a monthly basis, to ensure its security remains adequate. The Group relies on its data monitoring and verification processes to ensure that these reviews are able to detect any credit issues. Performance in the year has been broadly in line with expectations, with generally improved metrics across the book and all but one account classified in IFRS 9 Stage 1 at the year end.

In terms of the Group's impairments procedures, 9.5% of the segment's gross balances were considered as having an SICR (2022: 4.7%) including 3.3% which were credit impaired (2022: 0.7%). The increase in credit impaired cases related mostly to the development finance projects noted above.

Provision coverage increased to 156 basis points (2022: 134 basis points), principally as a result of the greater number of credit impaired cases. Coverage on fully performing accounts reduced from 108 basis points at 30 September 2022 to 82 basis points at the year end as some of the potential issues identified at the beginning of the year were clarified in the period, or the relevant accounts moved to Stage 2.

Outlook

All business lines within the Commercial Lending segment have been subject to increasing economic pressure over the last year, particularly towards the end of the period, with finance and other costs impacting on the cash flows of the majority of UK enterprises. This environment seems likely to continue for the near future with clear consequences for volumes.

However, all the division's businesses remain strong and the efficient and effective processes which have been rolled out through the Group's digitalisation programme so far, coupled with strong customer relationship management and the high standards of credit management applied over time, will both protect the value in the business and enable it to grow in the longer term.

2 FUNDING

The Group's retail deposit-taking operation, which operates under the Paragon Bank branding is central to its funding strategy. This is supplemented with a variety of other sources of central bank and wholesale funding and liquidity sources, creating an adaptable and sustainable funding position which can respond to developments in the business, its operating environment and the economic landscape.

The Group's debt has an investment grade credit rating, confirmed by Fitch in February 2023, which supports its status as a debt issuer. The Group is therefore able to access cost-effective funding, as well as raising finance for strategic initiatives on a timely basis.

During the year the Group was able to expand its retail deposit portfolio, both to support new lending and to repay more expensive wholesale borrowings, despite the continuing pressures on household savings resulting from increasing costs of living, which were mitigated by the increasing attractiveness of term deposits for customers, compared to other forms of saving. This growth in term deposits has generated a flow of funds from clearing banks to smaller deposit takers, such as the Group, whose market focus has historically been on this type of product.

The Group's funding at 30 September 2023 is summarised as follows:

	2023 £m	2022 £m	2021 £m
Retail deposit balances	13,265.3	10,669.2	9,300.4
Securitised and warehouse funding	28.0	995.3	1,246.0
Central bank facilities	2,750.0	2,750.0	2,819.0
Tier-2 and retail bonds	258.2	261.5	386.1
Sale and repurchase agreements	50.0	-	-
Total on balance sheet funding	16,351.5	14,676.0	13,751.5
Off balance sheet liquidity facilities	150.0	150.0	150.0
	16,501.5	14,826.0	13,901.5

The Group's retail deposit balance grew by 24.3% in the year to £13,265.3 million (2022: £10,669.2million), representing 81.1% of balance sheet funding (2022: 72.7%). Wholesale borrowings were also considerably reduced during the year.

At 30 September 2023 the proportion of easy access deposits, which are repayable on demand, was 25.7% of total on-balance sheet funding (2022: 27.0%). This reduction is a result, in part, of the market sentiment in favour of fixed-rate savings, especially towards the end of the year, with some savers anticipating little further increase in interest rates. The Group's proportion of easy access deposits remains low compared to the rest of the banking sector and can be expected to increase in the future.

The Group has built cash reserves during the period, applying them to repay wholesale borrowings, including the repayment of the last remaining funding structure from the period before Paragon Bank received its banking licence.

MANAGEMENT REPORT (Continued)

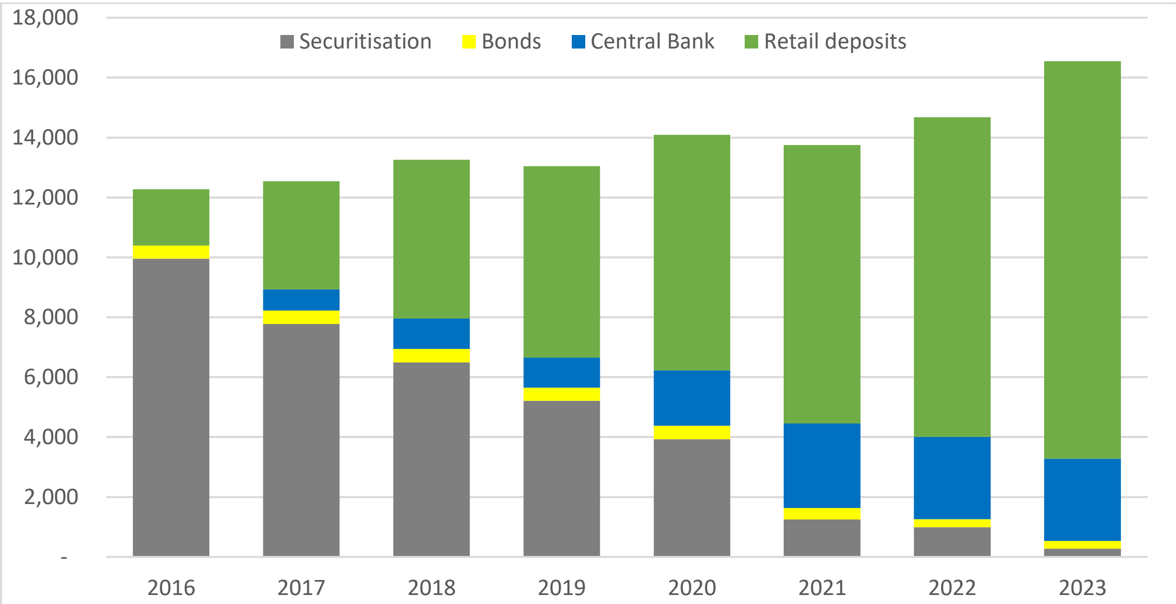
2 FUNDING

At the end of the year the Group had £2,907.7 million of cash available for liquidity and other purposes (2022: £1,689.1 million). This included operational liquidity and cash resources assembled in order to repay part of the Group's central bank exposures in the early part of the 2024 financial year. The appropriate level of cash reserves is monitored on an ongoing basis as part of the Group's capital and liquidity strategy, which continues to be based on a conservative view of the economic outlook and allows for the developing needs of the business.

The Group's long-term funding strategy, following the granting of its banking licence in 2014, has been to move to using retail deposits as its primary funding source, accessing the debt markets on an opportunistic basis for additional funding requirements. The Group's progress towards this goal is illustrated by the chart below which shows, at each of the financial year ends since 2015, the outstanding funding balance by type.

Funding by type (£m)

30 September 2016 –2023



The Group continues to adopt hedging strategies, including those using derivative financial instruments, to protect its income and operating model from adverse fluctuation in market interest rates. This activity was enhanced in the year in response to the higher interest-rate environment which developed during the period.

MANAGEMENT REPORT (Continued)

2 FUNDING

2.1 RETAIL FUNDING

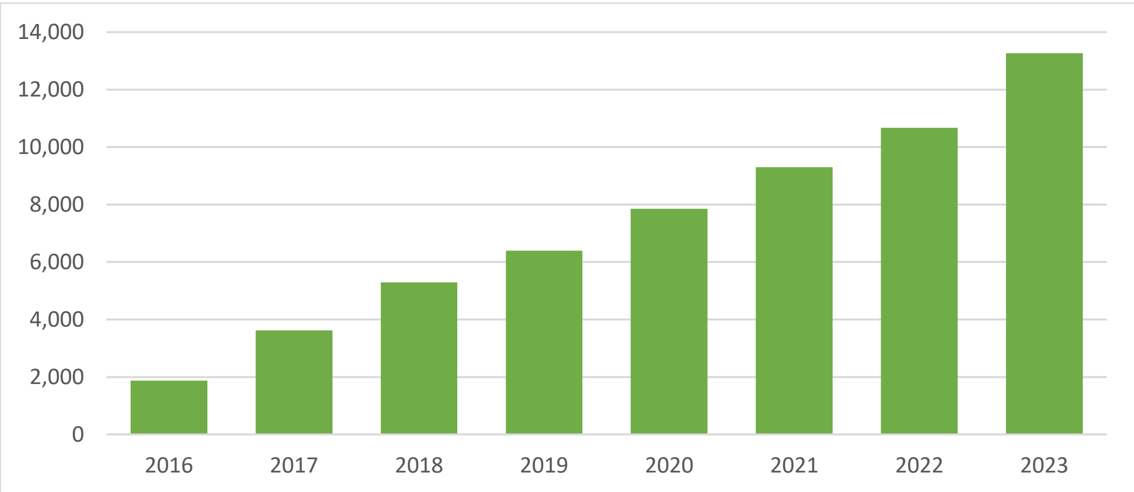
The UK savings market is a reliable, scalable and cost-effective source of funding, with the Group's strategy centred on offering sterling deposit products to UK households through a streamlined online presence, supported by an outsourced administration function, with additional routes to market provided by third party platforms.

Products include cash ISAs, where the Group has a significant market presence, term and notice deposits and easy access accounts. The proposition is based on competitive rates and value for money, combined with the Group's strong customer service ethic and the protection provided to depositors by the Financial Services Compensation Scheme ('FSCS'). The protection provided to depositors by the FSCS both incentivises larger savers to divide their deposits between several institutions and reduces the perceived risk for customers in using less familiar institutions, providing market opportunities for the Group's offering. At 30 September 2023, this FSCS protection covered around 95% of the Group's deposit balances.

The Group's retail deposit franchise performed strongly in the year and delivered the required funding base at an attractive cost compared to wholesale alternatives. The growth of the retail funding balance over recent years is set out below.

Retail deposits (£m)

At 30 September 2016 – 2023



During the year, UK deposit balances from individuals reported by the Bank of England remained relatively stable, despite increasing pressures on living costs, with balances at 30 September 2023 reaching £1.67 trillion (2022: £1.65 trillion), a year-on-year increase of 1.3%. Given that recent data shows a trend of household incomes diminishing in real terms, it is possible that overall UK savings balances may contract in the coming year, before returning to growth thereafter.

MANAGEMENT REPORT (Continued)

2 FUNDING

Against this relatively static background the Group's customer deposits increased much faster than the overall market, with a 24.3% increase in balances over the year. This reflects both the attractiveness of the Group's proposition and its continuing programme of business and systems development, which continued in the year. This was achieved despite the complexities inherent in more volatile market pricing as different deposit-takers responded to base rate increases in different ways and over differing time frames, and customers' savings preferences adapted to the higher rate environment.

Within the savings market there was a strong move towards fixed-term and notice deposits, with the Bank of England reporting a 60.8% (£88.9 billion) increase in such deposits from individuals during the year, despite the stable position of the overall savings base. National Savings deposits, which fulfil a similar function for consumers, also increased by 8.0% (£17.0 billion) in the period. These increases are attributable to the increasing opportunity cost to consumers of leaving excess savings in current accounts or low yielding deposit accounts as rates rise. As many of these fixed-term products are offered on a fixed-rate basis, this market shift also increased the proportion of the market represented by these products.

The Group benefitted from this market shift, with increasing demand for its core products. Specialist savings providers, such as the Group, typically have stronger product offerings in the fixed term, notice and ISA markets, with the current account and easy access markets dominated by the major clearing banks. Therefore, a market where fixed-term products are more attractive offers opportunities for the Group, evidenced by the increased proportion of the savings book represented by fixed rate products.

Increasing diversification and the FSCS guarantee are likely to reduce the potential for liquidity impacts and the Group's profiling of its target customers suggests they may be more resilient than average in the event of future economic stresses.

Savings accounts at the financial year end are analysed below.

	Average interest rate		**Proportion of deposits**	
	2023	**2022**	**2023**	**2022**
	%	**%**	**%**	**%**
Fixed rate deposits	4.07%	1.74%	65.5%	58.8%
Variable rate deposits	3.74%	1.55%	34.5%	41.2%
All balances	3.95%	1.66%	100.0%	100.0%

The increase in the Group's absolute funding costs is driven by market movements, where, following the rises in the Bank of England base rate during the year, saving rates have also moved sharply upwards. The Bank of England has reported average interest rates at 30 September 2023 for new 2-year fixed rate deposits at 5.50% (2022: 2.63%), and at 2.68% for instant access balances (2022: 0.60%), with similar rises across other product types.

2 FUNDING

This rise in market savings rates was, however, not as large as that seen for market benchmark rates. During the year the SONIA benchmark increased from 2.19% at 30 September 2022 to 5.18% at 30 September 2023, meaning the average variable rate paid by the Group represented a 144 basis point discount to SONIA (2022: 64 basis points) continuing the widening trend seen in the previous financial year. This represented a general realignment of borrowing and lending rates across the sector and increased the attractiveness of deposit funding compared to wholesale funds, which are generally priced at a margin above SONIA.

The average initial term of fixed rate deposits was 20 months (2022: 22 months), with such products representing a greater percentage of the portfolio, reflecting the market trends discussed above.

The Group’s presence on third party investment platforms and digital banks’ savings marketplaces provides an important alternative route to market for the savings operation. These channels provide access to a different customer demographic to the Group’s mainstream customers, with the more diversified sourcing offering enhanced opportunities to manage inflows and costs. The difference in profile of the platform customers is highlighted by their average account balances, which is far lower than that seen on direct business. The Group now has nine such relationships, compared to eight at 30 September 2022. These channels represent around 22% of the total deposit base (2022: 13%) and the Group has the systems and control framework in place to further increase its reach through these channels, if appropriate and cost-effective.

The Group’s strategy in the savings market relies on providing a high-quality customer offering and it conducts insight surveys throughout the customer journey. The results of this research in the period maintained the strongly positive position previously reported, demonstrating that the Group’s customer interactions infrastructure positions it well to retain customers and develop customers in the active and competitive market it serves.

For customers opening a savings account with the Group in the year, 88% of those who provided data stated that they would ‘probably’ or ‘definitely’ take a second product (2022: 88%). The NPS in the same survey was +62, similar to that in the previous year (2022: +59).

When customers with maturing savings balances in the year were surveyed, 88% stated that they would ‘probably’ or ‘definitely’ consider taking out a replacement product with the Group (2022: 87%) with an NPS at maturity of +59, an increase from that seen in the 2022 financial year (2022: +52).

The Group’s savings offering continues to win recognition from industry experts, being one of only four firms named as recommended savings providers by Which? in November 2023. Paragon Bank was also named ‘Best Multi-Channel Savings Provider’ at the 2023 Savings Champion awards and ‘Cash ISA Provider of the Year’ at the 2023 Moneynet awards, endorsing the Group’s diversified approach as well as one of its key products.

The Group’s retail deposit base continues to provide a stable foundation for its funding strategy, allowing volumes and rates to be effectively and flexibly managed. It is an important objective for the Group to develop its savings business further, broadening its product range, addressing wider demographics and expanding its presence on third party platforms. It will also continue to develop its systems and routes to market to ensure it is able to address the increasingly sophisticated needs of savers and meet the Group’s funding requirements into the future.

2 FUNDING

2.2 CENTRAL BANK FACILITIES

The Group's wholesale funding balance at the year end mostly comprises Bank of England facilities, principally those introduced to support SME lending during the Covid pandemic. The Group also has access to other facilities offered by the Bank, which it utilises from time to time as part of its overall funding strategy.

The Term Funding scheme for SMEs ('TFSME') provides the largest part of this funding, with borrowings at 30 September 2023 of £2,750.0 million (2022: £2,750.0 million). Interest is payable on these drawings at the Bank of England base rate, which is currently less attractive than rates available on retail deposits and the Group is seeking to strategically reduce this balance, with £300.0 million repaid early after the year end.

The Group has access to other Bank of England funding channels, including the Indexed Long-Term Repo ('ILTR') scheme, for liquidity purposes but has made no drawings in the period.

The Group expects to make use of central bank facilities going forward, in accordance with the objectives of the schemes, where using them is appropriate and cost-effective. Mortgage loans pre-positioned with the Bank of England are available to act as collateral for future drawings, if and when required. This provides access to potential liquidity or funding at 30 September 2023 of up to £1,715.4 million (2022: £1,776.0 million). Additionally, the Group's retained asset backed notes can be used to access Bank of England funding arrangements.

2.3 WHOLESALE FUNDING

The Group's wholesale funding options include securitisation funding, warehouse bank debt and retail and Tier-2 corporate bonds, which can be accessed from time to time as appropriate. The Group's Long-Term Issuer Default Rating was confirmed at BBB+ by Fitch in February 2023 with a stable outlook, enhancing the Group's funding capability.

During the year the Group reduced its wholesale funding significantly. The Paragon Mortgages (No. 25) PLC securitisation was redeemed in the year, at its expected date, while the Paragon Seventh Funding warehouse was repaid and termed out.

In September 2023, the Paragon Second Funding Warehouse structure, which had been in run-off since 2008 was redeemed in full, closing out the Group's final legacy funding liability from the period prior to the licencing of Paragon Bank.

This leaves the proportion of the Group's funding represented by wholesale borrowings at its lowest level since it received its banking licence. The relative attractiveness of retail funding has led to the Group's focus on that channel, although it retains the capacity to raise wholesale debt as required, where appropriate. The Group also entered into sale and repurchase transactions on a short term basis from time to time, to ensure it retains access to this channel for liquidity purposes, and balances of £50.0 million were outstanding at the year end (2022: £nil).

MANAGEMENT REPORT (Continued)

2 FUNDING

Capital markets have remained active in the period for most classes of debt, but the number of transactions coming to market has been lower than average, with firms which have access to retail funds finding wholesale pricing generally unattractive.

Historically the Group has been one of the principal issuers of UK residential mortgage-backed securities ('RMBS'), however, its reliance on this funding source has been significantly reduced over recent years, with the most recent issuance retained internally to support wider liquidity options, rather than being issued in the market. This was the case with the Paragon Mortgages (No. 29) PLC securitisation, completed after the year end, on 1 November 2023, where the £855.0 million of notes issued can be used to access central bank and third party facilities.

The Group's wholesale funding position now satisfies only a small part of its overall requirements, but remains available on a tactical basis when rate and conditions are attractive, and to provide contingent funding and support liquidity.

2.4 DERIVATIVES AND HEDGING

Derivative assets and liabilities continue to be used to hedge interest rate risk arising from fixed rate loans and deposits. The Group pre-hedges a proportion of its lending pipeline, which results in derivative positions being established before loans are completed.

While this strategy has not materially changed in the period, the movements in interest rate expectations over the most recent financial periods have resulted in large derivative asset balances being carried on the balance sheet at fair value, although the 30 September 2023 position was reduced from the previous financial year end. The size of these balances and the volatility in rates has also led to significant profit and loss account impacts. However, any such gains or losses, which tend to zero over time, are ancillary to the Group's lending and deposit-taking activities and it undertakes no trading in derivatives.

The Group's hedging strategy has been enhanced in the year to protect profit margins from the impact of future falls in interest rates of fixed rate borrowings and equity, which otherwise would cause a fixed / floating mismatch between the asset and liability sides of the balance sheet. A one-to-one interest rate hedge has been arranged for the Group's Tier 2 bond and accounted for as a micro hedge of interest rate risk (note 20).

An amount of the Group's fixed rate mortgage lending is also being attributed to provide natural equity hedging. At the end of the year £313.0 million had been attributed in this way, and it is the Group's intention to extend this balance to around £1,200.0 million, covering the majority of the equity balance. However, this form of hedging has no direct accounting impact.

2 FUNDING

2.5 FUNDING OUTLOOK

The year ended 30 September 2023 saw the continuing growth of the Group's savings proposition, with total balances reaching £13,265.3 million, 24.3% higher than a year earlier. The wholesale part of the funding base continued to reduce, a trend expected to continue into the new financial year. However, little refinancing is required in the short term, providing some protection against any developing issues in the UK economy.

This has been consistent with the Group's funding strategy, making strategic use of wholesale funding sources while maintaining its principal focus on the retail savings market. The Group is well placed to maintain this diverse, robust and adaptable strategy going forward, which will support the needs of its developing business into the future.

Further information on all the above borrowings is given in note 24.

MANAGEMENT REPORT (Continued)

3 CAPITAL

The Group's strong financial foundations form one of its three strategic pillars, with building and maintaining strong levels of core capital through the economic cycle a key strategic priority. The Group manages its balance sheet to maintain capital strength, ensure that its regulatory capital and liquidity positions are sufficient to safeguard depositors and provide capacity to meet its strategic objectives and other opportunities going forward.

The year has seen considerable fluctuation in UK economic metrics, coupled with changes in political priorities for the country, while the Basel 3.1 process to reform the regulatory capital regime has continued to progress. In the face of the uncertainties generated by this environment the Group has remained focussed on ensuring that its capital strength remains sufficient to withstand the potential pressures and address future changes in requirements.

For regulatory purposes the Group's capital comprises shareholders' equity and its Tier-2 green bond. It has no outstanding Additional Tier 1 ('AT1') issuance, but has the capacity to issue such securities, if considered appropriate, under an authority granted by shareholders at the 2023 Annual General Meeting ('AGM'), which will be proposed for renewal at the 2024 meeting.

3.1 REGULATORY CAPITAL

The Group is subject to supervision by the PRA on a consolidated basis, as a group containing an authorised bank. As part of this supervision, the regulator sets a Total Capital Requirement ('TCR') for the Group, the minimum amount of regulatory capital which it must hold. This is defined under the international Basel III rules, implemented through the PRA Rulebook.

The TCR is held in order to safeguard depositors in the event of severe losses being incurred by the Group and includes elements determined based on the Group's Total Risk Exposure ('TRE'), together with fixed elements. The TCR is specific to the Group and is set on the basis of periodic supervisory reviews carried out by the regulator, the most recent of which took place in 2021.

Strong capital and leverage ratios are fundamental to the Group's strategy. In 2019, along with most other UK banks, it was granted transitional relief for the capital impacts of the adoption of the IFRS 9 impairment regime, with additional relief granted in 2020 for the impact of provisions created in response to the Covid pandemic. This relief is being phased out, year-by-year, and with any reversal of Covid-related provisions also generating a corresponding reduction in relief, the impact on the Group's capital position of these reliefs is no longer significant.

MANAGEMENT REPORT (Continued)

3 CAPITAL

The PRA requires firms to disclose capital measures both on the regulatory basis and as if these reliefs had not been given, referred to as the 'fully loaded' basis. The value of the reliefs tapers over time, and the difference between measures on the regulatory and fully loaded bases has significantly narrowed and will eventually converge. The Group's principal capital measures, CET1 and Total Regulatory Capital ('TRC') are set out below on both bases.

	Regulatory basis		Fully loaded basis	
	2023	2022	2023	2022
	£m	£m	£m	£m
Capital				
CET1 capital	1,188.9	1,221.8	1,175.4	1,196.0
Total Regulatory Capital ('TRC')	1,338.9	1,371.8	1,325.4	1,346.0
Exposure				
TRE	7,668.7	7,515.0	7,665.3	7,489.2
Requirements				
TCR	673.4	660.6	672.2	658.4
Capital buffers	345.1	187.9	344.9	187.2

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

The decrease in capital in the period has arisen because distributions, in the form of dividends and share buy-backs, have exceeded accounting profit for the year. This however is principally a result of the fair value losses on hedge accounting reported in the year, which themselves represent an unwinding of gains reported in the previous year. Such gains and losses, which reverse over time, are disregarded for the purposes of long-term capital planning. The small increase in TCR on both the regulatory and fully loaded bases shown above has arisen principally as a result of balance sheet growth in the year, although the increase is less than might have been expected due to the relative risk weightings of the assets involved.

At 30 September 2023, the Group's TCR was 8.8% (2022: 8.8%), compared to the minimum TCR allowed under the Basel III framework of 8.0%. This low level gives it advantages in capital management and reflects the regulator's view of the maturity of the Group's systems for the management of capital and risk.

CET1 capital must also cover the buffers required by the 'Capital Buffers' part of the PRA Rulebook, the Counter-Cyclical ('CCyB') and Capital Conservation ('CCoB') buffers. These apply to all firms and are based on a percentage of total risk exposure. The CCoB remained at 2.5%, its long-term rate, throughout the year (2022: 2.5%), while the UK CCyB was increased to 2.0% in July 2023 (2022: 0.0%), generating the increase in the buffer amount shown above.

The Financial Policy Committee of the Bank of England has stated that it expects 2.0% to be the long-term standard level of the UK CCyB. Further buffers may be set by the PRA on a firm-by-firm basis but cannot be disclosed.

3 CAPITAL

The Group's capital ratios, after allowing for the proposed dividend for the year, but excluding the effect of future share buy-backs, are set out below.

	Basic		Fully loaded	
	2023	**2022**	**2023**	**2022**
CET1 ratio	15.5%	16.3%	15.4%	16.0%
Total capital ratio	17.5%	18.3%	17.3%	18.0%
UK leverage ratio	7.6%	7.9%	7.6%	7.8%

All the Group's capital ratios show a reversion to more normal levels over the year. This reflects the inclusion in trading profits of the unwind of fair value gains on hedge accounting recognised in the year ended 30 September 2022, which temporarily inflated capital at the previous year end. As the IFRS 9 reliefs are phased out the fully loaded and regulatory bases are automatically converging.

The PRA has announced that it intends to implement changes in its Rulebook to reflect the impact of the revisions to the Basel 3 framework made by the Basel Committee on Banking Supervision ('BCBS') from 1 July 2025. These changes, referred to as Basel 3.1, remain under consultation, and changes would affect both firms applying Internal Ratings Based ('IRB') approaches to capital and those using the Standardised Approach. The new requirements are likely to be phased in over a five-year period.

The Group has evaluated the initial PRA proposals and engaged with the regulator on its results. Certain of the proposals might adversely affect buy-to-let lending and lending to small business, notwithstanding the PRA's stated intention that the overall impact of the reforms should be broadly neutral. However, the Group's capital planning has allowed for a range of potential outcomes, and sufficient capital is being held to address the most negative scenarios, which would reduce the Group's CET 1 ratio by 2.2 percentage points.

The PRA has also launched a more extensive consultation on a 'strong and simple' approach to regulating non-systemically important banks without international activities. While its initial proposals address the smallest banks, it has indicated that this is a first step and that all non-systemic banks will be considered. The Group is monitoring these developments and will respond through its capital planning as appropriate.

The Group continues to refine its IRB submission with close engagement with the PRA. In addition to the submission for its buy-to-let approach, which is currently being processed, the Group has also prepared much of the documentation to support an IRB approach for development finance, which represents the next stage in the Group's IRB roadmap.

MANAGEMENT REPORT (Continued)

3 CAPITAL

3.2 LIQUIDITY

Liquid assets are held in the Group's business to meet cash requirements in the short and long term, as well as to provide a buffer under stress. There is also a regulatory requirement to hold liquidity in Paragon Bank. It continues to be the Group's policy to maintain strong levels of liquidity cover, and this policy impacts the Group's operational capital and funding requirements.

The Board regularly reviews liquidity risk appetite and closely monitors a number of key internal and external measures. The most significant of these, which are calculated for the Paragon Bank regulatory group on a basis which is standardised across the banking industry, are the Liquidity Coverage Ratio ('LCR') and Net Stable Funding Ratio ('NSFR').

The LCR measures short-term resilience and compares available highly liquid assets to forecast short-term outflows, calculated according to a prescribed formula, with a 30-day horizon. The monthly average of the Bank's LCR for the period was 193.7% compared to 146.2% during the 2022 financial year. This increase, which was particularly marked towards the end of the year, represents a build-up of retail funding in advance of settlement of wholesale borrowings just before the year-end, and in anticipation of payment of TFSME indebtedness in the early part of the new financial year described above. It also includes the impact of £383.4 million of swap collateral held in cash (2022: £388.6 million).

The NSFR is a longer-term measure of liquidity with a one-year horizon, supporting the management of balance sheet maturities. At 30 September 2023 the Bank's NSFR stood at 123.4% (30 September 2022: 122.3%), broadly comparable to its position twelve months earlier, and reflective of the strength of the overall funding and capital position.

3.3 DIVIDENDS AND DISTRIBUTION POLICY

A fundamental part of the Group's capital strategy has been to enhance shareholder returns on a sustainable basis, while protecting the capital base. In order to achieve this, it has adopted a dividend policy of distributing 40% of consolidated underlying earnings to shareholders in ordinary circumstances, achieving a dividend cover ratio of approximately 2.5 times. It has also undertaken buy-backs of shares in the market from time to time as part of its management of overall capital, where these enhance shareholder value and excess capital is available, addressing the expectations and requirements of different types of investor.

MANAGEMENT REPORT (Continued)

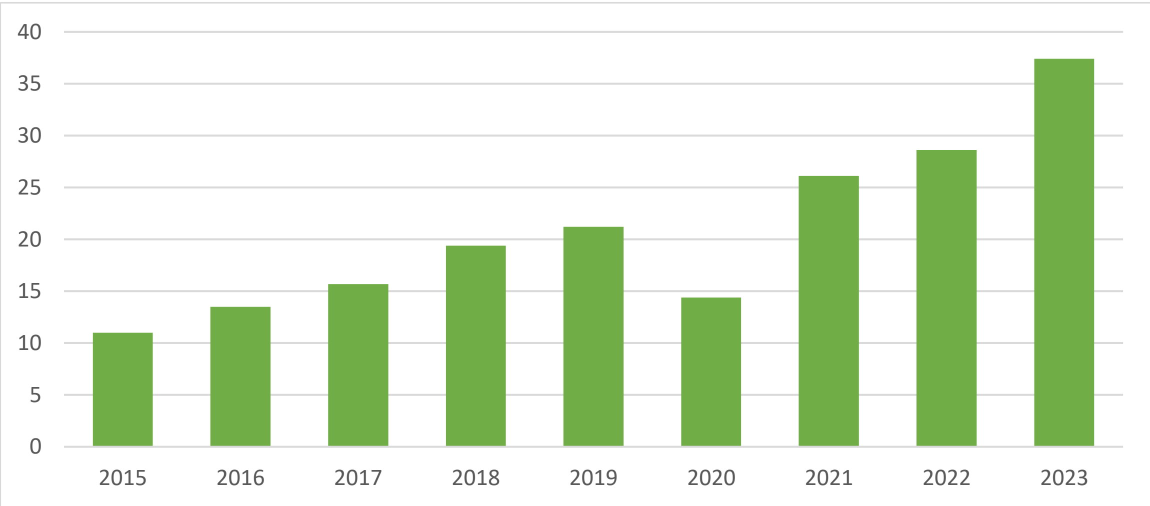
3 CAPITAL

An interim dividend for the year of 11.0p pence per share (2022: 9.4 pence per share) was paid in July 2023 and the Board is proposing, subject to approval at the AGM on 6 March 2024, a final dividend for the year of 26.4 pence per share (2022: 19.2 pence per share). This would give a total dividend of 37.4 pence per share (2022: 28.6 pence per share). During the year ended 30 September 2022 substantial fair value gains on hedge accounting were included in profit. As these gains were considered to be essentially timing differences it was decided to exclude them from the calculation of last year's dividend. During the year these gains reversed, in part, and the decision was made to exclude the fair value losses recorded from the current year's dividend calculation, for consistency. The dividend proposed therefore represents approximately 40% of the profit before fair value losses, giving a dividend cover on the adjusted basis of 2.52 times (2022: 2.50 times) (Appendix D).

The progress of the dividend for the year is shown in the chart below.

Dividend for the year (pence)

In respect of the years 2015 –2023



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

At the beginning of the financial year, the previous year's share buy-back programme was completed under an irrevocable authority. In December 2022 the Board authorised a buy-back programme for the year of £50.0 million, which was extended to £100.0 million in June 2023, and completed in September 2023. £111.5 million, including costs, was expended during the year (Note 28).

As part of the review of capital management described above, the Board decided that it was appropriate to authorise a further share buy-back programme of up to £50.0 million for the 2024 financial year. This will commence shortly after the announcement of the Group's 2023 year-end results.

3 CAPITAL

The Group has the general authority to make such purchases, granted at the AGM on 1 March 2023. Any purchases made under these programmes will be announced through the Regulatory News Service ('RNS') of the London Stock Exchange and the shares will initially be held in treasury.

During November 2023, the Board affirmed the existing dividend policy going forward, subject to an assessment of prevailing conditions at the time, including future operational and regulatory capital requirements, business strategy and external economic risks.

3.4 CAPITAL OUTLOOK

The Group's strategy is based on the quality of its capital position which it keeps under regular review as part of its management reporting and more formally through the annual Internal Capital Adequacy Assessment Process ('ICAAP'). Impacts of economic, strategic and regulatory factors on both the current and forecast position are considered and subjected to stress testing, examining the effect of a range of severe scenarios. The results of this testing confirm that the Group's capital position remains strong at the year end, even allowing for the potential effects of economic headwinds and the increase in the rate of the UK CCyB in the year.

As the Group enters 2024 it is well capitalised, even after allowing for forecast levels of distributions, and will remain so following the phasing out of IFRS 9 relief and the introduction of the Basel 3.1 reforms. Meanwhile, the Group continues to progress towards IRB accreditation, which will refine its capital requirements.

Despite the forecasts of a protracted high interest rate, low growth period for the UK economy, the Group's capital position is both prudent and sustainable, supporting the overall viability of the business for the benefit of all stakeholders.

MANAGEMENT REPORT (Continued)

4 FINANCIAL RESULTS

The financial year ended 30 September 2023 has seen the Group continue to deliver strong profit and margin growth at the underlying level (Appendix A), making progress on its strategic aims despite the economic and political uncertainties in the UK during the year. Underlying profit (Appendix A), which excludes fair value gains, again increased in the year, reaching £277.6 million, an increase of 25.4% (2022: £221.4 million). This, together with the impact of the Group's share buy-back programme, drove growth in underlying earnings per share, which rose by 34.8%, reaching 94.2 pence per share (2022: 69.9 pence per share).

As in the previous period, the Group's statutory results for the year have been significantly affected by the accounting treatment required for pipeline hedging. The Group's policy is to hedge a substantial part of its lending pipeline with interest rate derivatives, and these can lead to substantial fair value gains being recorded in a rapidly changing interest rate environment, such as that of the 2022 financial year, before the relevant loans complete.

The actual cash flows from hedging will impact on net margin through the subsequent life of the loan and the fair value gains will unwind. The current year has seen the beginning of the unwinding process, combined with a scaling back of expectations for future interest rates, resulting in fair value losses being recorded. The level of these unwinding losses decreased profit before tax on the statutory basis to £199.9 million (2022: £417.9 million), with earnings per share at 68.7 pence per share (2022: 129.2 pence per share).

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

4 FINANCIAL RESULTS

4.1 CONSOLIDATED RESULTS

CONSOLIDATED RESULTS
For the year ended 30 September 2023

	2023	2022
	£m	£m
Interest receivable	1,010.6	545.7
Interest payable and similar charges	(561.7)	(174.5)
Net interest income	**448.9**	**371.2**
Net leasing income	5.6	4.6
Gain on disposal of loan assets	-	4.6
Other income	11.5	12.6
Total operating income	**466.0**	**393.0**
Operating expenses	(170.4)	(153.0)
Provisions for losses	(18.0)	(14.0)
	277.6	226.0
Fair value net (losses) / gains	(77.7)	191.9
Operating profit being profit on ordinary activities before taxation	**199.9**	**417.9**
Tax charge on profit on ordinary activities	(46.0)	(104.3)
Profit on ordinary activities after taxation	**153.9**	**313.6**

	2023	2022
Dividend – rate per share for the year	37.4p	28.6p
Basic earnings per share	68.7p	129.2p
Diluted earnings per share	66.3p	125.9p

Income

The Group's total operating income increased by 18.6% in the year, reaching £466.0 million, compared to the £393.0 million recorded in the previous year, which also included a £4.6 million one-off gain on the sale of the Group's unsecured lending portfolio.

Net interest on lending assets continues to be the principal element of the Group's income. This increased from £371.2 million in 2022 to £448.9 million in 2023, a growth rate of 20.9%. This was driven by both net growth in the loan books, where the average outstanding balance increased by 5.3% to £14,542.3 million (2022: £13,806.5 million) (Appendix B), and by continuing net interest margin ('NIM') improvements in both of its divisions, with overall NIM increased by 40 basis points.

4 FINANCIAL RESULTS

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

	Total basis points
Year ended 30 September	
2023	***309***
2022	269
2021	239
2020	224
2019	229

This improving trend demonstrates the benefits of both the Group's hedging strategy in managing interest rate risk on fixed rate lending, particularly in the buy-to-let business, together with the careful long-term management of yields across all divisions. It is also a result of the enhancements to the cost of funds delivered by the Group's targeted funding strategy.

Interest income from the Group's loan assets is accounted for using the effective interest rate method set out in IFRS 9. This spreads the impact of initial and terminal fees received from the customer or paid to third parties through the life of the account and, where an account has different interest charging bases during its life, such as the majority of the Group's buy-to-let mortgage accounts which have a fixed initial rate, attempts to spread this effect. The pattern of income recognition is therefore based on estimates of customer settlement behaviour and future charging rates, and where the economic environment is likely to cause these to vary, as in the current year, the rates at which income is included in profit are adjusted.

The Group's other operating income (excluding the one-off gain in 2022) remained stable at £17.1 million (2022: £17.2 million), continuing to represent a combination of operating lease income and other sundry fees.

Costs

Operating expenses increased by 11.4% in the year to £170.4 million (2022: £153.0 million). The largest item within costs continues to be employment costs, forming 63.6% of the total at £108.3 million (2022: £103.6 million). The increase of 4.5% in the year is attributable to an increase in staff numbers, with average headcount increasing by 1.9% to 1,527, and to the 5% pay increase granted to most employees below senior management level at the beginning of the year.

During the year, a strategic review of the Group's operating structure took place, particularly focussed on the higher management levels, to ensure that the arrangements in place were appropriate to meet its strategic aspirations moving forward. As a result of this exercise a number of roles were identified as redundant, with people leaving the business shortly after the year end. Costs of £2.6 million related to this exercise are included in expenses for the year.

The closure of TBMC, the Group's mortgage brokerage business was also announced in the year. Costs of £2.0 million, mostly relating to the write-off of goodwill, are included in operating expenses.

4 FINANCIAL RESULTS

Costs not related to employment, excluding these one-off costs, at £57.5 million were 16.4% higher than those experienced in the previous year (2022: £49.4 million). Part of this represents the impact of inflation in the UK, which has been particularly severe for professional services, but also partly relates to the continued spend on the Group's digitalisation programme, with non-employment related IT costs increased by 28.7% in the period to £13.0 million (2022: £10.1 million). The digitalisation programme continues to deliver new systems and enhancements across the Group's businesses, forming a fundamental part of its strategy going forward.

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

	Underlying	**Statutory**
	%	**%**
Year ended 30 September		
2023	***36.6***	***36.6***
2022	39.4	38.9
2021	41.7	41.7
2020	43.0	43.0
2019	42.1	40.7

The Group's cost:income ratio continued to reduce in the year, primarily as a result of margins widening. Cost control is a strategic priority of the Group, but it recognises that the cost base must also adapt to deliver its strategic priorities and to meet regulatory expectations. A sustainably lower cost:income ratio is therefore a long-term aspiration, rather than a short-term priority, particularly in the face of continued expectations for inflation levels in the UK.

Impairment provisions

In the accounts for the year ended 30 September 2023 the Group has recognised a charge for impairment of £18.0 million (2022: £14.0 million), an increase of 28.6%. This results partly from experience in the year, where a number of portfolios have seen some increased evidence of delinquency, but also from management's view of the potential impact of the current high interest rate environment on its customers. The increases in the cost of living and of doing business, both those experienced over the last twelve months, and the further increases expected in the near term, being the main drivers for this behaviour.

The current year has seen both inflation and interest rates in the UK reach their highest levels for several years, with interest rates at the year end reaching their highest level since April 2008 and cost pressures on both consumers and businesses increasing. It is considered likely by most commentators that this will have a serious short to medium-term impact on credit quality, but the Group, in common with many lenders has seen only relatively minor impacts in the period up to the year end.

The Group's recognition of credit losses is governed by the accounting standard IFRS 9, which requires the directors to take a view on the future performance of the Group's loan assets and to base provisioning on expected credit losses ('ECL'). Where the economic outlook is complex, or where there is little relevant historical data to base loss predictions upon, this can be a challenging exercise.

4 FINANCIAL RESULTS

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

	Charge / (release)	Cost of risk
	£m	%
Year ended 30 September		
2023	***18.0***	***0.12***
2022	14.0	0.10
2021	(4.7)	(0.04)
2020	48.3	0.39
2019	8.0	0.07

The movements shown above demonstrate the impact of the various economic and political developments affecting the UK in recent years as they appear and then resolve over time. The high charge in 2020 represented the initial onset of the Covid pandemic, whilst in 2021 the position appeared to have become a little more stable. However, 2022 saw the transition into a period of much higher rates of interest and building economic headwinds which have continued into the current year.

The application of provisions in writing off accounts has generally remained more stable across the period. This highlights both the Group's careful approach to provisioning and the resilient nature of its assets.

Multiple economic scenarios and impacts

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

For portfolios where detailed models cannot be used the Group will also consider the potential impact of these economic scenarios where this might be significant. In the current period this applied particularly to the Group's development finance portfolio where the potential impacts of increased input costs and falling property prices were factored into ECL estimates.

At 30 September 2023, there is considerably more consensus on the UK's economic outlook than at the previous year end, which was dominated by the potential consequences of the mini-budget in September 2022. The dominant theme of these forecasts is generally pessimistic, with a significant potential for relatively high inflation rates and low growth to continue for some time, an opinion endorsed by the Bank of England's own predictions. This, however, is an unfamiliar position for the UK economy, and the consequences for longer-term prospects remain an area of significant disagreement amongst experts.

4 FINANCIAL RESULTS

The Group has constructed the scenarios required for its ECL modelling based on a number of forecasts from public and private bodies, synthesised to produce internally coherent sets of data. The central scenario is that used for the Group's planning process, while upside and downside scenarios have been derived from this.

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

Overall, the forecasts represent an environment of interest rate expectations continuing at historically high levels, a decline in property values, especially in the short term, minimal growth and inflation generally falling, although remaining at high levels compared to recent history.

Given the potential range of longer-term outcomes, the Group has maintained the weightings attributable to each scenario in its modelling at the levels used at the previous year end. The forecast economic assumptions within each scenario, and the weightings applied, are set out in more detail in note 18.

To illustrate the impact of these scenarios on the Group's IFRS 9 modelling, the impairment provisions before judgemental adjustments are set out below on the weighted average basis, and also shown on a single scenario basis for both the central and severe scenarios.

	2023		2022	
	Unadjusted provision £m	Cover ratio	Unadjusted provision £m	Cover ratio
Weighted average	67.1	0.44%	48.5	0.34%
Central scenario	60.9	0.41%	38.3	0.27%
Severe scenario	89.3	0.60%	85.3	0.60%

Calculated provisions have increased in the year, but remain somewhat lower that might be expected, given the nature of the economic outlook, some of which will relate to the ability of the Group's models to respond to the present economic circumstances, although the resilience of the loan book as a whole will also be a significant factor.

There is little recent historical evidence of the impact of a sustained period of high interest rates and inflation on customer credit, and both products and regulatory expectations have evolved significantly since interest rates last reached current levels. This means the Group's models will have been derived from datasets which include very few observations representative of this type of economic environment.

4 FINANCIAL RESULTS

The distribution of gross balances by IFRS 9 stage (defined in note 16) produced by the Group's impairment methodology at the two most recent year ends is set out below.

	2023	2022
Stage 1	93.5%	85.2%
Stage 2	5.0%	13.7%
Stage 3	1.3%	0.9%
POCI	0.2%	0.2%
Total	**100.0%**	**100.0%**

This demonstrates an increased number of Stage 3 cases, although from a very low base, as problem accounts react to economic conditions. It also shows the impact on the number of accounts identified as Stage 2 of the assumption of future stable or slowly declining interest rates and inflation, and the current low level of arrears. This reduces the calculated provision and management must assess whether the result is appropriate, given the economic outlook.

Judgemental adjustments

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

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

Impairment models are constructed by analysing the historically observed linkage between actual indicators of credit performance, whether internal, such as arrears metrics, or external, such as credit bureau information and economic indicators. The predictive power of any such model will, therefore, depend on the reliability of that linkage in the circumstances at the balance sheet date.

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

4 FINANCIAL RESULTS

The major issues addressed by management in considering the needs for judgemental overlays at 30 September 2023 can be summarised as follows:

- How far can impairment models be relied upon in a situation where the absolute magnitudes of economic indicators such as bank base rates and inflation, both currently and in the forecast period, lie significantly outside recent historical levels?
- How well can the models be relied on to reflect the credit impacts of a rapid movement in economic variables followed by a forecast period of stability or gradual recovery in a timely manner?
- To what extent will modelling in the buy-to-let book address the impact of payment shocks caused by customers reaching the end of a fixed-rate period?
- How may the negative outlook expressed by commentators on credit over the past year be reconciled with the generally mild impacts seen to date?
- What continuing impacts might there be from the Covid pandemic in terms of either corporate weakness or inflated cash balances, which might delay or change the responses to economic stimuli which might normally be anticipated?

The Group also considered whether some sectors served by the SME business, particularly those related to the construction industry, might be more vulnerable in the specific economic situations forecast.

Following consideration of the available internal and external evidence, the Group determined that judgemental overlays to its SME leasing and motor finance portfolios and to its buy-to-let mortgage book were required at the year end. The judgemental adjustments generated by this process, analysed by division are set out below.

	2023 £m	2022 £m
Mortgage Lending	3.0	5.0
Commercial Lending	3.5	10.0
	6.5	15.0

The reduction in the mortgage lending segment is principally a result of more at risk cases being identified by the model and of increased levels of default cases in the year, which resulted in the first upward movement in the number of receiver of rent cases seen for some years. However, the potential for further impacts, as customers move off fixed rates, remains a real concern and it was not felt appropriate to reduce the level of the overlay to zero.

The reduction in overlay in the SME lending book relates partly to the introduction of a new impairment model, incorporating a wider dataset and more up-to-date information, which removes some uncertainty from the modelling process. However, the sector has been impacted by a series of adverse situations over recent years, which may have impacted on resilience, while there is evidence that cash balances in the sector remain elevated, which may serve to delay credit impacts.

4 FINANCIAL RESULTS

There are also parts of the Group's SME portfolio which are connected directly or indirectly to the capital projects sector, where timescales for impacts may be longer. Overall management determined that the overlay in this sector should be reduced, but not eliminated and it stands at £2.5 million at the year end (2022: £10.0 million).

An additional overlay has been provided in the motor finance business. The provisioning model for this business, one of the Group's oldest, shows the lowest probability of default in some years, a function of the downward trend of inflation in the input scenarios. This is seriously at odds with market sentiment and an additional overlay of £1.0 million has been created to allow for this (2022: £ nil).

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

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

Ratios and trends

The results of the Group's ECL modelling, including the impact of the economic scenarios described above, together with the judgemental adjustments adopted to address uncertainties over the future performance of accounts, has resulted in the overall provision amounts and coverage ratios set out below.

	2023 £m	**2022 £m**	**2021 £m**
Calculated provision	67.1	48.5	46.0
Judgemental adjustments	6.5	15.0	19.4
Total	73.6	63.5	65.4
Cover ratio			
Mortgage Lending	0.33%	0.31%	0.32%
Commercial Lending	1.56%	1.34%	1.74%
Total	**0.49%**	**0.44%**	**0.49%**

4 FINANCIAL RESULTS

Following the judgemental adjustments, these ratios remain broadly in line with those seen in recent periods, although a greater proportion of the provision is generated by modelled approaches than in previous years. These levels remain higher than the 0.34% coverage ratio observed in September 2019, before the outbreak of the pandemic, and in a lower interest rate environment. This level was also recorded despite the level of security cover in the buy-to-let loan book being lower, with the average loan-to-value ratio being 67.4% at that time, higher than the 62.8% recorded at 30 September 2023 (2022: 57.9%).

Future levels of coverage will be dependent on the performance of the UK economy and its impact on the Group's customers and their markets, where applicable.

Fair value movements

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

The accounting entries included in this balance are primarily non-cash items, which reverse over the life of the hedging arrangement and the Group regards such movements as essentially representing the anticipation of gains belonging economically to later accounting periods and their subsequent unwinding. They are therefore excluded from underlying results.

During the 2022 financial year, particularly during the second half, there was a significant level of volatility in UK benchmark interest rate expectations, resulting in a fair value gain of £191.9 million being recorded in the year. This impact has been amplified by the Group's approach to pipeline hedging and the retention strategy applied to maturing five-year fixed loans, which meant that the pipeline was larger and of longer duration (and hence more exposed to movements in rates) than in earlier periods.

In the year ended 30 September 2023 the levels of volatility in market rates reduced, with longer term market rate expectations moderating, which, coupled with the conversion of loans which had been part of the hedged pipeline at the start of the year, and the consequent commencement of the run-off of hedging gains related to those loans, resulted in much of the previous period's gain being unwound and a fair value loss of £77.7 million being reported.

The Group has a net derivative position of £14.6 million (at notional value) at 30 September 2023, which is unmatched for hedge accounting, although forming part of the economic hedging position (2022: £1,201.0 million). Therefore, the Group is less exposed to value fluctuations on the pipeline going into the new financial year. There are, however, substantial gains from 2022 which are still to unwind.

4 FINANCIAL RESULTS

Tax

The effective tax rate applied to the Group's profits has decreased from 25.0% in 2022 to 23.0% during 2023, principally as a result of the unwinding of deferred tax on fair value gains, described above. The Group operates only in the UK and materially all its profit falls within the scope of UK taxation. The standard rate of corporation tax applicable to it in the year was 22.0% (2022: 19.0%), with the surcharge applicable to the profits of Paragon Bank at 5.5% (2022: 8.0%). The increase in the standard rate was offset, to some extent, by the cut in the surcharge as well as the increase in the profit threshold from which it applies (note 10).

As the bulk of the fair value loss arose in Paragon Bank, the banking surcharge means that it is subject to a higher rate of tax than the overall effective rate for the Group. This meant that the effective tax rate on underlying profit was 23.9% (2022: 23.4%), broadly similar to that in the previous year (Appendix A).

Results

The Group's profit before tax for the year on the statutory basis was £199.9 million (2022: £417.9 million), with the increase in profit at the underlying level reversed by a £269.6 million swing in fair value items. Profit after tax was £153.9 million (2022: £313.6 million). In addition, other comprehensive income of £1.6 million was recorded, relating to valuation gains on the Group's defined benefit pension scheme (the 'Plan').

Consolidated accounting equity at the year end, after dividends and share buy-backs was £1,410.6 million (2022: £1,417.3 million), and consolidated tangible equity was £1,242.4 million (2022: £1,247.1 million), representing a tangible net asset value of £5.79 per share (2022: £5.33 per share) and a net asset value on the statutory basis of £6.57 per share (2022: £6.06 per share) (Appendix E).

4.2 ASSETS AND LIABILITIES

The main driver of movements in the Group's balance sheet is the size and composition of its loan book. This, together with its policies on capital and liquidity, determines its funding requirements and hence the level of its liabilities.

The Group's loan portfolio grew by 4.7% during 2023, with growth in both Mortgage Lending and Commercial Lending. More detail on these movements is given in Section 1.

4 FINANCIAL RESULTS

The Group's assets and liabilities at the end of the financial year are summarised below.

SUMMARY BALANCE SHEET
30 September 2023

	2023 £m	2022 £m	2021 £m
Investment in customer loans			
Mortgage Lending	12,902.3	12,328.7	11,829.6
Commercial Lending	1,972.0	1,881.6	1,573.1
	14,874.3	14,210.3	13,402.7
Hedging adjustments	(379.3)	(559.9)	5.5
Derivative financial assets	615.4	779.0	44.2
Cash	2,994.3	1,930.9	1,360.1
Pension surplus	12.7	7.1	-
Intangible assets	168.2	170.2	170.5
Other assets	134.6	116.0	154.0
Total assets	18,420.2	16,653.6	15,137.0
Equity	1,410.6	1,417.3	1,241.9
Retail deposits	13,265.3	10,669.2	9,300.4
Hedging adjustments	(30.9)	(99.7)	(3.0)
Other borrowings	3,086.4	4,007.2	4,451.4
Derivative financial liabilities	39.9	102.1	43.9
Pension deficit	-	-	10.3
Other liabilities	648.9	557.5	92.1
Total equity and liabilities	18,420.2	16,653.6	15,137.0

Funding structure and cash resources

The Group's funding balance increased by 11.4% during the year, exceeding the growth in the loan book as cash balances increased in order to build liquidity and enable the repayment of wholesale borrowings in the early months of the new financial year. Cash balances consequently increased by 55.1%.

The proportion represented by retail deposits increased to 81.1% in accordance with the Group's long-term funding strategy (2022: 72.7%), with wholesale borrowings paid down, including the only remaining funding which pre-dated the licensing of Paragon Bank in 2014. Movements in funding balances are discussed in more detail in Section 2.

4 FINANCIAL RESULTS

Derivatives and hedging

The Group's derivative assets shown in the table above relate almost entirely to arrangements for hedging interest rate risk on fixed rate mortgage and savings products. These assets and liabilities are held at fair value, with the valuation based on future expectations of interest rates. The size of the balances is driven by the difference between current expectations for variable rates and the fixed rates applicable to the hedged items, set at the point of origination, meaning that where market rates have moved sharply, large balances will be carried.

During the year, expectations of future interest rate increases moderated, resulting in a reduction in the derivative valuation in the balance sheet, with swap assets falling by 21.0% in the year to £615.4 million (2022: £779.0 million) and swap liabilities decreasing by 60.9% to £39.9 million (2022: £102.1 million). While these movements do contribute to the fair value differences in the profit and loss account described above, they are mainly offset by fair value accounting adjustments to loan assets and deposit liabilities, with the adjustment in assets reducing by £180.6 million in the year and that in liabilities by £68.8 million.

Pension obligations

The IAS 19 valuation surplus on the Group's defined benefit pension scheme increased from £7.1 million at the start of the year to £12.7 million at the year end. The assumptions for this valuation are based on market-derived interest and bond rates and can be subject to fluctuation where market rates do not move in parallel.

The changes in inputs between the valuations at the beginning and end of the year are smaller than those seen in some recent periods, with the principal differences being the increase in the discount rate used in evaluating scheme liabilities, based on long-term corporate bond yields, from 5.00% to 5.55%, and the assumed rate of RPI inflation, based on gilt yields decreasing from 3.55% to 3.25%. These movements led to a pre-tax valuation gain of £2.4 million being booked in other comprehensive income (2022: £15.3 million).

While the valuation under IAS 19 is that which is required to be disclosed in the accounts, pension trustees generally use the technical provisions basis as provided in the Pensions Act 2004 to measure scheme liabilities. On this basis, the surplus at 30 September 2023 was estimated at £11.9 million, an increase of £7.6 million in the period (2022: surplus of £4.3 million).

4 FINANCIAL RESULTS

Other assets and liabilities

Sundry assets increased from £116.0 million to £134.6 million in the year, largely a result of increased cash ratio deposits, which grew by £7.8 million as a consequence of the increased central bank cash balance, and a higher level of accrued interest income, which increased by £3.6 million as a result of higher interest rates.

Sundry liabilities grew from £557.5 million to £648.9 million at 30 September 2023. This was principally a result of the impact of the increasing interest rate environment, with accrued interest payable increasing by £133.0 million. This was offset by a fall of £26.7 million in deferred tax, a result of the reversal of fair value movements.

4.3 SEGMENTAL RESULTS

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

	2023	2022 (restated)
	£m	£m
Segmental profit		
Mortgage Lending	246.6	229.6
Commercial Lending	113.2	86.7
	359.8	316.3
Unallocated central costs and other one-off items	(82.2)	(90.3)
	277.6	226.0

The Group's central administration and funding costs, principally the costs of service areas, establishment costs and bond interest have not been allocated. For the current financial year, the Group's internal cost allocation processes have been updated to recharge items relating to certain treasury activities to the segments, as described in note 2. Comparative amounts have been restated accordingly.

4 FINANCIAL RESULTS

Mortgage Lending

The Mortgage Lending division continues to perform well and grow its NIM, with margin on fixed rate accounts protected by the Group's hedging arrangements. Net interest grew by 10.5% in the year to £277.6 million (2022: £251.2 million) with the average net loan balance growing by 4.4% to £12,615.5 million (2022: £12,079.2 million) as NIM increased to 220 basis points (2022: 208 basis points).

Credit performance in the period remained good, but an increased level of arrears and defaults through the year was noted. The charge for impairment increased to £10.4 million in the year (2022: £4.6 million) with the cost of risk at 8 basis points (Appendix B). IFRS 9 Stage 3 cases increased from £119.3 million to £142.2 million, with increases in both current three-month arrears accounts and realisation cases, although these continue to form a very small part of the portfolio.

Overall contribution from the division increased by 7.4% to £246.6 million (2022: £229.6 million).

Commercial Lending

Average balances in the Commercial Lending division grew by 11.5% to £1,926.8 million (2022: £1,727.3 million), which, together with an increase in NIM from 644 basis points to 704 basis points, generated an increase of 22.0% in net interest to £135.7 million (2022: £111.2 million). This reflected the continuing focus on yield management, together with changes in product mix and tighter funding costs.

Impairment charges for the period, at £7.6 million, had reduced a little from the 2022 financial year (2022: £9.4 million). Credit performance in the year has remained largely stable in the motor finance and SME lending elements of the portfolio, with low arrears and relatively few defaulted cases, although the Group maintains a cautious attitude towards credit prospects for the sector. An increasing number of watchlist cases have been recorded in the development finance business, contributing £56.8 million of the £58.7 million increase in IFRS 9 Stage 3 balances in the year.

These factors led to an increase in segmental profit of 30.7% to £113.3 million (2022: £86.7 million).

MANAGEMENT REPORT (Continued)

5 OPERATIONS

The Group's strategic pillars include a customer-focussed culture and a dedicated team, highlighting the importance of its experienced, skilled and engaged workforce facilitated by systems and analytics in delivering its purpose. The Group's strategy relies on sector knowledge, specialist systems and the careful management of risk across all its operations to meet its goals.

In the year the Group has continued to invest in its people, progress its long-term programme to enhance processes and technology, addressing both internal systems and those facing its customers and business partners, and enhance its risk management framework to support the digitalised vision of its future operating model.

This continuing prioritisation ensures that the Group maintains a firm foundation on which to build its business and deliver its strategy in the future.

5.1 OPERATIONS

The Group operates primarily on a centralised basis, with a workforce which exceeded 1,500 people at the year end. The majority of these people are attached to one of the Group's office sites in Solihull, Southampton and London, but work on a hybrid basis. During the year the hybrid working approach has continued to be refined to ensure both the most effective use of the Group's people and the optimal working experience for them, as well as the best possible interactions with customers and business partners.

The Group recognises that its strategy of tailoring its operational approach to the specialist needs of its customers and markets implies that there is unlikely to be a single preferred approach to service delivery, and business areas are tasked with establishing working methods to suit the needs of their operations and customers, with the Group investing in appropriate system enhancements as required.

The year saw continuing progress with the Group's digitalisation agenda, which includes major projects to improve systems and procedures in the Group's main lending areas. A new customer portal in buy-to-let mortgages was a significant deliverable during the year, while improved system-based support for decisioning was rolled out in SME lending. Significant enhancements made to systems in both development finance and SME lending towards the end of the previous year also continued to be rolled out, enabling more customers and business partners to benefit.

The digitalisation programme also includes a variety of other enhancements to the Group's infrastructure and operational systems, including enhancement to the resilience of the hardware supporting the Group's loan administration systems, improvements to telephony for motor finance and a new system to improve supplier management, enabling better management of ESG considerations in the supply chain.

Towards the end of the year considerable progress had been made on a project which will see 28 of the Group's 30 major operational systems transferred from on-site mainframe computers into the cloud in the early part of the new financial year, opening the way to further developments and efficiencies.

MANAGEMENT REPORT (Continued)

5 OPERATIONS

The Group's offices remain valuable as hubs for the growth of its culture and identity, where collaboration can be fostered, communication facilitated, and learning promoted. During the period initiatives continued to ensure they remain fit for purpose as working practices evolve. These included a decarbonisation review of the Group's head office building, initiatives to improve energy efficiency, and the expansion of on-site charging capabilities for electric vehicles across the Group's estate.

The operational resilience of the business remains an important area of focus for the Group and its regulators. During the period the second formal self-assessment required by regulators was successfully completed, providing an opportunity to evaluate developments in this area since the exercise was first completed.

A significant part of the Group's operational infrastructure exists to drive its focus on high quality customer service throughout the period. Regular surveys are conducted with customers and business introducers to monitor satisfaction, which have remained positive in the period.

The first phase of the introduction of the new FCA Consumer Duty in July 2023 required significant attention across all operational teams to ensure that the regulator's expectations were embedded in systems and processes, meeting the deadlines for the first phase of implementation. While the new duty is a significant change in the way the regulator approaches firm's responsibilities, the Group considers that its culture and values have always aligned with its underlying philosophy.

The rising interest rate climate in the year, coupled with the impacts of inflation on customers' incomes, meant that a significant focus for the Group's customer service teams was identifying the potential impact on customers who are, or may become, vulnerable and ensuring that they receive good outcomes. The Group monitors customer complaints as a metric of customer outcomes and it was pleasing that these levels remained low by industry standards, despite the economic pressures.

5.2 GOVERNANCE

The Group believes that high standards of corporate governance are fundamental to the effective execution of its strategy. It is subject to the UK Corporate Governance Code (the 'Code') and the Group has continued to comply with the Code's principles and provisions throughout the period.

The Group continues to adopt a 'comply and explain' approach to Provision 21 of the Code. Having deferred the external board evaluation, which had been due in 2022, until the new Chair had been in post for a sufficient time to make such an assessment more meaningful, relevant and useful, this evaluation was completed in the year.

Board of directors and senior management

A review of the skills and experience of the non-executive directors determined that the Board would benefit from additional experience in the fields of sustainability and customer experience, and it was agreed to recruit an additional non-executive director with particular strength in these areas.

MANAGEMENT REPORT (Continued)

5 OPERATIONS

Following an extensive search and assessment process, Zoe Howorth was appointed to the Board on 1 June 2023. Zoe's breadth of knowledge, which includes branding, digital and sustainability understanding, and her strong focus on the customer will enhance the diversity of perspective on the Board. Her executive experience includes 16 years with the Coca-Cola Company across a variety of roles, culminating in her role as UK Marketing Director. Zoe is a non-executive director, chair of the ESG committee and a member of the remuneration committee at AG Barr PLC, a FTSE-250 consumer goods business. In 2021, Zoe joined the board of International Schools Partnership Limited, a global education business, where she has board responsibility for ESG and brand. Zoe is also a director of the Water Babies Group Limited.

Hugo Tudor, who was the Company's senior independent director and chair of its remuneration committee reached the ninth anniversary of his appointment to the Board in November 2023. During the year the Board and the Nomination Committee undertook a process to identify a successor to Hugo in each of his roles, which resulted in the appointment of Alison Morris, the Chair of the Audit Committee as Senior Independent Director from August 2023 and the announcement, on 27 October 2023, that Tanvi Davda, a non-executive director, would become Chair of the Remuneration Committee on 7 December 2023. Hugo will remain on the Board, but will be considered to be a non-independent non-executive director from the conclusion of the 2024 AGM.

Following the announcement that Pam Rowland intended to retire as the Group's Chief Operating Officer at the end of March 2023, the Group was pleased to announce the appointment of Zish Khan to the position in December 2022. Zish brings a wealth of experience in technology, change and operations having over 20 years' experience across the financial services sector. A smooth transition and handover of responsibilities was completed during the year.

The Group continues to be conscious of the need to ensure that the Board contains an appropriate balance and diverse set of skills and experience. It has noted statements on diversity and governance from the PRA and the FCA, as well as in the corporate world more generally, setting out enhanced expectations and new regulatory requirements in this area. With effect from 1 June 2023 the Group now complies with the new FCA Listing Rules requirements on diversity, which apply to it for the first time for this financial year.

As at 30 September 2023, the Board had four female directors out of a total of ten board members, forming 40.0% of the Board, with one senior board position, that of Senior Independent Director, held by a female director.

MANAGEMENT REPORT (Continued)

5 OPERATIONS

Remuneration policy

The Group's triennial review of the Directors' Remuneration policy was approved at the 2023 Annual General Meeting ('AGM') following extensive consultation with shareholders, investor bodies and other stakeholder groups and we thank them for their feedback and support. The Directors' Remuneration Report was passed with 69.19% of votes cast in favour, which represents a "significant vote against" the report as defined by the Code. Accordingly, the Remuneration Committee considered carefully the points raised by those shareholders who were not supportive of the report seeking additional input as appropriate. As required by the Code, the Company published an update on its position within six months of the meeting.

5.3 MANAGEMENT AND PEOPLE

At 30 September 2023 the Group employed 1,522 people, an increase of 1.3% year-on-year. The majority are based at its Solihull Head Office but with hybrid working arrangements. People are the Group's most important asset, and it is accredited as a platinum status employer under the Investors in People programme. The Group focusses on providing people with opportunities for varied and rewarding careers, offering extensive training and coaching opportunities to meet their own ambitions whilst delivering on the strategic objectives of the business.

Conditions and culture

During the period the Group undertook an exercise to look at its operating model and as a result it has made some changes to streamline and simplify its organisational structure, making sure it is best positioned to continue its focus on providing good outcomes for our customers, while protecting and developing specialist skills. While the business continues to be financially strong it was considered that there was a need to examine the resource requirements of potential future challenges and opportunities, while ensuring the Group operates in the most cost-efficient way possible.

As part of this process the Group has realigned non-core origination activities and reviewed all origination activities, reducing management layers from eight to six across most areas, right-sizing teams, consolidating operational teams, and restructuring its mortgage lending, SME lending and external relations areas. This was in addition to the closure of the Group's non-core TBMC mortgage brokerage operation (Section 1.1).

Whilst the Group seeks to avoid compulsory redundancies wherever possible, it entered into a consultation period with a number of employees in September 2023. Some of the affected employees secured alternative roles in the Group, and others were made redundant, both on a voluntary and compulsory basis. The exercise, along with reduced recruitment resulted in a headcount reduction of around 5%, subsequent to the year end.

5 OPERATIONS

In May 2023 the Group conducted its first full employee engagement survey since 2021, with 88% of employees sharing their views (2021: 86%). The survey produced a strong set of positive indicators, with an overall engagement score of 90%; 5% above the industry average. The survey asked for employees' feedback on topics such as organisational integrity, leadership, wellbeing, management, development and employee voice, and the results remained either static or improved across all themes.

With a total employee attrition rate of 12.6% (2022: 15.7%) the Group continues to track below the national average. These high levels of retention are further bolstered by 56% of employees achieving over 5 years' service, 11.5% achieving over 20 years with the Group and 4% achieving over 30 years' service.

Employees continued to show flexibility during the year with many undertaking secondments and transfers to different areas of the business to ensure that the Group continued to meet the needs of its customers.

The Group maintains its accreditation from the UK Living Wage Foundation and minimum pay exceeds the levels set by the Foundation. During the period the Group made the decision to align apprentice rates to the Living Wage Foundation. The Group increased its minimum wage to £12.00 per hour, in line with the Foundation's recommendations, from 1 November 2023.

During the year employees were supported through the cost of living crisis by the Group's profit related pay scheme, which, as a result of the 2022 profit, provided an additional £3,300 to all full time employees below senior management level. Many employees also benefitted in the year from the Group's maturing sharesave scheme, being able to buy shares with a market value in the region of £5.00, each for an option price of £2.79.

On 11 December 2020, all eligible employees were granted a one-off award of £1,000 worth of shares to recognise the contribution that they had made to the business during the Covid pandemic. This award will mature in December 2023 with employees being given the choice to retain or sell their shares.

Equality and diversity

The Group continued to make progress on its equality, diversity and inclusion ('EDI') agenda during the year. The Group's EDI Network, launched in October 2020, continues to have an important impact and has been involved in the launch of several initiatives and offerings to all employees during the year.

The campaign to capture diversity data for all employees continues and by September 2023, 76.8% (2022: 73.1%) of employees had completed a diversity profile on the HR management system. The collation of this data from employees provides the Group with an enhanced ability to monitor and improve the diversity of the workforce going forward.

5 OPERATIONS

The Group continues to be committed to improving the diversity of its workforce and ensuring that talented people from all backgrounds can reach their full potential by breaking down barriers to progression. During the year the Group launched Ignite, an internal development programme for employees in underrepresented groups.

The Group continues to make progress towards its Women in Finance target of 40.0% female representation in senior management roles by December 2025, having achieved 38.8% female representation at 30 September 2023 (2022: 38.1%).

To support its efforts to improve gender equality the Group has continued to participate in the Mission Gender Equity cross-company mentoring scheme, sponsored by the 30% Club. This programme has proven popular with both mentors and mentees and a similar scheme is being piloted for employees from ethnic minorities and other underrepresented groups over the coming year.

The Group welcomes the increasing interest in the diversity and inclusion agenda from all its stakeholders and has participated in the recent FCA Diversity and Inclusion survey.

5.4 SUSTAINABILITY

Sustainability, including resilience in the face of climate change risks, is core to the Group's strategy: to focus on specialist customers, delivering long-term sustainable growth and returns through a low risk and robust business model. Sustainability influences every aspect of the Group's business and means:

- Reducing the impact of the Group's operations on the environment
- Ensuring the Group has a positive effect on our stakeholders and communities
- Delivering sustainable lending and savings offerings through the design of products and the choices of sectors in which to operate

Sustainability issues are coordinated on a group-wide basis by the Sustainability Committee, which reports directly to the Executive Committee. This ensures that information on initiatives within business areas is shared across the Group and facilitates the development of a coordinated and proactive approach.

During the year the Committee has overseen mapping the Group's strategic priorities against the United Nations Sustainable Development Goals, a framework agreed by world leaders which aims to end poverty, fight inequality and address the urgency of climate change. It is also responsible for driving the Group's initiatives on climate change and progressing other projects in the field of sustainability.

In December 2023 the Group will publish its third annual sustainability report, the Responsible Business Report. This provides more detailed information on sustainability initiatives and demonstrates how sustainability is embedded throughout the Group. It is published on the Group's corporate website at www.paragonbankinggroup.co.uk, alongside other information and documentation relevant to ESG issues.

5 OPERATIONS

Climate change

The Group has made a commitment to achieve net zero in line with, and in support of, UK Government commitments. In doing so the Group recognises that net zero cannot be achieved by any entity in isolation and therefore this commitment is dependent on appropriate government and industry support and action. As members of Bankers for Net Zero ('B4NZ') the Group aims to provide input into the wider efforts of the financial services industry in creating a clear pathway for the decarbonisation of the UK economy.

Climate change has been designated as a principal risk within the Group's Enterprise Risk Management Framework. As a result, the Group's responses to climate change are considered within the Board's overall strategy. These risks fall into two main groups:

- Physical risks (which arise from weather-related events)
- Transitional risks (which come from the adoption of a low-carbon economy)

Information and measures on climate-related risks and opportunities are considered at board level through the CEO's monthly reports. Developments in sustainable products and climate-related exposures are considered for each business line as part of strategy deep dives which feed into the annual board strategy event and into the Corporate Plan.

During the year, in-depth risk reviews have been carried out with input from key business areas and credit risk, which identified no new material risks. The findings have been used to inform the Group's climate change scenario analysis exercise and identify the key drivers of its climate change risk profile and opportunities. The exercise was conducted in line with the outputs of the Climate Financial Risk Forum ('CFRF') scenario analysis working group, of which the Group is a member, and incorporated within the 2023 ICAAP.

As part of the ongoing development of its reporting in line with the recommendations of the Taskforce of Climate-related Financial Disclosures, the Group has enhanced its analysis of financed emissions and a more detailed emissions balance sheet is being presented in the 2023 Annual Report and Accounts.

Developments within business lines which contribute towards the Group's climate risk strategy are set out in the relevant business reviews.

As a financial services provider the direct environmental impact of the Group's operations is considered low. However, the Group recognises the importance of reducing the impact these operations have on the environment. The Group has committed to reduce its operational footprint to net zero by 2030 and now reports its operational footprint on a quarterly basis at the Sustainability Committee with a summary report escalated to the Board.

In support of the Group's net zero operational footprint target, for the 2023 financial year the Group purchased certified carbon offsets equivalent to its operational footprint for the twelve months, following the precedent set in the 2022 financial year. It intends to repeat this for each year going forward, however, it acknowledges that reducing impacts is preferable to offsetting, where possible.

MANAGEMENT REPORT (Continued)

5 OPERATIONS

Group initiatives to reduce operational environmental impacts during the year include:

- Decarbonisation assessment of the Group's head office building, which is responsible for around 30% of its operational footprint, and the identification of actions to further reduce emissions
- Enhanced support for essential car users following the 2022 update to the company car policy which aims to eliminate diesel and petrol vehicles from its company car fleet by 2025. Electric vehicle users now receive a subsidy to source an appropriate charging unit at their home address
- Appointment of a new waste contractor for the Group's head office building, from May 2023, leading to improvements in both waste management and reporting
- Completion of the LED lighting roll-out at the Group's head office by April 2023, which is reducing overall energy consumption
- Development of a supplier survey, which was rolled out across a sample of suppliers in the second half of the year, aimed at identifying climate and other sustainability risks in those business relationships

Social engagement

The Group's Charity Committee raised £45,000 for Newlife, the charity chosen by employees for the financial year, which supports children who have cancer, birth defects, diseases and infections, and their parents. For the next financial year, ending 30 September 2024, employees have selected Molly Ollys as the beneficiary of the committee's fundraising activities. Molly Ollys supports children with life-threatening illnesses and their families and helps with their emotional wellbeing.

The Group's employee volunteering initiative also expanded during the year. Employees are entitled to an annual paid volunteering day, and the year saw an increasing number of people taking advantage of this, with more opportunities becoming available and teams and departments joining together to address bigger projects. The number of days used increased by 64.0% from 286 in 2022 to 469. Opportunities were focussed on the areas of poverty, education and the environment, and the Group is promoting a wider take-up for the coming year.

5 OPERATIONS

5.5 RISK

The effective management of risk remains crucial to the achievement of the Group's strategic objectives. It operates a risk governance framework designed around a formal three lines of defence model (business areas, risk and compliance function and internal audit) supervised at board level.

Risk environment

Over the last year the principal challenges facing the Group have shifted from those related to the direct consequences of the Covid pandemic and the immediate post-pandemic period, to ones arising from increasing global economic and geopolitical threats. This shift in the risk landscape is presenting its own unique challenges with wide ranging consequences such as the rising costs of living and doing business in the UK, global economic uncertainty and potential instability in the banking sector earlier in the year.

The Group's response to this changing risk environment requires it to remain agile and resilient in its risk management capability, and to monitor impacts on its operations and risk profile on an ongoing basis. The Group's Enterprise-wide Risk Management Framework ('ERMF') provides a robust mechanism ensuring that new risks are promptly identified, assessed, managed, and appropriately overseen from a risk governance perspective.

The risk agenda has been dominated over the last year by economic threats, precipitated by the global impacts of the conflict in Ukraine and exacerbated in the UK by the impacts of the mini-budget of September 2022, which continued to be felt through the early part of the year. Consequences in the UK included rising energy, utility and commodity prices and higher interest rates, impacting the Group's customers. Based on current economic forecasts, these strategic issues are expected to continue to pose challenges for the foreseeable future:

- In an environment of rising interest rates and cost pressures for both new and existing loan customers the Group continues to ensure that high standards of prudent lending are maintained. The Group takes a forward-looking as well as current view of affordability and has adjusted credit policy and loan products to ensure loan repayments are sustainable for customers and will continue to be so
- The Group takes its responsibilities in respect of customers in vulnerable circumstances extremely seriously and continues to ensure that, where appropriate forbearance solutions are necessary, these are tailored to individual customer circumstances and aligned to regulatory guidance and expectations
- The welfare of its employees is a key priority for the Group, and it will continue to ensure that individuals feel fully supported during this period of economic uncertainty. Financial and wellbeing initiatives are in place to ensure that people have access to information and resources to assist in navigating cost of living challenges

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

5 OPERATIONS

Risk management

The need for a robust risk management framework as a mechanism for identifying, mitigating and managing new and emerging risks is a core priority, and the Group has successfully continued to enhance and embed its ERMF to meet this need. This ongoing process has enabled it to manage all categories of risk and further mature its overall risk approach ensuring that risk considerations remain central to day-to-day and strategic decision making.

Key to the Group's approach is the evolution of the ERMF to ensure that the framework continues to remain effective and proportionate, in line with the Group's strategic aspirations. This approach has been enabled during the period by increasing capability in the risk function, ensuring that appropriately skilled resource is available to provide appropriate oversight and assurance around the management of all categories of risk.

Good progress continues to be made in enhancing the suite of policies that underpin the management of each of the Group's identified principal risks. This, in turn, has resulted in the refinement of associated risk appetites and better articulation of the control environment for each risk type. The Group continues to promote a risk aware culture as being at the heart of its values, ensuring that each individual fully understands their accountabilities and responsibilities in respect of risk.

The Group remains committed to the further development of the ERMF as necessary to ensure it remains relevant and in line with regulatory expectations. Key to this vision will be investment in the implementation of an enhanced risk management system over the next 18 months, which will further improve the analysis and reporting of risk-related data, giving better insight into the risk profile at all levels within the Group.

Despite the pervasive impact of the rising interest rate environment in the year coupled with inflationary challenges which have been a significant risk focus in the year, the Group has identified and addressed a number of additional strategic risk issues including:

- **Consumer Duty** – Successfully delivering the first phase of the FCA Consumer Duty, meeting the regulatory deadlines for those products and services in scope, ensuring that the Group's culture is driving good outcomes for its customers

- **Resilience** – Further enhancing the operational resilience framework and resilience capabilities ensuring the Group can demonstrate it can consistently remain within stated impact tolerances to meet the 2025 regulatory deadline. The Group continues to refine its overarching approach, using its programme of self-assessment and testing to ensure that operational resilience remains a central objective during its transformation programme, which increasingly relies on third parties to deliver core services

- **Climate** – Addressing the impact of climate change on managing financial risks and considering this as part of the wider ESG agenda across the Group, with clear commitments made to drive net zero ambitions in line with wider governmental strategy

- **IRB** – Continuing to develop IRB model methodologies for the buy-to-let and development finance portfolios, while embedding the overarching model risk framework to enhance credit risk management and support the IRB application process

5 OPERATIONS

- **Stress testing** – Enhancing stress testing procedures to ensure the robustness of capital and liquidity positions
- **Cyber-security** – Ensuring effective cyber-security controls and a robust data protection approach are in place, particularly with the evolving and increasingly sophisticated nature of cyber threats

The Group continues to review its exposure to emerging developments in the Brexit process as further clarity is received as to future dealings with the EU; however it is clear this will take time to manifest itself fully and the long-term impact continues to emerge. Whilst the Group does not have operations outside the UK it has continued to review the capital, liquidity and operational implications of the stresses which might be caused by the process.

In particular, it has continued to monitor the issues related to the supply of essential goods which have caused shortages in a number of sectors. Whilst this has eased in recent months, and the Group was not directly affected by these issues earlier in the year, the Board continues to keep the situation under ongoing review as future supply issues in areas such as building materials and IT equipment could impact the Group's operations or those of its customers.

Risk outlook

The principal significant and emerging risk areas expected to impact the Group during the coming year ending 30 September 2024 and beyond include:

- **Costs of living and doing business** – Management of risks associated with the wider economic landscape and the impacts this has already had, and will continue to have, on the financial position of people and corporates in the UK. Consecutive interest rate rises, and the continuing inflationary pressures pose an ongoing challenge to the Group's customers. The Group remains committed to ensuring appropriate treatment of ongoing arrears and the position of affected customers. Key to this will be ensuring that the treatment of customers is fair and conduct principles remain at the forefront of all interactions
- **Compliance expectations** – Addressing an increasing level of regulatory compliance standards, where the Group is committed to ensuring it remains compliant in all areas of its business. Particular focus in the year has been on ensuring the Group was able to meet regulatory requirements in respect of the new FCA Consumer Duty rules for those products in scope for the July 2023 deadline. The priority for the Group is to continue to embed the Consumer Duty within its business lines ensuring that good customer outcomes and deep understanding of these remain at the forefront of all customer interactions
- **Financial crime** – Ensuring continuous improvement in the Group's capability to combat the risks of financial crime. Significant work has been undertaken during the previous financial year to ensure that regulatory expectations in respect of anti-money laundering and wider financial crime control frameworks are met, and the Group continues to invest in this area

MANAGEMENT REPORT (Continued)

5 OPERATIONS

- **Climate** – Risks associated with climate change remain an ever-present challenge. The UK Government confirmed its goal of net zero carbon by 2050 in November 2020, and the Group, together with the rest of the financial services industry, have a vital role to play in that commitment. As global strategies continue to be refined, the Group is seeking to ensure that the impact of climate change is considered as a core driver for both its operational activities and its lending strategies

5.6 REGULATION

Paragon Bank is authorised by the PRA and regulated by the PRA and the FCA. The Group is subject to consolidated supervision by the PRA and a number of its subsidiaries are authorised and regulated by the FCA. As a result, current and projected regulatory changes continue to pose a significant risk for the Group. All potential regulatory changes to the business are closely monitored through the comprehensive governance and control structures in place.

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

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

- **Consumer Duty** – The FCA Consumer Duty sets higher expectations for the standard of support provided to customers, and challenges firms to evidence the customer outcomes they are delivering. Implementation of the new rules is staged (with the requirement for existing products to be compliant by July 2023, and closed products by July 2024). This has been a priority area for the Group during the year with activity being championed by the Board, and a non-executive director assigned responsibility for oversight of the programme. The areas targeted for implementation during 2023 were delivered as planned, with the focus now on implementation for the Group's closed products by July 2024

- **Basel 3.1** – The PRA published a Consultation Paper on Basel 3.1 implementation in November 2022 (CP16/22). The consultation closed on 31 March 2023 and the final policy outcome has yet to be published. The expected implementation date for Basel 3.1 is 1 July 2025. The Group proactively monitors and manages its capital, assessing the implications of a range of different possible impacts including potential worse case scenarios as part of its capital planning activities

5 OPERATIONS

- **Regulatory framework** – The PRA has continued to develop its thinking on the Strong and Simple approach for small firms with a consultation on liquidity and disclosure requirements (CP 4/23) and expansion of the definition of a simpler firm in the Basel 3.1 consultation paper to include firms with total assets of up to £20 billion. While the current proposals are unlikely to apply to the Group, developments are being monitored closely given the potential impact of future proposals for mid-tier banks

- **Recovery and resolution planning** – The PRA has commenced consultations on new requirements for 'non-systemic' firms, which would include the Group, to undertake 'solvent wind down' planning – the process through which a firm could transfer or repay all deposits and exit the deposit market while remaining solvent throughout. Firms would be expected to undertake such planning in addition to the Recovery Plan. Whilst implementation of this requirement is not expected until the third quarter of 2025, the Group is actively engaged in the consultation process

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

- **Borrowers in financial difficulties** – The FCA issued findings from their 'Borrowers in Financial Difficulties' project, setting out clear expectations on the level of support that firms should provide to their customers. The regulator is also consulting on proposals to implement the additional consumer protections put in place during the pandemic as permanent requirements. Considerable work has already been undertaken in this area by the Group and therefore it considers itself well-positioned to meet any future requirements

- **Operational resilience** – Having successfully met the March 2022 policy implementation requirements, the Group has continued to embed its resilience approach to ensure it is well positioned to meet the 2025 regulatory deadline. By this time the Group will need to demonstrate an embedded resilience framework and the ability to stay consistently within impact tolerances for important business services

  The 2023 self-assessment set clear objectives for the next assessment period and clearly demonstrates the Group's ongoing commitment to continuous improvement in respect of its resilience capability. It also provides evidence of compliance with regulatory requirements which require that 'Important Business Services' are mapped and tested using severe but plausible scenarios to test the boundaries of the ability of infrastructure, key dependencies and third parties to recover from disruption

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

5 OPERATIONS

A deep dive review of the Group's climate change risk and opportunities by business area is performed on a regular basis to ensure risks and opportunities are captured where material. Managing the impacts of climate change is seen as a key strategic priority for the Group and a detailed plan of work has been developed which reflects regulatory and wider requirements. This will continue to be refined as new thinking emerges

- **Regulatory reform** – The Financial Services and Markets Act 2023 is a key piece of post-Brexit legislation that came into force in June 2023. The Act formalises new secondary objectives for the PRA and FCA covering long-term growth and international competitiveness. The Group continues to closely monitor developments in this area and the emerging implications of Brexit more widely, and how these may ultimately impact the specific regulatory frameworks under which the Group operates

- **MREL** – Although the Group is not subject to MREL requirements currently, given its potential for growth it may be required to issue MREL eligible instruments at some point in the future and therefore continues to closely monitor developments including regular engagement with regulators

Certain regulations applying in the financial services sector only affect entities over a certain size, which the Group might meet within its current planning horizon. The Group considers whether and when these regulations might apply to it in light of the growth implicit in its business plans and puts appropriate arrangements in place to ensure it would be able to comply at that point.

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

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

PRINCIPAL RISKS

We have identified a number of principal risks, arising from both the environment in which we operate and our business model, which could impact our ability to achieve our strategic priorities. We have an Enterprise Risk Management Framework ('ERMF') in place to ensure that these risks are monitored and managed in accordance with the Group's risk appetite.

Capital
Insufficient capital to operate effectively and meet minimum requirements.

Liquidity and funding
Insufficient financial resources to enable us to meet our obligations as they fall due.

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

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

Model
Making incorrect decisions based on the output of internal models.

Reputational
Failing to meet the expectations and standards of our stakeholders.

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

Climate change
Financial risks arising through climate change impacting the Group and our strategy.

Conduct
Poor behaviours or decision making leading to failure to achieve fair outcomes for customers or to act with integrity.

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

DIRECTORS' RESPONSIBILITIES

The following statement of directors' responsibilities in respect of financial statements is included in the Annual Report and Accounts of the Group for the year ended 30 September 2023.

The directors are responsible for preparing this Annual Report, including the consolidated and company financial statements in accordance with applicable law and regulations.

Company law, including the Companies Act 2006 (the 'Companies Act'), requires the directors to prepare consolidated financial statements for the Group and separate financial statements for the Company in respect of each financial year. In respect of the financial statements for the year ended 30 September 2023, that law requires the directors to prepare the consolidated financial statements in accordance with UK-adopted international accounting standards in conformity with the requirements of the Companies Act and they have also elected to prepare the separate financial statements of the Company on the same basis.

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

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

The directors are responsible for keeping adequate accounting records for the Company that are sufficient to record and explain its transactions, disclose with reasonable accuracy at any time its financial position and enable them to ensure that its financial statements comply with the requirements of the Companies Act.

They are responsible for the implementation of such internal control processes as they deem necessary to enable the preparation of financial statements which are free from material misstatements, whether due to fraud or error, and have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

DIRECTORS' RESPONSIBILITIES (Continued)

Under applicable law and regulations, the directors are also responsible for the preparation of a strategic report, directors' report, directors' remuneration report and corporate governance statement, which comply with that law and those regulations.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website (www.paragonbankinggroup.co.uk). Legislation in the UK governing the preparation and dissemination of financial statements differs from legislation in other jurisdictions.

In accordance with Disclosure Guidance and Transparency Rule ("DTR") 4.1.16R, the financial statements will form part of the annual financial report prepared in accordance with DTR 4.1.17R and 4.1.18R. The auditor's report on these financial statements provides no assurance over whether the annual financial report has been prepared in accordance with those requirements.

Confirmation by the Board of Directors

The Board of Directors currently comprises:

R D East (Chair of the Board)

N S Terrington (CEO)

R J Woodman (CFO)

H R Tudor (Senior Independent Director)

B A Ridpath (Non-executive director)

G H Yorston (Non-executive director)

A C M Morris (Non-executive director)

P A Hill (Non-executive director)

T P Davda (Non-executive director)

Z L Howorth (Non-executive director)

Each of the directors named above confirms that, to the best of their knowledge:

- The financial statements, prepared in accordance with applicable accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and of the Group taken as a whole
- The Directors' Report, including those other sections of the Annual Report incorporated by reference, comprises a management report for the purposes of the DTR, and includes a fair review of the development and performance of the business and the consolidated position of the Group taken as a whole, together with a description of the principal risks and uncertainties that it faces
- The Annual Report (including the consolidated and company financial statements), taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's position, performance, business model and strategy

Approved by the Board of Directors as the persons responsible within the Company.

Signed on behalf of the Board

CIARA MURPHY

Company Secretary

6 December 2023

PRELIMINARY FINANCIAL INFORMATION

CONSOLIDATED STATEMENT OF PROFIT OR LOSS
For the year ended 30 September 2023

	Note	2023 £m	2023 £m	2022 £m	2022 £m
Interest receivable	3		1,010.6		545.7
Interest payable and similar charges	4		(561.7)		(174.5)
Net interest income			448.9		371.2
Other leasing income		27.4		24.6	
Related costs		(21.8)		(20.0)	
Net operating lease income		5.6		4.6	
Gain on disposal of financial assets	5	-		4.6	
Other income	6	11.5		12.6	
Other operating income			17.1		21.8
Total operating income			466.0		393.0
Operating expenses			(170.4)		(153.0)
Provisions for losses	8		(18.0)		(14.0)
Operating profit before fair value items			277.6		226.0
Fair value net (losses) / gains	9		(77.7)		191.9
Operating profit being profit on ordinary activities before taxation			199.9		417.9
Tax charge on profit on ordinary activities	10		(46.0)		(104.3)
Profit on ordinary activities after taxation for the financial year			153.9		313.6

	Note	2023	2022
Earnings per share			
- basic	11	68.7p	129.2p
- diluted	11	66.3p	125.9p

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

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
For the year ended 30 September 2023

	Note	2023 £m	2023 £m	2022 £m	2022 £m
Profit for the year			153.9		313.6
Other comprehensive income					
Items that will not be reclassified subsequently to profit or loss					
Actuarial gain on pension scheme	21	2.4		15.3	
Tax thereon		(0.8)		(3.7)	
Other comprehensive income for the year net of tax			1.6		11.6
Total comprehensive income for the year			155.5		325.2

CONSOLIDATED BALANCE SHEET
30 September 2023

	Note	2023 £m	2022 £m	2021 £m
Assets				
Cash – central banks	12	2,783.3	1,612.5	1,142.0
Cash – retail banks	12	211.0	318.4	218.1
Loans to customers	13	14,495.0	13,650.4	13,408.2
Derivative financial assets	20	615.4	779.0	44.2
Sundry assets		51.0	39.2	69.2
Current tax assets		8.9	5.4	-
Deferred tax assets		-	-	14.4
Retirement benefit obligations	21	12.7	7.1	-
Property, plant and equipment		74.7	71.4	70.4
Intangible assets	22	168.2	170.2	170.5
Total assets		18,420.2	16,653.6	15,137.0
Liabilities				
Short term bank borrowings		0.2	0.4	0.3
Retail deposits	23	13,234.4	10,569.5	9,297.4
Derivative financial liabilities	20	39.9	102.1	43.9
Asset backed loan notes	24	28.0	409.3	516.0
Secured bank borrowings	24	-	586.0	730.0
Retail bond issuance	24	112.4	112.3	237.1
Corporate bond issuance	24	145.8	149.2	149.0
Central bank facilities	24	2,750.0	2,750.0	2,819.0
Sale and repurchase agreements	24	50.0	-	-
Sundry liabilities	25	631.2	513.1	90.7
Current tax liabilities		-	-	1.4
Deferred tax liabilities		17.7	44.4	-
Retirement benefit obligations	21	-	-	10.3
Total liabilities		17,009.6	15,236.3	13,895.1
Called up share capital	26	228.7	241.4	262.5
Reserves	27	1,257.5	1,223.9	1,056.1
Own shares	28	(75.6)	(48.0)	(76.7)
Total equity		1,410.6	1,417.3	1,241.9
Total liabilities and equity		18,420.2	16,653.6	15,137.0

Approved by the Board of Directors on 6 December 2023.

Signed on behalf of the Board of Directors

N S Terrington	R J Woodman
Chief Executive	Chief Financial Officer

CONSOLIDATED CASHFLOW STATEMENT
For the year ended 30 September 2023

	Note	2023 £m	2022 £m
Net cash generated by operating activities	30	2,171.7	1,168.7
Net cash (utilised) by investing activities	31	(3.1)	(2.4)
Net cash (utilised) by financing activities	32	(1,105.0)	(595.6)
Net increase in cash and cash equivalents		1,063.6	570.7
Opening cash and cash equivalents		1,930.5	1,359.8
Closing cash and cash equivalents		2,994.1	1,930.5
Represented by balances within:			
Cash	12	2,994.3	1,930.9
Short term bank borrowings		(0.2)	(0.4)
		2,994.1	1,930.5

CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY

For the year ended 30 September 2023

Year ended 30 September 2023

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m
Transactions arising from							
Profit for the year	-	-	-	-	153.9	-	153.9
Other comprehensive income	-	-	-	-	1.6	-	1.6
Total comprehensive income	-	-	-	-	155.5	-	155.5
Transactions with owners							
Dividends paid (note 29)	-	-	-	-	(67.9)	-	(67.9)
Own shares purchased	-	-	-	-	-	(120.5)	(120.5)
Irrevocable instruction accrual	-	-	-	-	-	10.8	10.8
Exercise of share awards	0.2	0.3	-	-	(11.4)	14.8	3.9
Shares cancelled	(12.9)	-	12.9	-	(67.3)	67.3	-
Capital reorganisation	-	-	(71.8)	-	71.8	-	-
Charge for share based remuneration	-	-	-	-	9.6	-	9.6
Tax on share based remuneration	-	-	-	-	1.9	-	1.9
Net movement in equity in the year	(12.7)	0.3	(58.9)	-	92.2	(27.6)	(6.7)
Opening equity	241.4	71.1	71.8	(70.2)	1,151.2	(48.0)	1,417.3
Closing equity	228.7	71.4	12.9	(70.2)	1,243.4	(75.6)	1,410.6

CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY
For the year ended 30 September 2023

Year ended 30 September 2022

	Share capital £m	Share premium £m	Capital redemption reserve £m	Merger reserve £m	Profit and loss account £m	Own shares £m	Total equity £m
Transactions arising from							
Profit for the year	-	-	-	-	313.6	-	313.6
Other comprehensive income	-	-	-	-	11.6	-	11.6
Total comprehensive income	-	-	-	-	325.2	-	325.2
Transactions with owners							
Dividends paid (note 29)	-	-	-	-	(68.9)	-	(68.9)
Own shares purchased	-	-	-	-	-	(79.5)	(79.5)
Irrevocable instruction accrual	-	-	-	-	-	(10.8)	(10.8)
Exercise of share awards	0.4	1.0	-	-	(10.3)	9.6	0.7
Shares cancelled	(21.5)	-	21.5	-	(109.4)	109.4	-
Capital reorganisation	-	-	-	-	-	-	-
Charge for share based remuneration	-	-	-	-	9.2	-	9.2
Tax on share based remuneration	-	-	-	-	(0.5)	-	(0.5)
Net movement in equity in the year	(21.1)	1.0	21.5	-	145.3	28.7	175.4
Opening equity	262.5	70.1	50.3	(70.2)	1,005.9	(76.7)	1,241.9
Closing equity	241.4	71.1	71.8	(70.2)	1,151.2	(48.0)	1,417.3

NOTES TO THE FINANCIAL INFORMATION

For the year ended 30 September 2023

1. GENERAL INFORMATION

The financial information set out in the announcement does not constitute the Company's statutory accounts for the years ended 30 September 2021, 30 September 2022 or 30 September 2023, but is derived from those statutory accounts, which have been reported on by the Company's auditors. Statutory accounts for the years ended 30 September 2021 and 30 September 2022 have been delivered to the Registrar of Companies and those for the year ended 30 September 2023 will be delivered to the Registrar following the Company's 2024 Annual General Meeting. The reports of the auditors in each case were unqualified, did not draw attention to any matters by way of emphasis and did not contain an adverse statement under sections 498(2) or 498(3) of the Companies Act 2006.

Copies of the Annual Report and Accounts for the year ended 30 September 2023 will be distributed to shareholders in due course. Copies of this announcement can be obtained from the Company Secretary, Paragon Banking Group PLC at 51 Homer Road, Solihull, West Midlands, B91 3QJ and on the Group's website at www.paragonbankinggroup.co.uk.

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

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

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

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

2. SEGMENTAL INFORMATION

The Group analyses its operations, both for internal management reporting and external financial reporting, on the basis of the markets from which its assets are generated. The segments used at 30 September 2023 are described below:

- Mortgage Lending, including the Group's buy-to-let, and owner-occupied first and second charge lending and related activities
- Commercial Lending, including the Group's equipment leasing activities, development finance, structured lending and other offerings targeted towards SME customers, together with its motor finance business

These segments are the same as those used at 30 September 2022.

Dedicated financing and administration costs of each of these businesses are allocated to the segment. With effect from the 2023 financial year, interest impacts of fair value hedging activities have been allocated to segments for management accounting purposes. Comparative figures have been adjusted for consistency. Shared central costs are not allocated between segments, nor is income from central cash balances or the carrying costs of unallocated savings balances.

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

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

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

Other assets and liabilities are not allocated between segments.

All the Group's operations are conducted in the UK, all revenues arise from external customers and there are no inter-segment revenues. No customer contributes more than 10% of the revenue of the Group.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

2. SEGMENTAL INFORMATION (CONTINUED)

Financial information about these business segments, prepared on the same basis as used in the consolidated accounts of the Group, is shown below.

Year ended 30 September 2023

	Mortgage Lending £m	Commercial Lending £m	Unallocated items £m	Total £m
Interest receivable	713.6	207.4	89.6	1,010.6
Interest payable	(436.0)	(71.7)	(54.0)	(561.7)
Net interest income	277.6	135.7	35.6	448.9
Other operating income	5.6	11.5	-	17.1
Total operating income	283.2	147.2	35.6	466.0
Operating expenses	(26.2)	(26.4)	(117.8)	(170.4)
Provisions for losses	(10.4)	(7.6)	-	(18.0)
	246.6	113.2	(82.2)	277.6

Year ended 30 September 2022 (restated)

	Mortgage Lending £m	Commercial Lending £m	Unallocated items £m	Total £m
Interest receivable	399.7	134.8	11.2	545.7
Interest payable	(148.5)	(23.6)	(2.4)	(174.5)
Net interest income	251.2	111.2	8.8	371.2
Other operating income	7.4	9.8	4.6	21.8
Total operating income	258.6	121.0	13.4	393.0
Operating expenses	(24.4)	(24.9)	(103.7)	(153.0)
Provisions for losses	(4.6)	(9.4)	-	(14.0)
	229.6	86.7	(90.3)	226.0

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

	2023 £m	2022 £m
Results shown above	277.6	226.0
Fair value items	(77.7)	191.9
Operating profit	199.9	417.9

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

2. SEGMENTAL INFORMATION (CONTINUED)

The assets of the segments listed above are:

	2023 £m	2022 £m	2021 £m
Mortgage Lending	12,988.4	12,569.2	11,952.9
Commercial Lending	2,016.3	1,923.2	1,612.4
Total segment assets	15,004.7	14,492.4	13,565.3
Unallocated assets	3,415.5	2,161.2	1,571.7
Total assets	18,420.2	16,653.6	15,137.0

An analysis of the Group's loan assets by type and segment is shown in note 13.

3. INTEREST RECEIVABLE

Interest receivable is analysed as follows.

	Note	2023 £m	2022 £m
Interest receivable in respect of			
Loans and receivables		642.9	486.7
Finance leases		59.6	45.0
Invoice finance income		4.3	3.4
Interest on loans to customers		706.8	535.1
Effect of fair value hedging of loan assets		210.0	(1.5)
Interest on loans to customers after hedging		916.8	533.6
Pension scheme surplus	21	0.4	-
Other interest receivable		93.4	12.1
Total interest on financial assets		1,010.6	545.7

The above amounts relate to:

	2023 £m	2022 £m
Financial assets held at amortised cost	740.6	502.2
Finance leases	59.6	45.0
Pension scheme surplus	0.4	-
Derivative financial instruments held at fair value	210.0	(1.5)
	1,010.6	545.7

Other interest receivable relates principally to cash deposits at central and retail banks.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

4. INTEREST PAYABLE AND SIMILAR CHARGES

	Note	2023 £m	2022 £m
On financial liabilities			
Retail deposits		334.1	108.8
Effect of fair value hedging of deposits		54.4	4.2
Interest on retail deposits after hedging		388.5	113.0
Asset backed loan notes		10.9	9.1
Bank loans and overdrafts		34.8	13.3
Corporate bonds		6.6	6.6
Effect of fair value hedging of bonds		0.6	-
Retail bonds		6.5	9.1
Central bank facilities		111.9	22.2
Sale and repurchase agreements		0.7	-
Total interest on financial liabilities		560.5	173.3
Pension scheme deficit	21	-	0.2
Discounting on contingent consideration		-	0.1
Discounting on lease liabilities		0.3	0.2
Other finance costs		0.9	0.7
		561.7	174.5

The above amounts relate to:

	2023 £m	2022 £m
Financial liabilities held at amortised cost	505.5	169.1
Derivative financial instruments held at fair value	55.0	4.2
Other items	1.2	1.2
	561.7	174.5

5. GAIN ON DISPOSAL OF FINANCIAL ASSETS

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

6. OTHER INCOME

	2023 £m	2022 £m
Loan account fee income	4.8	6.1
Broker commissions	2.1	2.3
Third party servicing	4.3	3.5
Other income	0.3	0.7
	11.5	12.6

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

7. TBMC CLOSURE

During the year, after a review of strategic priorities, the Group announced the closure of its TBMC mortgage brokerage business, which it considered to be non-core. As a result of this decision the remaining goodwill balance of the TBMC CGU and the other intangible assets relating to the business have been derecognised.

The total amount expense to the profit and loss account on the closure is set out below.

	2023 £m
Goodwill derecognised	1.6
Intangible assets derecognised	0.2
Other closure costs	0.2
Total closure costs	2.0

The contribution to profit of the closed business in the year, which was included in the Mortgage Lending segment, was a loss of £0.5m excluding the costs shown above (2022: loss of £0.8m).

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

8. LOAN IMPAIRMENT PROVISIONS CHARGED / (CREDITED) TO INCOME

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

	Mortgage Lending £m	Commercial Lending £m	Total £m
30 September 2023			
Provided in period (note 17)	10.8	8.3	19.1
Recovery of written off amounts	(0.4)	(0.7)	(1.1)
	10.4	7.6	18.0
Of which			
Loan accounts	10.4	10.5	20.9
Finance leases	-	(2.9)	(2.9)
	10.4	7.6	18.0
30 September 2022			
Provided in period (note 17)	5.1	10.7	15.8
Recovery of written off amounts	(0.5)	(1.3)	(1.8)
	4.6	9.4	14.0
Of which			
Loan accounts	4.6	2.4	7.0
Finance leases	-	7.0	7.0
	4.6	9.4	14.0

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

9. FAIR VALUE NET (LOSSES) / GAINS

	2023 £m	2022 £m
Ineffectiveness of fair value hedges		
Portfolio hedges of interest rate risk		
Deposit hedge	7.8	11.6
Loan hedge	(23.7)	15.1
	(15.9)	26.7
Individual hedges of interest rate risk	-	-
	(15.9)	26.7
Other hedging movements	(53.5)	4.7
Net gains / (losses) on other derivatives	(8.3)	160.5
	(77.7)	191.9

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

10. TAX CHARGE ON PROFIT ON ORDINARY ACTIVITIES

Income tax for the year ended 30 September 2023 is charged at an effective rate of 23.0% (2022: 25.0%).

The standard rate of corporation tax in the UK applicable to the Group in the year was 22.0% (2022 : 19.0%), based on legislation enacted at the year end. During the year ended 30 September 2021, the UK Government enacted legislation increasing the standard rate of corporation tax in the UK from 19.0% to 25.0% from April 2023. Consequently, the current year falls partly in the period during which the 19.0% rate applies and partly in that where the rate is 25.0%. These measures will increase the standard rate of corporation tax applicable to the Group to 25.0% in the year ending 30 September 2024 and thereafter. The effect of these changes on deferred tax balances was accounted for in the year ended 30 September 2021.

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

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

In the financial year ended 30 September 2022 the UK Government enacted legislation reducing the rate of the Banking Surcharge from 8.0% to 3.0%, from April 2023, while increasing the profit threshold at which the surcharge applies to £100.0m from £25.0m. This has resulted in the surcharge applying to Paragon Bank in the current year reducing to 5.5%, with a threshold of £62.5m, while in future years a surcharge of 3.0% on earnings over £100.0m will apply. The impact of this change on deferred tax balances was accounted for in the year ended 30 September 2022. The combination of the standard rate of tax and the surcharge results in taxable profits in excess of the annual threshold arising in Paragon Bank being taxed at 27.5% in the current year (2022: 27.0%). This will rise to 28.0% in subsequent financial years.

11. EARNINGS PER SHARE

Earnings per ordinary share is calculated as follows:

		2023	2022
Profit for the year (£m)		153.9	313.6
Basic weighted average number of ordinary shares ranking for dividend during the year (m)		224.1	242.7
Dilutive effect of the weighted average number of share options and incentive plans in issue during the year (m)		8.0	6.4
Diluted weighted average number of ordinary shares ranking for dividend during the year (m)		232.1	249.1
Earnings per ordinary share	- basic	68.7p	129.2p
	- diluted	66.3p	125.9p

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

12. CASH AND CASH EQUIVALENTS

'Cash and Cash Equivalents' includes current bank balances, money market placements and fixed rate sterling term deposits with London banks, and balances with the Bank of England. It is analysed as set out below.

	2023 £m	2022 £m	2021 £m
Deposits with the Bank of England	2,783.3	1,612.5	1,142.0
Balances with central banks	2,783.3	1,612.5	1,142.0
Deposits with other banks	211.0	318.4	218.1
Balances with other banks	211.0	318.4	218.1
Cash and cash equivalents	2,994.3	1,930.9	1,360.1

Not all of the Group's cash is immediately available for its general purposes, including liquidity management. Cash received in respect of loan assets funded through warehouse facilities and securitisations is not immediately available, due to the terms of those arrangements. This cash is shown as 'securitisation cash' below.

Cash held by the Trustee of the Group's employee share ownership plan ('ESOP') may only be used to invest in the shares of the Company, pursuant to the aims of that plan. This is shown as 'ESOP cash' below.

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

	2023 £m	2022 £m	2021 £m
Available cash	2,907.7	1,689.1	1,236.5
Securitisation cash	86.1	240.5	123.3
ESOP cash	0.5	1.3	0.3
	2,994.3	1,930.9	1,360.1

The 'Cash and Cash Equivalents' amount of £27.6m (2022: £19.7m, 2021: £19.6m) shown in the Company balance sheet is not subject to restrictions.

Cash and cash equivalents are classified as Stage 1 exposures (see note 16) for the purposes of impairment provisioning. The probabilities of default have been assessed to be so low as to require no significant impairment provision.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

13. LOANS TO CUSTOMERS

The Group's loans to customers at 30 September 2023, analysed between the segments described in note 2 are as follows:

	Note	2023 £m	2022 £m	2021 £m
First mortgages		12,747.8	12,122.4	11,460.6
Second charge mortgages		154.5	206.3	281.7
Unsecured consumer loans		-	-	87.3
Total Mortgage Lending		12,902.3	12,328.7	11,829.6
Finance lease receivables		907.3	825.2	720.3
Development finance		747.8	719.9	608.2
Other secured commercial lending		227.6	238.1	168.0
Other commercial loans		89.3	98.4	76.6
Total Commercial Lending		1,972.0	1,881.6	1,573.1
Loans to customers		14,874.3	14,210.3	13,402.7
Fair value adjustments from portfolio hedging	20	(379.3)	(559.9)	5.5
		14,495.0	13,650.4	13,408.2

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

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

14. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS

The following notes set out information on the Group's impairment provisioning under IFRS 9 for the loans to customers balances set out in note 13, including both finance leases, accounted for under IFRS 16, and loans held at amortised cost, accounted for under IFRS 9, as both groups of assets are subject to the IFRS 9 impairment requirements.

The disclosures are set out within the following notes:

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

The impact on the Group's profit and loss account for the year is set out in note 8.

15. LOAN IMPAIRMENT - BASIS OF PROVISION

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

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

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

15. LOAN IMPAIRMENT – BASIS OF PROVISION (CONTINUED)

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

For the majority of the Group's loan assets, the ECL is generated using statistical models applied to account data to generate PD and LGD components. In determining for which portfolios a statistically modelled approach is appropriate, the Group considers the volume of available data and the level of similarity of the credit characteristics of the underlying accounts.

PD on both a twelve month and lifetime basis is estimated based on statistical models for the Group's most significant asset classes. The PD calculation is a function of current asset performance, customer information and future economic assumptions. The structure of the models was derived through analysis of correlation in historic data, which identified which current and historical customer attributes and external economic variables were predictive of future loss. PD measures are calculated for the full contractual lives of loans with the models deriving probabilities that, at a given future date, a loan will be in default, performing or closed. The Group utilised all reasonably available information in its possession for this exercise.

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

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

The largest portfolio where a fully modelled approach is not taken is the Group's development finance book, which has a relatively low number of cases (less than 250) and a low incidence of historical losses on which to base a model. For this portfolio the impairment provision is based on the output of internal case-by-case monitoring.

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

In extreme or unprecedented economic conditions, it is likely that mechanical models will be less predictive of outcomes as the historical data used for modelling will be insufficiently representative of conditions at the balance sheet date. This may be the case where economic indicators at the reporting date and future expectations for those indicators lie outside the range of the observations used to construct the models. In such circumstances, management carefully review all outputs to ensure provision is adequate.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

15. LOAN IMPAIRMENT – BASIS OF PROVISION (CONTINUED)

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

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

The methodologies used to derive the Group's ECL provisions at 30 September 2023 are analysed below.

	Gross £m	Impairment £m	Net £m
30 September 2023			
Modelled portfolios	13,825.4	(48.3)	13,777.1
Judgemental adjustments thereon	-	(6.5)	(6.5)
	13,825.4	(54.8)	13,770.6
Non-modelled portfolios	1,122.5	(18.8)	1,103.7
Total	14,947.9	(73.6)	14,874.3
30 September 2022			
Modelled impairments	13,167.2	(39.9)	13,127.3
Judgemental adjustments thereon	-	(15.0)	(15.0)
	13,167.2	(54.9)	13,112.3
Non-modelled	1,106.6	(8.6)	1,098.0
Total	14,273.8	(63.5)	14,210.3

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

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

15. LOAN IMPAIRMENT – BASIS OF PROVISION (CONTINUED)

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

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

As part of its determination of whether model outputs form a reliable basis for impairment provisioning, the Group considered whether it had any evidence of groups of accounts demonstrating factors indicating a higher level of credit risk than other accounts in the same portfolios, either from operational experience or its regular credit risk monitoring activities. No such evidence was noted at 30 September 2023 or 30 September 2022, and hence no additional accounts were identified as having an SICR.

iii) Definitions of default

As the IFRS 9 definition of ECL is based on PD, default must be defined for this purpose. The analysis of these default cases provides the foundation for the Group's PD modelling. IFRS 9 provides a rebuttable presumption that an account is in default when it is 90 days overdue and this was used as the basis of the Group's definition, combined with qualitative and quantitative factors specific to each portfolio.

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

This ensures that Group's definitions of default for its various portfolios are materially aligned to the regulatory definitions of default used internally, and are broadly aligned to its internal operational procedures, allowing for the arbitrary nature of the 90-day cut-off, which is a regulatory rather than an operational requirement. In particular the Group's receiver of rent cases are defined as defaulted for modelling purposes as the behaviour of the case after that point is significantly influenced by internal management decisions.

iv) Credit Impaired loans

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

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

15. LOAN IMPAIRMENT – BASIS OF PROVISION (CONTINUED)

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

Loans are retained in Stage 3 for three months after the point where they cease to exhibit the characteristics of default. After this point, they may move to Stage 2 or Stage 1 depending on whether an SICR trigger remains.

All default cases are considered to be credit impaired, including all receiver of rent cases and all cases with at least one payment more than 90 days overdue, even where such cases are being managed in the expectation of realising all of the carrying balance.

In order to provide better information for users, additional analysis of credit impaired accounts has been presented in note 16, distinguishing between probationary accounts, receiver of rent accounts, accounts subject to realisation / enforcement procedures and long term managed accounts, all of which are treated as credit impaired. While other indicators of default are in use, the categories shown account for the overwhelming majority of Stage 3 cases.

v) Monitoring of ECL estimation processes

The Group's ECL models are compiled on the basis of the analysis of relevant historical data. Before a model is adopted for use its operations and outputs are examined to ensure that it is expected to be appropriately predictive and, if it is an updated model, expected to be more predictive than any existing model. Before a new model is adopted the changes and impacts will be considered by the CFO, alongside any advice from the Group's independent model review functions. The performance of all models is reviewed on an ongoing basis, by senior finance and risk management, including the CFO. Monitoring packs comparing actual and predicted loss levels are produced at regular intervals, set on the basis of the materiality of each model. The continuing appropriateness of model assumptions is also reviewed as part of this process.

Models are revisited on a regular basis to ensure that they continue to reflect the most recent data as the available information increases over time.

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

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

15. LOAN IMPAIRMENT – BASIS OF PROVISION (CONTINUED)

vi) Model development

The models used by the Group are updated from time to time to allow for changes in the business, developments in best practice and the availability of additional data with the passing of time. During the year ended 30 September 2023 a major update to the SME Lending PD model took place, meaning that two of the Group's four principal PD models, covering over 96% of modelled balances, have been updated since IFRS9 was implemented.

The adoption of the new SME lending model has enabled the reporting process in the year to be more streamlined, and supported increased use of scenario analysis, and increased the ability of the model to respond to economic inputs and wider customer credit data. This included more extensive use of external credit bureau data, enabling at risk cases to be identified for provisioning on a more timely basis.

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

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

The impacts of the adoption of the new SME lending PD model in the year ended 30 September 2023 on a like-for-like basis were to increase provision by £0.9m and transfer £10.8m of gross balances from Stage 1 to Stage 2.

vii) Judgemental Adjustments

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

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

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

15. LOAN IMPAIRMENT – BASIS OF PROVISION (CONTINUED)

The Group's approach to impairment modelling is based on the analysis of historical credit data. In normal circumstances the Group's objective is to develop its modelling to the point where the level of judgemental adjustments required is minimal, but in economic conditions where previous relevant experience is limited or non-existent, some form of judgemental adjustment is always likely to be necessary. While high interest rate and inflation scenarios have occurred in the UK in the past, market conditions, products and regulatory expectations have moved on considerably in the meantime, and most such observations would pre-date the existence of buy-to-let mortgages as a distinct asset class. This means that the value of past history as a guide to future credit performance is reduced.

The current model behaviour and the potential for unobserved credit issues have meant that the requirement for such adjustments over recent periods has been significant. Evidence considered by management included internal performance data, customer and broker feedback, insight surveys, industry intelligence, evidence on the wider economy and quantitative and qualitative data and statements from industry, government and regulatory bodies. These were combined with the expert knowledge within the business to form a broad estimate of the level of provision required across the Group.

As part of this exercise, the potential for climate related issues to impact on customer business models or security values over the timescales for ECL calculation required by IFRS 9 was considered. No specific requirement for additional impairment provisions over the amounts already determined was identified.

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

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

	2023 £m	2022 £m
Mortgage Lending	3.0	5.0
Commercial Lending	3.5	10.0
	6.5	15.0

The movements in the year represent principally the extent to which the anticipated economic and customer behaviours which gave rise to judgemental adjustments at 30 September 2022 are now observable and thus are reflected by the Group's models. The movements also reflect the enhanced ability of the new SME lending PD model introduced in the year to identify potential impairment, reducing the need for additional overlays. There has also been a reduction in the levels of economic and political uncertainty in the UK, compared to the position at 30 September 2022, which also impacts on the level of adjustments required. The movements in the 2022 financial year represented a transition from Covid related overlays to ones which related more to the responsiveness of the Group's provision models to economic conditions at the end of that year.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

15. LOAN IMPAIRMENT – BASIS OF PROVISION (CONTINUED)

The adjustment at 30 September 2022 in the Mortgage Lending book was principally a result of a disconnect between the credit metrics which drive the models and the economic expectations of management, brokers and customers at the year end date. While some of the anticipated impacts have begun to manifest themselves in arrears performance, neither the Group nor the mortgage industry more generally has seen a significant reaction to higher levels of interest rates and inflation in credit performance as yet. Combined with potential model limitations in responding to significant rapid changes in interest and inflation rates, management determined it was appropriate to reduce, but not remove the judgmental adjustment.

In the Commercial Lending segment the adjustment at 30 September 2022 related to general economic exposures for SMEs, with the outlook for the sector considered to be less positive than credit metrics indicated at that time. While business confidence is somewhat improved over the period, views on the outlook are generally mixed, with contradictory indicators on the likely future direction. Overall, however, the available information is indicative of a more negative position than indicated by the credit metrics in the portfolio alone.

During the period a new SME lending model was introduced, addressing some of the weakness in the Group's modelling approach, reducing the need for judgemental adjustments. However, issues relating to the availability of data representing similar economic conditions to those currently being observed remain, and it is likely that in the short term a judgemental adjustment will remain necessary to ensure appropriate provisioning levels. These factors together reduced the SME lending overlay to £2.5m (2022: £10.0m).

In addition a £1.0m overlay was made to the modelled motor finance provision (2022: £nil) to allow for difficulties noted in that model in responding to a period of falling inflation rapidly following a period of sharp price rises. This economic scenario depressed the calculated provision below a level management considered reasonable, given other portfolio data.

The Group's analysis found no evidence of particular concentrations of credit risk below portfolio level. Given this, and the high level nature of the exercise undertaken, the judgemental adjustments have been apportioned across the Group's buy-to-let mortgage, SME lending and motor finance portfolios, as appropriate, to individual Stage 1 cases. As such they are included in the credit risk disclosures required by IFRS 7.

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

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

16. LOAN IMPAIRMENTS BY STAGE AND DIVISION

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

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

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

For assets which were 'Purchased or Originated as Credit Impaired' ('POCI') accounts (those considered as credit impaired at the point of first recognition), such as certain of the Group's acquired assets in Mortgage Lending, the carrying valuation is based on expected cash flows discounted by the EIR determined at the point of acquisition.

The recommendations of the taskforce on Disclosures about Expected Credit Loss ('DECL') suggest standard categories for analysis of firm's loan books. In the context of the DECL categorisation the Group's Mortgage Lending balances are classified as 'UK retail mortgage' business while its Commercial Lending balances, being advanced primarily to SME entities correspond with the 'UK other retail' business classification.

The Group defines coverage as the value of the ECL provision divided by the gross carrying value of the related loans.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

16. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

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

	Stage 1 £m	Stage 2 * £m	Stage 3 * £m	POCI £m	Total £m
30 September 2023					
Gross loan book					
Mortgage Lending	12,159.7	625.0	142.2	17.7	12,944.6
Commercial Lending	1,812.6	119.8	63.8	7.1	2,003.3
Total	13,972.3	744.8	206.0	24.8	14,947.9
Impairment provision					
Mortgage Lending	(4.8)	(6.1)	(31.4)	-	(42.3)
Commercial Lending	(14.8)	(3.3)	(8.4)	(4.8)	(31.3)
Total	(19.6)	(9.4)	(39.8)	(4.8)	(73.6)
Net loan book					
Mortgage Lending	12,154.9	618.9	110.8	17.7	12,902.3
Commercial Lending	1,797.8	116.5	55.4	2.3	1,972.0
Total	13,952.7	735.4	166.2	20.0	14,874.3
Coverage ratio					
Mortgage Lending	0.04%	0.98%	22.08%	-	0.33%
Commercial Lending	0.82%	2.75%	13.17%	67.61%	1.56%
Total	0.14%	1.26%	19.32%	19.35%	0.49%

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

16. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

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

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

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

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

The Group's acquired consumer loans are included in the Mortgage Lending segment, together with its closed second charge mortgage portfolios. Acquired loans which were performing on acquisition are included in the staging analysis above.

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

16. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

Analysis of Stage 2 loans

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

Cases which have been greater than one month in arrears in the last three months, but which are not at the balance sheet date are shown as 'recent arrears' in the tables below.

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

The Group 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.

The value of accounts in Stage 2 has reduced significantly in the Mortgage Lending segment over the year. This is driven principally by a lower number of accounts identified through model based criteria which are driven by the economic scenarios input into the models. The economic forecasts at 30 September 2022 included significant short term shifts in interest rates and house prices. These have been reflected in actual economic performance, to some extent, and the initial part of the September 2023 scenarios have lower rate movements.

The number of arrears cases being recorded has increased, as a result of increasing economic pressure on customers, to some extent representing a proportion of the SICR cases identified at the previous year end. However the scale of this increase is less than indicated by the Group's modelling at 30 September 2022, with accounts not, so far, as severely impacted by rate rises and cost-of-living issues as predicted. Together these factors have led to a reduction in the overall Stage 2 pool.

In the Commercial Lending segment the number of Stage 2 accounts has increased across all categories as the impact of economic pressures begins to be demonstrated, but arrears levels remain low. The number of Stage 2 cases has also been increased through the adoption of a new SME lending model, which is better able to identify cases where external data indicates a customer having credit problems before any impact is seen on the Group's loan book.

Overall Stage 2 provisions have increased with the Stage 2 balance, but coverage levels, on average, also increasing. Provision coverage levels in the Mortgage Lending segment have generally increased, partly as a result of downward pressure on property prices impacting on security values. Coverage levels in the Commercial Lending segment increased, although this was more related to the mix of Stage 2 assets, and the relatively small number of cases involved.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

16. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

	< 1 month arrears	Recent arrears	> 1 <= 3 months arrears	Total
	£m	£m	£m	£m
30 September 2023				
Gross loan book				
Mortgage Lending	518.1	15.8	91.1	625.0
Commercial Lending	116.3	0.4	3.1	119.8
Total	634.4	16.2	94.2	744.8
Impairment provision				
Mortgage Lending	(2.3)	(0.1)	(3.7)	(6.1)
Commercial Lending	(2.9)	-	(0.4)	(3.3)
Total	(5.2)	(0.1)	(4.1)	(9.4)
Net loan book				
Mortgage Lending	515.8	15.7	87.4	618.9
Commercial Lending	113.4	0.4	2.7	116.5
Total	629.2	16.1	90.1	735.4
Coverage ratio				
Mortgage Lending	0.44%	0.63%	4.06%	0.98%
Commercial Lending	2.49%	-	12.90%	2.75%
Total	0.82%	0.62%	4.35%	1.26%

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

16. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

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

Analysis of Stage 3 loans

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

- In the process of sale or other enforcement procedures ('Realisations')
- Where a receiver of rent ('RoR') has been appointed by the Group to manage the property on the customers' behalf
- Which are being managed on a long-term basis and where full recovery is possible, but which are considered to meet regulatory default criteria at the balance sheet date ('>3 month arrears')
- Which no longer meet regulatory default criteria but which are being retained in Stage 3 for a probationary period ('Probation')

Where an account meets two of the criteria, it will be assigned to the category shown first in the list above.

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

16. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

The number and value of Stage 3 accounts has increased in the year across all books. This has mostly been driven by increases in the number of accounts in serious arrears and by an increased number of poorly performing development finance cases in the Commercial Lending book. This sort of increase is not unexpected in a climate of economic tightening.

Realisations cases, particularly in Mortgage Lending have increased, as the increase in arrears cases reported at the half year works its way through the system. RoR cases in the Mortgage Lending division have remained broadly stable, however there has been a level of churn in the book with old cases settled and new appointments made.

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

The relatively low amount of Commercial Lending cases and the variety of credit profiles covered by the division's lending means that the coverage ratio at any particular time tends to be more a function of the particular accounts in the Stage 3 population at that point, rather than indicative of a general trend. The increased number of development finance cases, where security cover is relatively high, within the arrears population has reduced the overall percentage provision requirement in that division.

	Probation	> 3 month arrears	RoR managed	Realisations	Total
	£m	£m	£m	£m	£m
30 September 2023					
Gross loan book					
Mortgage Lending	8.8	40.4	50.3	42.7	142.2
Commercial Lending	1.1	57.8	-	4.9	63.8
Total	9.9	98.2	50.3	47.6	206.0
Impairment provision					
Mortgage Lending	-	(1.2)	(16.6)	(13.6)	(31.4)
Commercial Lending	(0.3)	(5.5)	-	(2.6)	(8.4)
Total	(0.3)	(6.7)	(16.6)	(16.2)	(39.8)
Net loan book					
Mortgage Lending	8.8	39.2	33.7	29.1	110.8
Commercial Lending	0.8	52.3	-	2.3	55.4
Total	9.6	91.5	33.7	31.4	166.2
Coverage ratio					
Mortgage Lending	-	2.97%	33.00%	31.85%	22.08%
Commercial Lending	27.27%	9.52%	-	53.06%	13.17%
Total	3.03%	6.82%	33.00%	34.03%	19.32%

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

16. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

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

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

	2023 £m	2022 £m
First mortgages	89.5	66.2
Second mortgages	10.2	14.6
Asset finance	1.6	1.6
Motor finance	1.2	0.7
	102.5	83.1

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

16. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

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

Mortgage Lending balances with over three months arrears include second charge mortgage accounts originated over ten years ago which have been over three months in arrears for some time. These accounts are generally making regular payments and have significant levels of equity in the underlying property which reduces the required provision to the value shown above. It is expected that a high proportion of these accounts will eventually redeem naturally, either on the sale of the property or by the satisfaction of the amount due through instalment payments.

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

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

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

	30 September 2023		30 September 2022	
	No.	£m	No.	£m
Managed accounts				
Appointment date				
2010 and earlier	135	20.1	199	31.2
2011 to 2015	31	4.5	49	7.1
2016 to 2020	15	2.0	24	3.2
2021 and later	154	23.7	62	8.1
Total managed accounts	335	50.3	334	49.6
Accounts in the process of realisation	225	41.0	141	23.5
	560	91.3	475	73.1

Receiver of rent accounts in the process of realisation at the period end are included under that heading in the Stage 3 tables above. In addition to the cases analysed above there were four other receiver of rent cases in acquired mortgage books classified as POCI (2022: nil), meaning that the Group's total of receiver of rent cases at 30 September 2023 was 564 (2022: 475).

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

17. LOAN IMPAIRMENTS – PROVISION MOVEMENTS IN THE YEAR

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

	Mortgage Lending £m	Commercial Lending £m	Total £m
At 30 September 2022	38.0	25.5	63.5
Provided in period (note 8)	10.8	8.3	19.1
Amounts written off	(6.5)	(2.5)	(9.0)
Assets derecognised	-	-	-
At 30 September 2023 (note 16)	42.3	31.3	73.6
At 30 September 2021	37.7	27.7	65.4
(Released) / provided in period (note 8)	5.1	10.7	15.8
Amounts written off	(3.6)	(12.9)	(16.5)
Assets derecognised	(1.2)	-	(1.2)
At 30 September 2022 (note 16)	38.0	25.5	63.5

Accounts are considered to be written off for accounting purposes if a balance remains once standard enforcement processes have been completed, subject to any amount retained in respect of expected salvage receipts. This has no effect on the net carrying value, only on the amounts reported as gross loan balances and accumulated impairment provisions.

At 30 September 2023, enforceable contractual balances of £7.6m (2022: £4.9m) were outstanding on non-POCI assets written off in the period. This excludes those accounts where a full and final settlement was agreed and those where the contractual terms do not permit any further action. Enforceable balances are kept under review for operational purposes, but no amounts are recognised in respect of such accounts unless further cash is received or there is a strong expectation that it will be.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

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

A more detailed analysis of these movements by IFRS 9 stage on a consolidated basis for the year ended 30 September 2023 and 30 September 2022 is set out below.

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

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

The changes in models introduced during the year did not create significant movements in balances.

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Loss allowance at 30 September 2022	25.5	8.0	28.5	1.5	63.5
New assets originated or purchased	9.5	-	-	-	9.5
Changes in loss allowance					
Transfer to Stage 1	2.8	(2.7)	(0.1)	-	-
Transfer to Stage 2	(1.7)	2.0	(0.3)	-	-
Transfer to Stage 3	(0.2)	(1.9)	2.1	-	-
Changes on stage transfer	(2.5)	2.3	14.6	-	14.4
Changes due to credit risk	(13.8)	1.7	4.0	3.3	(4.8)
Loans sold	-	-	-	-	-
Write offs	-	-	(9.0)	-	(9.0)
Loss allowance at 30 September 2023	19.6	9.4	39.8	4.8	73.6
Loss allowance at 30 September 2021	15.0	11.3	38.9	0.2	65.4
New assets originated or purchased	7.2	-	-	-	7.2
Changes in loss allowance					
Transfer to Stage 1	2.6	(2.3)	(0.3)	-	-
Transfer to Stage 2	(1.6)	2.3	(0.7)	-	-
Transfer to Stage 3	(0.2)	(0.4)	0.6	-	-
Changes on stage transfer	(2.4)	1.8	4.3	-	3.7
Changes due to credit risk	4.9	(4.7)	3.4	1.3	4.9
Loans sold	-	-	(1.2)	-	(1.2)
Write offs	-	-	(16.5)	-	(16.5)
Loss allowance at 30 September 2022	25.5	8.0	28.5	1.5	63.5

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

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

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

The net reduction in Stage 1 provisions includes the effect of changes in judgemental adjustments in the period, with items formerly addressed by these provisions beginning to move through Stage 2 and Stage 3. These movements were driven by both account performance, and by the impact of more severe actual and forecast economic conditions.

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

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

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

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

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Balance at 30 September 2022	12,157.0	1,963.6	124.4	28.8	14,273.8
New assets originated or purchased	3,128.4	-	-	-	3,128.4
Changes in staging					
Transfer to Stage 1	1,258.9	(1,255.7)	(3.2)	-	-
Transfer to Stage 2	(365.6)	372.9	(7.3)	-	-
Transfer to Stage 3	(28.9)	(104.7)	133.6	-	-
Redemptions and repayments	(2,773.3)	(250.6)	(44.8)	(10.5)	(3,079.2)
Loans sold	-	-	-	-	-
Write offs	-	-	(9.0)	-	(9.0)
Other changes	595.8	19.3	12.3	6.5	633.9
Balance at 30 September 2023	13,972.3	744.8	206.0	24.8	14,947.9
Loss allowance	(19.6)	(9.4)	(39.8)	(4.8)	(73.6)
Carrying value	13,952.7	735.4	166.2	20.0	14,874.3
Balance at 30 September 2021	11,900.4	1,279.1	164.3	124.3	13,468.1
New assets originated or purchased	3,020.8	-	-	-	3,020.8
Changes in staging					
Transfer to Stage 1	519.4	(516.8)	(2.6)	-	-
Transfer to Stage 2	(1,365.2)	1,378.2	(13.0)	-	-
Transfer to Stage 3	(29.5)	(16.6)	46.1	-	-
Redemptions and repayments	(2,311.2)	(230.4)	(55.6)	(33.1)	(2,630.3)
Loans sold	-	-	(1.5)	(73.8)	(75.3)
Write offs	-	-	(16.5)	-	(16.5)
Other changes	422.3	70.1	3.2	11.4	507.0
Balance at 30 September 2022	12,157.0	1,963.6	124.4	28.8	14,273.8
Loss allowance	(25.5)	(8.0)	(28.5)	(1.5)	(63.5)
Carrying value	12,131.5	1,955.6	95.9	27.3	14,210.3

Other changes includes interest and similar charges.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

18. LOAN IMPAIRMENTS – ECONOMIC INPUTS TO CALCULATIONS

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

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

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

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

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

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

The upside and downside scenarios continue to be derived from the central scenario, as they have been in previous periods. The shapes of these three scenarios are broadly similar across the forecast period, with the upside scenario having a more rapid reduction in inflation, leading to a faster reduction in base rates and a stronger recovery. The downside includes traditional recessionary factors with additional pressure on house prices and rising unemployment, with interest rates being reduced more rapidly in response.

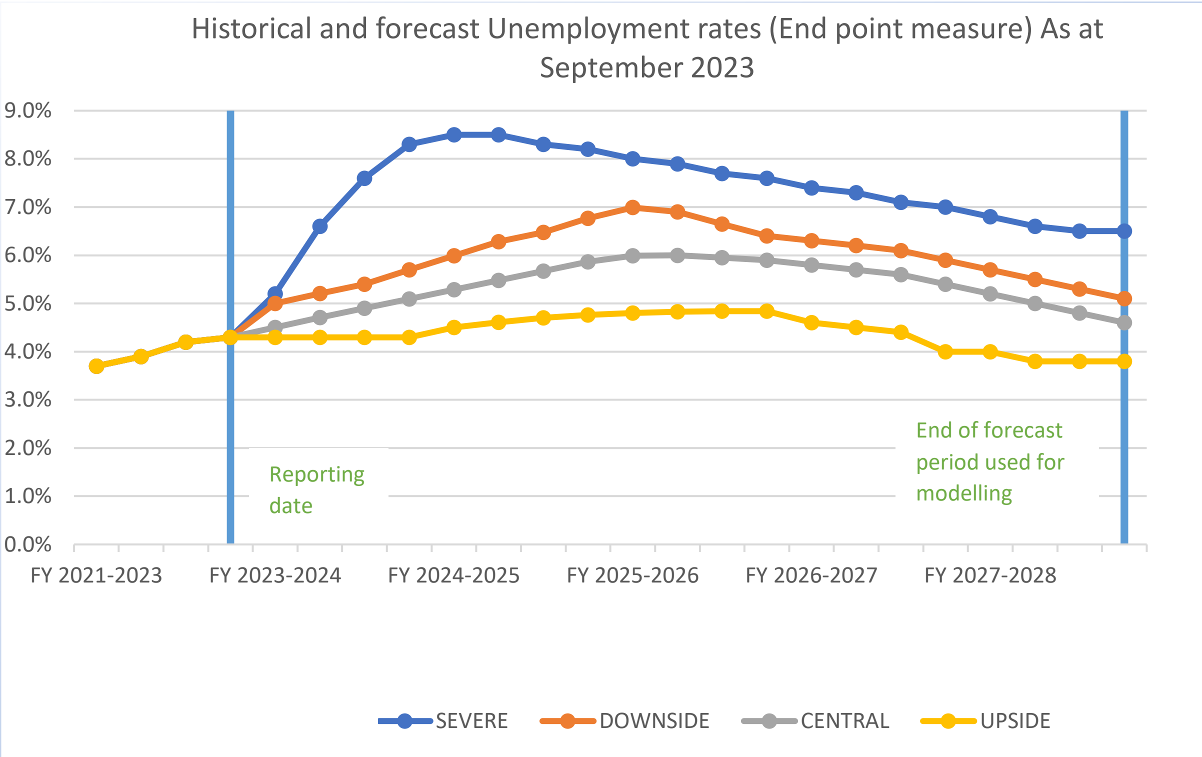
The severe scenario has been derived from stress testing scenarios published by the Bank of England, as in previous periods, with the 2022 Annual Cyclical Scenario ('ACS') being used at 30 September 2023. This scenario is based on a pronounced recession with interest rates remaining high, rising unemployment and a slump in house prices.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

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

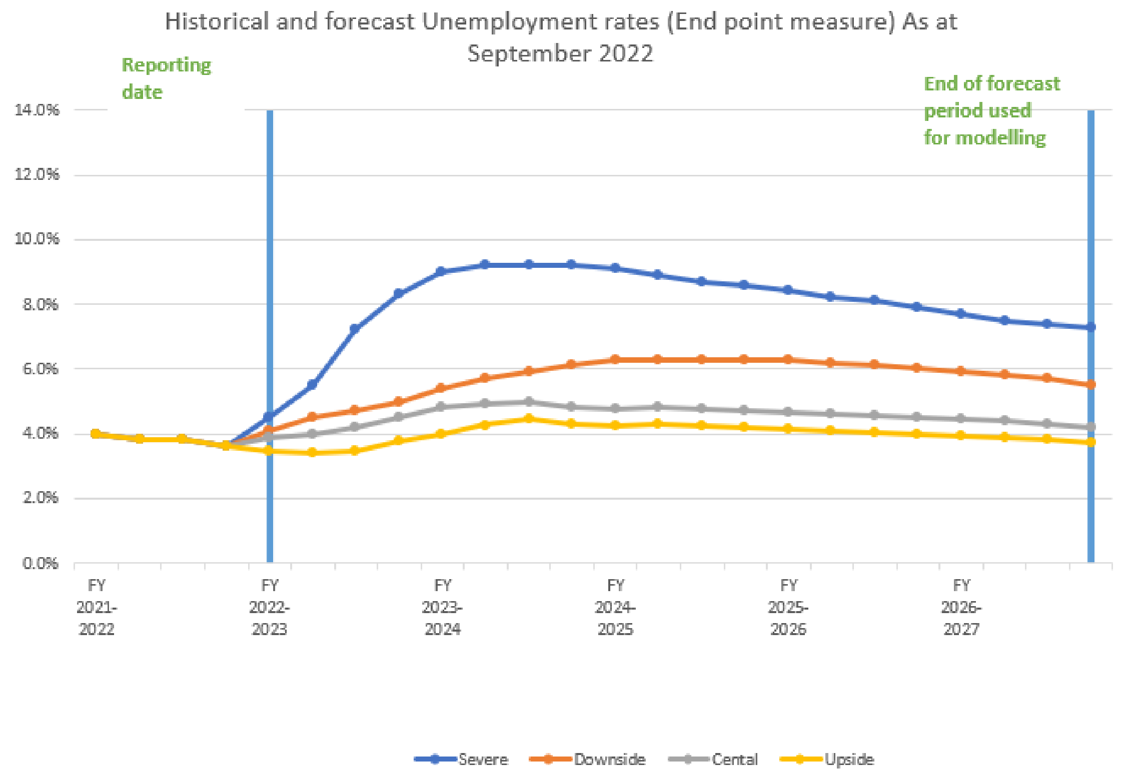
The overall shape of the scenarios adopted, and the change in the forecasts year-on-year is illustrated by the forecasts of the UK's unemployment rate set out in the charts below. The unemployment rate has been presented as it is the principal indicator of general economic activity used in modelling losses in the Group's buy-to-let mortgage portfolio.



NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

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



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

Sensitivities comparing the effect of these weightings with those which might be seen in a more normal economic environment are set out in Note 19.

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

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

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

The Group's economic scenarios comprise seven variables based on standard publicly available metrics for the UK. These variables are

- Year-on-year change in Gross Domestic Product ('GDP') as measured by the Office of National Statistics ('ONS')
- Year-on-year change in the House Price Index ('HPI') as measured by the Nationwide Building Society
- Bank Base Rate ('BBR'), as set by the Bank of England
- Consumer Price Inflation ('CPI') rate, as measured by the ONS
- Unemployment rate, as measured by the ONS
- Annual change in secured lending, as measured by the Bank of England 'mortgage advances' data series
- Annual change in consumer credit, as measured by the Bank of England 'unsecured advances' data series

The projected average annual values of each of these variables in each of the first five financial years of the forecast period are set out below.

30 September 2023

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

	2024	**2025**	**2026**	**2027**	**2028**
Central scenario	0.4%	0.9%	1.0%	1.2%	1.2%
Upside scenario	1.6%	1.4%	1.0%	1.2%	1.2%
Downside scenario	(0.4)%	0.7%	1.0%	1.2%	1.2%
Severe scenario	(3.6)%	(0.2)%	1.2%	1.2%	1.2%

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

	2024	**2025**	**2026**	**2027**	**2028**
Central scenario	(6.4)%	(1.7)%	4.7%	4.4%	3.2%
Upside scenario	(1.1)%	5.8%	6.8%	5.0%	4.5%
Downside scenario	(10.7)%	(2.2)%	4.0%	4.0%	2.6%
Severe scenario	(13.1)%	(15.1)%	-	7.0%	5.6%

Bank Base Rate ('BBR') (rate)

	2024	**2025**	**2026**	**2027**	**2028**
Central scenario	5.5%	5.4%	4.8%	4.4%	4.1%
Upside scenario	5.2%	4.4%	3.7%	3.5%	3.5%
Downside scenario	5.6%	3.8%	2.6%	2.0%	2.0%
Severe scenario	6.0%	5.8%	5.1%	4.3%	3.4%

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

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

Consumer Price Inflation ('CPI') (rate)

	2024	2025	2026	2027	2028
Central scenario	4.4%	2.6%	1.6%	1.8%	2.0%
Upside scenario	3.7%	2.1%	2.1%	2.0%	2.1%
Downside scenario	4.5%	1.0%	0.7%	1.8%	2.0%
Severe scenario	15.7%	12.8%	3.7%	2.4%	2.1%

Unemployment (rate)

	2024	2025	2026	2027	2028
Central scenario	4.8%	5.6%	6.0%	5.6%	4.9%
Upside scenario	4.3%	4.6%	4.8%	4.4%	3.9%
Downside scenario	5.3%	6.4%	6.7%	6.1%	5.4%
Severe scenario	6.9%	8.4%	7.8%	7.2%	6.6%

Secured lending (annual change)

	2024	2025	2026	2027	2028
Central scenario	0.8%	0.3%	1.8%	3.0%	3.0%
Upside scenario	1.5%	1.0%	2.5%	3.2%	3.0%
Downside scenario	-	(0.5)%	1.0%	2.8%	3.0%
Severe scenario	(1.3)%	(1.8)%	(0.3)%	2.5%	3.0%

Consumer credit (annual change)

	2024	2025	2026	2027	2028
Central scenario	3.5%	2.3%	3.9%	4.9%	5.0%
Upside scenario	4.3%	3.0%	4.7%	5.1%	5.0%
Downside scenario	2.8%	1.5%	3.2%	4.8%	5.0%
Severe scenario	1.5%	0.3%	1.9%	4.4%	5.0%

30 September 2022

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

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

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

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

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For the year ended 30 September 2023

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

Bank Base Rate ('BBR') (rate)

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

Consumer Price Inflation ('CPI') (rate)

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

Unemployment (rate)

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

Secured lending (annual change)

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

Consumer credit (annual change)

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

After the end of the initial five year period, the final rate or rate of change (as appropriate) is assumed to continue into the future in each scenario.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

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

To illustrate the levels of non-linearity in the various scenarios, the maximum and minimum quarterly levels for each variable over the five year period commencing on the balance sheet date are set out below.

30 September 2023

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

30 September 2022

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

The asymmetry in the models is demonstrated by comparing the calculated impairment provision with that which would have been produced using the central scenario alone, 100% weighted.

	2023 £m	2022 £m
Provision using central scenario 100% weighted		
Mortgage Lending	38.4	29.1
Commercial Lending	29.0	24.2
	67.4	53.3
Calculated impairment provision	73.6	63.5
Effect of multiple economic scenarios	6.2	10.2

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For the year ended 30 September 2023

19. LOAN IMPAIRMENTS – SENSITIVITY ANALYSIS

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

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

Economic conditions

To illustrate the potential impact of differing future economic scenarios on the total impairment, the provisions which would be calculated if each of the economic scenarios were 100% weighted are shown below:

	2023		2022	
Scenario	**Provision £m**	**Difference £m**	**Provision £m**	**Difference £m**
Central	67.4	(6.2)	53.3	(10.2)
Upside	59.0	(14.6)	46.8	(16.7)
Downside	73.4	(0.2)	62.5	(1.0)
Severe	95.7	22.1	100.3	36.8

The weighted average of these 100% weighted provisions need not equal the weighted average ECL due to the impact of the differing PDs on staging.

Scenario weightings

In order to illustrate the impact of scenario weightings on the outcomes, the impairment provision requirements were sensitised using alternative weightings. The sensitivity is based on the weightings used at IFRS 9 transition on 1 October 2018. The use of the 2018 weighting is intended to represent a more settled outlook than has been evident at either of the three most recent year ends.

The weightings used, and the results of applying these sensitivities to the 30 September 2023 scenarios are set out below.

	Weighting				Impairment	Difference
	Central	**Upside**	**Downside**	**Severe**	**£m**	**£m**
As reported	40%	10%	30%	20%	73.6	-
Sensitivity	40%	30%	25%	5%	67.6	(6.0)

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

19. LOAN IMPAIRMENTS – SENSITIVITY ANALYSIS (CONTINUED)

Significant increase in credit risk

The most important driver of SICR is relative PD. If all PDs across the Group's principal buy-to-let mortgage book were increased by 10%, loans with a gross value of £68.4m would transfer from Stage 1 to Stage 2 (2022: £136.8m), and the total provision would increase by £0.8m from the combined effects of higher PDs on expected losses and the impact of providing for expected lifetime losses, rather than 12-month losses on the additional Stage 2 cases (2022: £0.9m).

Value of security

The principal assumptions impacting on LGD are the estimated security values. If the rate of growth in house prices assumed by the model after the forecast minimum were halved, ignoring any PD effects, then the provision for the Group's first and second mortgage assets under the central scenario would increase by £0.7m (2022: £2.7m).

Receiver of rent

The majority of receiver of rent cases, which are included in Stage 3, are managed long-term and therefore their assumed realisation date has an important impact on the provision calculation. If the assumed rate of realisations was increased by 20%, the impairment provision in the central scenario would increase by £0.1m (2022: £0.4m).

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

20. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING

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

- Fair value hedges of portfolio interest rate risk, which are used to manage the interest rate risk inherent in fixed rate lending and deposit taking
- Fair value hedges of interest rate risk relating to individual financial liabilities.

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

The analysis below splits derivatives between those accounted for within portfolio fair value hedges and those which, despite representing an economic hedge, are not accounted for as hedges.

	2023 Assets £m	2023 Liabilities £m	2022 Assets £m	2022 Liabilities £m
Derivatives in hedge accounting relationships				
Fair value portfolio hedges				
Interest rate swaps				
Fixed to floating	519.0	(5.1)	652.7	-
Floating to fixed	76.2	(27.0)	0.3	(98.5)
Total derivatives in portfolio for value hedging relationship	595.2	(32.1)	653.0	(98.5)
Individual fair value hedges				
Interest rate swaps				
Floating to fixed	-	(3.7)	-	-
Total derivatives in hedge accounting relationships	595.2	(35.8)	653.0	(98.5)
Other derivatives				
Interest rate swaps	20.2	(4.1)	125.5	(3.6)
Currency futures	-	-	0.5	-
Total recognised derivative assets / (liabilities)	615.4	(39.9)	779.0	(102.1)

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

20. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (CONTINUED)

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

	Note	2023 £m	2022 £m
Derivative financial instruments			
Assets		615.4	779.0
Liabilities		(39.9)	(102.1)
		575.5	676.9
Fair value hedging adjustments			
On loans to customers	13	(379.3)	(559.9)
On retail deposits	23	30.9	99.7
On borrowings		3.7	-
		(344.7)	(460.2)
Net balance sheet position		230.8	216.7
Collateral balances			
Posted (in sundry assets)		-	-
Received (in sundry liabilities)	25	(383.4)	(388.6)
		(383.4)	(388.6)

21. RETIREMENT BENEFIT OBLIGATIONS

Since the last IAS 19 actuarial valuation at 30 September 2022 there have been movements in financial conditions, requiring an adjustment to the actuarial assumptions underlying the calculation of the defined benefit obligation at 30 September 2023. In particular, over the period since the 30 September 2022 actuarial valuation, the discount rate has increased by 55 basis points per annum, whereas expectations of long-term inflation have decreased by around 30 basis points. The performance of the Plan assets was also impacted by market movements.

The Group has recognised the surplus as an asset at the balance sheet date as it anticipates being able to access economic benefits at least as great as the carrying value. However such assets are eliminated from capital for regulatory purposes (note 34).

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

21. RETIREMENT BENEFIT OBLIGATIONS (CONTINUED)

The movements in the deficit on the defined benefit plan during the year ended 30 September 2023 are summarised below.

	2023 £m	2022 £m
Opening pension surplus / (deficit)	7.1	(10.3)
Employer contributions	3.9	4.0
Amounts posted to profit and loss		
Service cost	(0.5)	(0.9)
Past service cost	-	-
Net funding income / (cost) (note 3 / 4)	0.4	(0.2)
Administrative expenses	(0.6)	(0.8)
Amounts posted to other comprehensive income		
Return on plan assets not included in interest	(7.8)	(43.1)
Experience (loss) on liabilities	(1.8)	(1.3)
Actuarial gain from changes in financial assumptions	11.1	61.9
Actuarial gain / (loss) from changes in demographic assumptions	0.9	(2.2)
Closing pension surplus	12.7	7.1

Pursuant to the recovery plan agreed with the Trustee of the pension plan, the Group has effectively granted a first charge over its freehold head office building as security for its agreed contributions. No account of this charge is taken in the calculation of the above deficit.

22. INTANGIBLE ASSETS

Intangible assets at net book value comprise:

	2023 £m	2022 £m	2021 £m
Goodwill	162.8	164.4	164.4
Computer software	4.4	3.9	3.4
Other intangibles	1.0	1.9	2.7
Total assets	168.2	170.2	170.5

The balance for goodwill at 30 September 2022 shown above includes £113.0m in respect of the SME lending Cash Generating Unit ('CGU') and £49.8m in respect of the Development Finance CGU. The balance in respect of the TBMC CGU was written off in the year (note 7).

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

22. INTANGIBLE ASSETS (CONTINUED)

(a) SME lending

The goodwill carried in the accounts relating to the SME lending CGU was recognised on acquisitions in the years ended 30 September 2016 and 30 September 2018.

An impairment review undertaken at 30 September 2023 indicated that no write down was required.

The recoverable amount of the SME lending CGU used in this impairment testing is determined on a value in use basis using pre-tax cash flow projections based on financial budgets approved by the Board in November 2023 covering a five-year period.

The key assumptions underlying the value in use calculation for the SME lending CGU are:

- Level of business activity, based on management expectations. The forecast assumes a compound annual growth rate ('CAGR') for new lending over the five-year period of 14.12%, compared with 10.56% used in the calculation at 30 September 2022. The new lending forecasts are the key driver for the profit and cashflow forecasts. Cash flows beyond the five-year budget are extrapolated using a constant growth rate of 1.20% (2022: 1.54%) which does not exceed the long term average growth rates for the markets in which the business is active

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

- Discount rate, which is based on third party estimates of the implied industry cost of capital. The pre-tax discount rate applied to the cash flow projection is 16.2% (2022: 14.8%)

As an illustration of the sensitivity of this impairment test to movements in key assumptions, the Group has calculated that a 0.0% growth rate combined with a 11.5% reduction in profit levels would eliminate the projected headroom of £59.1m. While such movements are not expected by management, they are considered 'reasonably possible' for the purposes of IAS 36. A 0.0% growth rate combined with an 14.4% reduction in profit levels would generate a write down of £10.0m.

In the testing carried out at 30 September 2022, a 0.0% growth rate combined with a 7.5% reduction in profit levels, would have eliminated the projected headroom at that date of £45.3m. A 0.0% growth rate combined with an 11.2% reduction in profit levels would have generated a write down of £10.0m.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

22. INTANGIBLE ASSETS (CONTINUED)

(b) Development finance

The goodwill carried in the accounts relating to the development finance CGU was first recognised on a business acquisition in the year ended 30 September 2018.

An impairment review undertaken at 30 September 2023 indicated that no write down was required.

The recoverable amount of the development finance CGU used in this impairment testing is determined on a value in use basis using pre-tax cash flow projections based on financial budgets approved by the Board in November 2023 covering a five-year period.

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

- Level of business activity, based on management expectations. The forecast assumes a CAGR for drawdowns over the five-year period of 11.12%, compared with 8.77% used in the calculation at 30 September 2022. Cash flows beyond the five-year budget are extrapolated using a constant growth rate of 1.2% (2022: 1.54%) which does not exceed the long-term average growth rate for the UK economy

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

- Discount rate, which is based on third party estimates of the implied industry cost of capital. The pre-tax discount rate applied to the cash flow projection is 15.9% (2022: 14.4%)

As an illustration of the sensitivity of this impairment test to movements in key assumptions, the Group has calculated that a 1.07% growth rate combined with a 3.1% reduction in profit levels would eliminate the projected headroom of £13.9m. While such movements are not expected by management, they are considered ‘reasonably possible’ for the purposes of IAS 36. A 0.17% growth rate combined with a 2.9% reduction in profit levels would generate a write down of £10.0m.

On the basis of the testing carried out at 30 September 2022, management concluded that reasonably no possible change in the key assumptions above would cause the recoverable amount of the development finance CGU to fall below the balance sheet carrying value.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

23. RETAIL DEPOSITS

The Group's retail deposits, held by Paragon Bank PLC, were received from customers in the UK and are denominated in sterling. The deposits comprise principally term deposits, and notice and easy access accounts. The method of interest calculation on these deposits is analysed as follows:

	2023 £m	2022 £m	2021 £m
Fixed rate	8,690.2	6,201.3	5,466.0
Variable rates	4,575.1	4,467.9	3,834.4
	13,265.3	10,669.2	9,300.4

The weighted average interest rate on retail deposits at 30 September 2023, analysed by charging method, was:

	2023 %	2022 %	2021 %
Fixed rate	4.07%	1.74	1.25
Variable rates	3.74%	1.55	0.42
All deposits	3.95%	1.66	0.91

The contractual maturity of these deposits is analysed below.

	2023 £m	2022 £m	2021 £m
Amounts repayable			
In less than three months	1,589.4	929.0	789.0
In more than three months, but not more than one year	5,193.7	3,732.1	3,105.4
In more than one year, but not more than two years	1,643.0	1,627.3	1,580.1
In more than two years, but not more than five years	631.8	421.4	507.4
Total term deposits	9,057.9	6,709.8	5,981.9
Repayable on demand	4,207.4	3,959.4	3,318.5
	13,265.3	10,669.2	9,300.4
Fair value adjustments for portfolio hedging (note 20)	(30.9)	(99.7)	(3.0)
	13,234.4	10,569.5	9,297.4

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

24. BORROWINGS

In February 2023 Fitch Ratings confirmed the Group's Long-Term Issuer Default Rating from at BBB+, with a stable outlook. It also confirmed the senior unsecured debt rating at BBB and the rating of the Group's Tier-2 bond at BBB-, meaning that this security enjoys an investment-grade rating.

All borrowings described in the Group Accounts for the year ended 30 September 2022 remained in place throughout the period, except as noted below.

During the year, on 15 May 2023, the Group repaid the outstanding balances on the asset backed loan notes issued in its Paragon Mortgages (No. 25) PLC securitisation. On 29 September 2023 the outstanding balance on the Paragon Second Funding Limited warehouse borrowing was also repaid.

From time to time the Group enters into short-term sale and repurchase agreements with highly-rate UK banks as part of its liquidity management operations. At 30 September 2023 £50.0m was outstanding under such arrangements (2022: £nil).

Repayments made in respect of the Group's borrowings are shown in note 32.

On 1 November 2023, after the year end, a group company, Paragon Mortgages (No. 29) PLC, issued £855.0m of sterling mortgage backed floating rate notes, analysed below, at par.

Class	Fitch Rating	Moody's rating	Interest margin above compounded SONIA	Principal value
				£m
A	AAA	Aaa	1.20%	747.0
B	AA	Aa1	1.90%	33.7
C	A-	Aa2	2.75%	29.3
D	B+	A2	3.80%	45.0
				855.0

All the above notes were retained by the Group.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

25. SUNDRY LIABILITIES

Sundry liabilities include:

	Note	2023 £m	2022 £m
Amounts falling due within one year			
Accrued interest		156.7	42.2
Contingent consideration		-	2.2
Lease payables		2.6	2.2
CSA liabilities	20	383.4	388.6
Purchase of own shares	28	-	10.8
Other sundry liabilities		47.2	44.0
		589.9	490.0
Amounts falling due after more than one year			
Accrued interest		31.5	13.0
Lease payables		6.3	6.8
Other sundry liabilities		3.5	3.3
		41.3	23.1
Total			
Contingent consideration		-	2.2
Lease payables		8.9	9.0
Other sundry liabilities		622.3	501.9
		631.2	513.1

26. CALLED-UP SHARE CAPITAL

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

Movements in the issued share capital in the year were:

	2023 Number	2022 Number
Ordinary shares		
At 1 October 2022	241,409,624	262,495,185
Shares issued	160,833	386,039
Shares cancelled	(12,870,044)	(21,471,600)
At 30 September 2023	228,700,413	241,409,624

During the year, the Company issued 160,833 shares (2022: 386,039) to satisfy options granted under Sharesave schemes for a consideration of £534,954 (2022: £1,309,525).

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

26. CALLED-UP SHARE CAPITAL (CONTINUED)

On 24 November 2021, 12,100,834 shares, held in treasury at 30 September 2021, were cancelled. On 8 September 2022 a further 9,370,766 shares, purchased into treasury during the year ended 30 September 2020 were also cancelled.

On 1 June 2023, 12,870,044 of the shares held in treasury at that date were cancelled (note 28).

27. RESERVES

	2023 £m	2022 £m	2021 £m
Share premium account	71.4	71.1	70.1
Capital redemption reserve	12.9	71.8	50.3
Merger reserve	(70.2)	(70.2)	(70.2)
Profit and loss account	1,243.4	1,151.2	1,005.9
	1,257.5	1,223.9	1,056.1

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

The merger reserve arose, due to the provisions of UK company law at the time, on a group restructuring on 12 May 1989 when the Company became the parent entity of the Group.

On 28 March 2023 the High Court confirmed the cancellation of the Company's capital redemption reserve, following shareholder approval at the AGM on 1 March 2023. This reserve had arisen on the cancellation of ordinary shares which had been purchased in the market and held in treasury. The balance outstanding on the capital redemption reserve at that time was transferred to the profit and loss account.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

28. OWN SHARES

	2023 £m	2022 £m
Treasury shares		
Opening balance	18.2	60.7
Shares purchased	111.5	66.9
Options exercised	(8.4)	-
Shares cancelled	(67.3)	(109.4)
Closing balance	54.0	18.2
ESOP shares		
Opening balance	19.0	16.0
Shares purchased	9.0	12.6
Options exercised	(6.4)	(9.6)
Closing balance	21.6	19.0
Irrevocable authority to purchase		
Opening balance	10.8	-
Given in year	-	10.8
Expiring / utilised in year	(10.8)	-
Closing balance	-	10.8
Total closing balance	75.6	48.0
Total opening balance	48.0	76.7

At 30 September 2023 the number of the Company's own shares held in treasury was 10,074,002 (2022: 3,640,519). These shares had a nominal value of £10,074,002 (2022: £3,640,519). These shares do not qualify for dividends.

The ESOP shares are held in trust for the benefit of employees exercising their options under the Company's share option schemes and awards under the Paragon PSP and Deferred Share Bonus Plan. The trustees' costs are included in the operating expenses of the Group.

At 30 September 2023, the trust held 4,009,490 ordinary shares (2022: 3,879,160) with a nominal value of £4,009,490 (2022: £3,879,160) and a market value of £19,727,084 (2022: £15,314,924). Options, or other share-based awards, were outstanding against all of these shares at 30 September 2023 (2022: all). The dividends on all of these shares have been waived (2022: all).

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

29. EQUITY DIVIDEND

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

	2023 Per share	2022 Per share	2023 £m	2022 £m
Equity dividends on ordinary shares				
Final dividend for the previous year	19.2p	18.9p	43.7	46.6
Interim dividend for the current year	11.0p	9.4p	24.2	22.3
	30.2p	28.3p	67.9	68.9

Amounts paid and proposed in respect of the year:

	2023 Per share	2022 Per share	2023 £m	2022 £m
Interim dividend for the current year	11.0p	9.4p	24.2	22.3
Proposed final dividend for the current year	26.4p	19.2p	56.7	44.9
	37.4p	28.6p	80.9	67.2

The proposed final dividend for the year ended 30 September 2023 will be paid on 8 March 2024, subject to approval at the AGM, with a record date of 2 February 2024. The dividend will be recognised in the accounts when it is paid.

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

30. NET CASH FLOW FROM OPERATING ACTIVITIES

	2023 £m	2022 £m
Profit before tax	199.9	417.9
Non-cash items included in profit and other adjustments:		
Depreciation of operating property, plant and equipment	4.0	3.5
(Profit) on disposal of operating property, plant and equipment	(0.1)	(0.1)
Amortisation and derecognition of intangible assets	3.6	2.0
Non-cash movements on borrowings	(2.5)	1.9
Impairment losses on loans to customers	18.0	14.0
Charge for share based remuneration	9.6	9.2
Net (increase) / decrease in operating assets:		
Assets held for leasing	(2.7)	(2.3)
Loans to customers	(682.0)	(821.6)
Derivative financial instruments	163.6	(734.8)
Fair value of portfolio hedges	(180.6)	565.4
Other receivables	(15.0)	22.9
Net increase / (decrease) in operating liabilities:		
Retail deposits	2,596.1	1,368.8
Derivative financial instruments	(62.2)	58.2
Fair value of portfolio hedges	68.8	(96.7)
Other liabilities	128.3	416.9
Cash generated by operations	2,246.8	1,225.2
Income taxes (paid)	(75.1)	(56.5)
	2,171.7	1,168.7

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

31. NET CASH FLOW FROM INVESTING ACTIVITIES

	2023 £m	2022 £m
Proceeds from sales of operating property, plant and equipment	0.1	0.6
Purchases of operating property, plant and equipment	(1.6)	(1.3)
Purchases of intangible assets	(1.6)	(1.7)
Net cash (utilised) by investing activities	(3.1)	(2.4)

NOTES TO THE FINANCIAL INFORMATION - ANALYSIS

For the year ended 30 September 2023

32. NET CASH FLOW FROM FINANCING ACTIVITIES

	2023 £m	2022 £m
Shares issued (note 26)	0.5	1.4
Dividends paid (note 29)	(67.9)	(68.9)
Repayment of asset backed floating rate notes	(382.1)	(107.6)
Repayment of retail bond	-	(125.0)
Movement on central bank facilities	-	(69.0)
Movement on other bank facilities	(586.0)	(144.6)
Movement on sale and repurchase agreements	50.0	-
Capital element of lease payments	(2.4)	(1.7)
Purchase of own shares (note 28)	(120.5)	(79.5)
Exercise of share awards	3.4	(0.7)
Net cash (utilised) by financing activities	(1,105.0)	(595.6)

33. RELATED PARTY TRANSACTIONS

During the year, certain directors of the Group were beneficially interested in savings deposits made with Paragon Bank, on the same terms as were available to members of the public. Deposits of £720,000 were outstanding at the year-end (2022: £779,000), and the maximum amounts outstanding during the year totalled £771,000 2022: £793,000).

The Paragon Pension Plan (the 'Plan') is a related party of the Group. Transactions with the Plan are described in note 21.

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

NOTES TO THE FINANCIAL INFORMATION – CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

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

34. CAPITAL MANAGEMENT

The Group's objectives in managing capital are:

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

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

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

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

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

34. CAPITAL MANAGEMENT (CONTINUED)

(a) Regulatory capital

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

The Group's regulatory capital is monitored by the Board, its Risk and Compliance Committee and by the Executive Risk Committee ('ERC') and the Asset and Liability Committee, which ensure that appropriate action is taken to ensure compliance with the regulator's requirements. The future regulatory capital requirement is also considered as part of the Group's forecasting and strategic planning process.

The Group has elected to take advantage of the IFRS 9 transitional arrangements set out in Article 473a of the CRR, which allow the capital impact of expected credit losses to be phased in over a five-year period. The phase-in factors applying to transition adjustments will allow for a 95% add back to CET1 capital and Risk Weighted Assets ('RWA') in the financial year ended 30 September 2019, reducing to 85%, 70%, 50% and 25% for the financial years ending in 2020 to 2023, with full recognition of the impact on CET1 capital in the 2024 financial year.

As part of the regulatory response to Covid, Article 473a was revised to extend the transitional arrangements for Stage 1 and Stage 2 impairment provisions created in the financial year ended 30 September 2020 and the financial year ended 30 September 2021, while maintaining the transitional arrangements for impairment provisions created before those years. In order to increase institutions lending capacity in the short term, the EU determined that these additional provisions should be phased into capital over the financial years ending 30 September 2022 to 30 September 2024, rather than recognising the reduction in capital immediately.

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

The tables below demonstrate that at 30 September 2023 the Group's total regulatory capital of £1,338.9m (2022: £1,371.8m) exceeded the amounts required by the regulator, including £673.4m (2022: £660.6m) in respect of its TCR, which is comprised of fixed and variable elements (amounts not subject to audit).

The total regulatory capital at 30 September 2023 on the fully loaded basis of £1,325.4m (2022: £1,346.0m) was in excess of the TCR of £672.2m (2022: £658.4m) on the same basis (amounts not subject to audit).

At 30 September 2023, the Group's TCR represented 8.8% of TRE (2022: 8.8%).

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

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

34. CAPITAL MANAGEMENT (CONTINUED)

The Group's regulatory capital differs from its equity as certain adjustments are required by the PRA Rulebook or the regulator. A reconciliation of the Group's equity to its regulatory capital determined which that capital accordance with the PRA Rulebook at 30 September 2023 is set out below.

	Note	Regulatory basis		Fully loaded basis	
		2023	2022	2023	2022
		£m	£m	£m	£m
Total equity		1,410.6	1,417.3	1,410.6	1,417.3
Deductions					
Proposed final dividend	29	(56.7)	(44.9)	(56.7)	(44.9)
IFRS 9 transitional relief	*	13.5	25.8	-	-
Intangible assets	22	(168.2)	(170.2)	(168.2)	(170.2)
Pension surplus net of deferred tax	21	(9.6)	(5.3)	(9.6)	(5.3)
Prudent valuation adjustments	§	(0.6)	(0.9)	(0.6)	(0.9)
Insufficient coverage	ψ	(0.1)	(0.0)	(0.1)	(0.0)
Common Equity Tier 1 ('CET1') capital		1,188.9	1,221.8	1,175.4	1,196.0
Other tier 1 capital		-	-	-	-
Total Tier 1 capital		1,188.9	1,221.8	1,175.4	1,196.0
Corporate bond		150.0	150.0	150.0	150.0
Eligibility cap	Φ	-	-	-	-
Total Tier 2 capital		150.0	150.0	150.0	150.0
Total regulatory capital ('TRC')		1,338.9	1,371.8	1,325.4	1,346.0

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

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

ψ Regulatory deduction where there is insufficient coverage for non-performing exposures required under AT1BCAGR 47(c) of the CRR. This requirement remained in force in the UK, at the year end, under the Brexit arrangements but was removed by the PRA with effect from 14 November 2023. The amount required at 30 September 2022 was less than £0.1m.

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

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

34. CAPITAL MANAGEMENT (CONTINUED)

The TRE amount calculated under the PRA Rulebook framework against which this capital is held, which includes Risk Weighted Asset ('RWA') amounts for credit risk, and the proportion of these assets which that capital represents, are calculated as shown below.

	Regulatory basis		Fully loaded basis	
	2023	**2022**	**2023**	**2022**
	£m	**£m**	**£m**	**£m**
Credit risk				
Balance sheet assets	6,784.2	6,652.1	6,784.3	6,652.1
Off balance sheet	87.2	85.4	87.2	85.4
IFRS 9 transitional relief	13.5	25.8	-	-
Total credit risk	6,884.9	6,763.3	6,871.5	6,737.5
Operational risk	740.2	633.1	740.2	633.1
Market risk	-	-	-	-
Other	43.6	118.6	43.6	118.6
Total risk exposure amount ('TRE')	7,668.7	7,515.0	7,655.3	7,489.2
Solvency ratios	%	%	%	%
CET1	15.5	16.3	15.4	16.0
TRC	17.5	18.3	17.3	18.0

This table is not subject to audit

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

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

34. CAPITAL MANAGEMENT (CONTINUED)

Leverage ratio

The table below shows the calculation of the UK leverage ratio, based on the consolidated balance sheet assets adjusted as shown. The PRA has proposed a minimum UK leverage ratio of 3.25% for UK firms, with retail deposits of over £50.0 billion. In addition, in October 2021 the PRA stated its expectation that all other UK firms should manage their leverage risk so that this ratio does not ordinarily fall below 3.25%.

	Note	2023 £m	2022 £m
Total balance sheet assets		18,420.2	16,653.6
Add: Credit fair value adjustments on loans to customers	13	379.3	559.9
Debit fair value adjustments on retail deposits	23	30.9	99.7
Adjusted balance sheet assets		18,830.4	17,313.2
Less: Derivative assets	20	(615.4)	(779.0)
Central bank deposits	12	(2,783.3)	(1,612.5)
CRDs		(38.0)	(30.2)
Accrued interest on sovereign exposures		(4.2)	(1.0)
On-balance sheet items		15,389.5	14,890.5
Less: Intangible assets	22	(168.2)	(170.2)
Pension surplus	21	(12.7)	(7.1)
Total on balance sheet exposures		15,208.6	14,713.2
Regulatory exposure for derivatives		179.6	434.7
Total derivative exposures		179.9	434.7
Post offer pipeline at gross notional amount		993.3	1,307.9
Adjustment to convert to credit equivalent amounts		(815.7)	(1,094.1)
Off balance sheet items		177.6	213.8
Tier 1 capital		1,188.9	1,221.8
Total leverage exposure before IFRS 9 relief		15,565.8	15,361.7
IFRS 9 relief		13.5	25.8
Total leverage exposure		15,579.3	15,387.5
UK leverage ratio		7.6%	7.9%

This table is not subject to audit

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

34. CAPITAL MANAGEMENT (CONTINUED)

The fully loaded leverage ratio is calculated as follows

	2023 £m	2022 £m
Fully loaded Tier 1 capital	1,175.4	1,196.0
Total leverage exposure before IFRS 9 relief	15,565.8	15,361.7
Fully loaded UK leverage exposure	7.6%	7.8%

This table is not subject to audit

Following regulatory changes introduced from 1 January 2022, the Group calculates regulatory exposure on derivatives using the Standardised Approach for Counterparty Credit Risk ('SA-CCR'), which includes elements based on the market value of derivative assets adjusted for collateral, amongst other things, and based on potential future exposure in respect of all derivatives held.

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

Capital requirements in subsidiary entities

The regulatory capital disclosures in these financial statements relate only to the consolidated position for the Group. Individual entities within the Group are also subject to supervision on a standalone basis. All such entities complied with the requirements to which they were subject during the year.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

34. CAPITAL MANAGEMENT (CONTINUED)

(b) Return on tangible equity ('RoTE')

RoTE is a measure of an entity's profitability used by investors. RoTE is defined by the Group by comparing the profit after tax for the year, adjusted for amortisation charged on intangible assets, to the average of the opening and closing equity positions, excluding intangible assets and goodwill.

It effectively reflects a return on equity as if all intangible assets are eliminated immediately against reserves. As this is similar to the approach used for the capital of financial institutions it is widely used in the sector.

The Group's consolidated RoTE for the year ended 30 September 2023 is derived as follows:

	Note	2023 £m	2022 £m
Profit for the year after tax		153.9	313.6
Amortisation and derecognition of intangible assets		3.6	2.0
Adjusted profit		157.5	315.6
Divided by			
Opening equity		1,417.3	1,241.9
Opening intangible assets	22	(170.2)	(170.5)
Opening tangible equity		1,247.1	1,071.4
Closing equity		1,410.6	1,417.3
Closing intangible assets	22	(168.2)	(170.2)
Closing tangible equity		1,242.4	1,247.1
Average tangible equity		1,244.7	1,159.3
Return on Tangible Equity		12.7%	27.2%

This table is not subject to audit

(c) Dividend and distribution policy

The Company is committed to a long-term sustainable dividend policy. Ordinarily, dividends will increase in line with earnings, subject to the requirements of the business and the availability of cash resources. The Board reviews the policy at least twice a year in advance of announcing its results, taking into account the Group's strategy, capital requirements, principal risks and the objective of enhancing shareholder value.

In determining the level of dividend for any year, the Board expects to follow the dividend policy, but will also take into account the level of available retained earnings in the Company, its cash resources and the cash and capital requirements inherent in its business plans. In addition to the payment of dividends, the Board may also consider whether it is appropriate to apply excess capital in the market purchase of the Group's shares.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

34. CAPITAL MANAGEMENT (CONTINUED)

The distributable reserves of the Company comprise its profit and loss account balance (note 27) and, other than the regulatory requirement to retain an appropriate level of capital in Paragon Bank PLC, there are no restrictions preventing profits elsewhere in the Group from being distributed to the parent.

Since the year ended 30 September 2018, the Company has adopted a policy of paying out approximately 40% of its basic earnings per share as dividend (a dividend cover ratio of around 2.5 times), in the absence of any idiosyncratic factors which might make such a dividend inappropriate. This policy is reviewed by the Board at least annually. The Company considers it has access to sufficient cash resources to pay dividends at this level and that its distributable reserves are abundant for this purpose.

To provide greater transparency, the Board also adopted a policy of paying an interim dividend in each year equivalent to half of the preceding final dividend in the absence of any factors which might make such a distribution inappropriate. For the current year, based on its review of the Group's capital position and forecasts, and taking account of Covid-related impacts on the relative size of interim and final dividends in recent years and the desire to normalise the ongoing relationship between the half-year and final payments, the Board concluded that a one-off enhancement to the interim dividend could be made. It therefore declared an interim dividend for the year of 11.0p per share (2022: 9.4p per share). The Board also confirmed that the Group's normal approach of paying an interim dividend of 50% of the preceding year's final dividend would continue to apply in future years.

The appropriate level of final dividend for the current year was considered by the Board in light of economic and regulatory developments in the year, and the various potential paths for the UK economy. In particular the levels of provision in the Group's loan portfolios and the potential for further provision under stress in the event of a worsening UK economic position were considered by the Board. These were compared to the regulatory capital position at the year end along with the capital impacts of stress testing carried out as part of the ICAAP and forecasting processes, and the potential impacts of ongoing developments in the regulatory regime for capital including the introduction in the UK of Basel 3.1.

The Board particularly considered the appropriateness of including net losses relating to fair value adjustments from hedging in the calculation of any dividend or distribution, as these primarily result from the reversal of gains recorded in earlier years which were disregarded, at the time, for the purpose of determining dividends. Given the size of such adjustments in the period, the Board concluded that their inclusion was not consistent with its overarching aim of delivering a sustainable dividend which grows with the earnings of the business.

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

The Board will therefore propose a final dividend for the year of 26.4p per share (2022: 19.2p per share) for approval at the 2024 AGM, making a total dividend for the year of 37.4p per share (2022: 28.6p per share).

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

34. CAPITAL MANAGEMENT (CONTINUED)

During the year the share buy-back programme announced during the 2022 financial year was completed under an irrevocable authority put in place in September 2022. A buy-back programme for the current financial year, for up to £50.0m of ordinary shares was authorised at the time of the Group's 2022 results announcement. This was extended to £100.0m in June 2022. The amount expended in these programmes in the year was £111.5m (note 28) and the buy-back was completed before the year end.

As part of its consideration of capital described above the Board of Directors authorised a new buy-back of up to £50.0m to commence shortly after the announcement of the 2023 results. All shares acquired in buy-back programmes are initially held in treasury.

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

The most recent policy review, in November 2023, also confirmed the existing dividend policy would continue to apply for future periods, subject to the impact of any future events, and the Board will consider the appropriateness and scale of any interim dividend in the context of the Group's results and the operating and economic environment at the time. Share buy-backs will be considered where excess capital has arisen, either operationally or as a result of changed regulatory requirements.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

35. CREDIT RISK

Loans to customers

The Group's credit risk is primarily attributable to its loans to customers and its business objectives rely on maintaining a high-quality customer base and place strong emphasis on prudent credit management, both at the time of acquiring or underwriting a new loan, where robust lending criteria are applied, and throughout the loan's life.

The Group's balance sheet loan assets at 30 September 2023 are analysed as follows:

	2023		2022	
	£m	%	£m	%
Buy-to-let mortgages	12,720.1	85.6%	12,086.0	85.1%
Owner-occupied mortgages	27.7	0.1%	36.4	0.2%
Total first charge residential mortgages	12,747.8	85.7%	12,122.4	85.3%
Second charge mortgage loans	154.5	1.0%	206.3	1.4%
Loans secured on residential property	12,902.3	86.7%	12,328.7	86.7%
Development finance	747.8	5.0%	719.9	5.1%
Loans secured on property	13,650.1	91.7%	13,048.6	91.8%
Asset finance loans	559.1	3.8%	498.8	3.5%
Motor finance loans	297.7	2.0%	261.3	1.8%
Aircraft mortgages	26.9	0.2%	33.7	0.3%
Secured RLS and CBILS	50.5	0.4%	65.1	0.4%
Structured lending	169.0	1.1%	178.7	1.3%
Invoice finance	31.7	0.2%	25.7	0.2%
Total secured loans	14,785.0	99.4%	14,111.9	99.3%
Professions finance	52.2	0.4%	60.9	0.4%
Unsecured RLS, CBILS and BBLS	16.7	0.1%	22.9	0.2%
Other unsecured commercial loans	20.4	0.1%	14.6	0.1%
Total loans to customers	14,874.3	100.0%	14,210.3	100.0%

First and second charge mortgages are secured by charges over residential properties in England and Wales, or similar Scottish or Northern Irish securities.

Development finance loans are secured by a first charge (or similar Scottish security) over the development property and various charges over the build.

Asset finance loans and motor finance loans are effectively secured by the financed asset, while aircraft mortgages are secured by a charge on the aircraft funded.

Structured lending and invoice finance balances are effectively secured over the assets of the customer, with security enhanced by maintaining balances at a level less than the total amount of the security (the advance percentage).

Professions finance balances are generally short term unsecured loans made to firms of lawyers and accountants for working capital purposes.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

35. CREDIT RISK (CONTINUED)

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

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

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

	2023 £m	2022 £m
Buy-to-let mortgages	149.6	151.9
Development finance	390.6	306.9
Structured lending	160.3	179.4
Asset finance	24.6	-
	725.1	638.2

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

Credit grading

An analysis of the Group's loans to customers by absolute level of credit risk at 30 September 2023 is set out below. The analysed amount represents gross carrying amount.

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
30 September 2023					
Very low risk	11,393.7	23.0	1.9	6.6	11,425.2
Low risk	2,236.4	395.5	73.8	2.5	2,708.2
Moderate risk	157.1	147.3	9.7	1.8	315.9
High risk	34.0	113.3	13.6	3.2	164.1
Very high risk	37.7	63.3	104.1	9.3	214.4
Not graded	113.4	2.4	2.9	1.4	120.1
Total gross carrying amount	13,972.3	744.8	206.0	24.8	14,947.9
Impairment	(19.6)	(9.4)	(39.8)	(4.8)	(73.6)
Total loans to customers	13,952.7	735.4	166.2	20.0	14,874.3

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

35. CREDIT RISK (CONTINUED)

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
30 September 2022					
Very low risk	10,270.3	846.7	1.1	9.2	11,127.3
Low risk	1,563.9	932.0	63.6	1.9	2,561.4
Moderate risk	118.6	114.1	4.3	2.5	239.5
High risk	35.0	34.6	9.7	4.1	83.4
Very high risk	44.4	35.1	42.2	9.3	131.0
Not graded	124.8	1.1	3.5	1.8	131.2
Total gross carrying amount	12,157.0	1,963.6	124.4	28.8	14,273.8
Impairment	(25.5)	(8.0)	(28.5)	(1.5)	(63.5)
Total loans to customers	12,131.5	1,955.6	95.9	27.3	14,210.3

Gradings above are based on credit scorecards or internally assigned risk ratings as appropriate for the individual asset class. These measures are calibrated across product types and used internally to monitor the Group's overall credit risk profile against its risk appetite.

These gradings represent current credit quality on an absolute basis and this may result in assets in higher IFRS 9 stages with low risk grades, especially where a case qualifies through breaching, for example, an arrears threshold but is making regular payments. This will apply especially to Stage 3 cases reported in note 16, other than those shown as 'realisations'.

Examples of lower risk cases in higher IFRS 9 stages include fully up-to-date receiver of rent cases; accounts where the customer is in arrears on their account with the Group but up to date on accounts with other lenders, creating an overall positive credit rating; and accounts where the default on the Group's loan has yet to impact on the external credit score.

A small proportion of the loan book (2023: 0.8%, 2022: 0.9%) is classed as 'not graded' above. This rating generally relates to loans that have been fully underwritten at origination but where the customer falls outside the automated assessment techniques used post-completion.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

35. CREDIT RISK (CONTINUED)

Credit characteristics by portfolio

Loans secured on residential property

First mortgage loans have a contractual term of up to thirty years and second charge mortgage loans up to twenty five years. In all cases the customer is entitled to settle the loan at any point and in most cases early settlement does take place. All customers on these accounts are required to make monthly payments.

An analysis of the indexed Loan-to-Value ('LTV') ratio for those loan accounts secured on residential property by value at 30 September 2023 is set out below. LTVs for second charge mortgages are calculated allowing for the interest of the first charge holder, based on the most recent first charge amount held by the Group, while for acquired accounts the effect of any discount on purchase is allowed for.

	First charge mortgages		Second charge mortgages	
	2023	**2022**	**2023**	**2022**
	%	**%**	**%**	**%**
Loan to value ratio				
Less than 70%	72.7	89.2	94.6	95.6
70% to 80%	23.8	9.4	3.2	2.4
80% to 90%	2.5	0.4	0.9	0.8
90% to 100%	0.2	0.3	0.3	0.2
Over 100%	0.8	0.7	1.0	1.0
	100.0	100.0	100.0	100.0
Average LTV ratio	62.7	57.8	52.3	50.6
Of which:				
Buy-to-let	62.8	57.9		
Owner-occupied	39.0	37.6		

The regionally indexed LTVs shown above are affected by changes in house prices, with the Nationwide house price index, for the UK as a whole, registering an annual decrease of 5.3% in the year ended 30 September 2023 (2022: increase of 9.5%).

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

35. CREDIT RISK (CONTINUED)

The geographical distribution of the Group's residential mortgage assets by gross carrying value is set out below.

	First Charge		Second Charge	
	2023	**2022**	**2023**	**2022**
	%	**%**	**%**	**%**
East Anglia	3.3	3.3	3.4	3.3
East Midlands	5.9	5.7	6.2	6.2
Greater London	18.2	18.2	7.4	7.8
North	3.5	3.3	4.2	4.1
North West	10.3	10.3	7.5	7.7
South East	30.6	31.2	37.8	38.2
South West	9.0	8.8	8.4	8.4
West Midlands	6.2	5.9	7.3	7.4
Yorkshire and Humberside	7.4	7.8	6.2	6.1
Total England	94.4	94.5	88.4	89.2
Northern Ireland	-	0.1	2.3	2.0
Scotland	2.5	2.3	5.5	5.4
Wales	3.1	3.1	3.8	3.4
	100.0	100.0	100.0	100.0

Development finance

Development finance loans have an average term of 26 months (2022: 24 months). Settlement of principal and accrued interest takes place either on the sale of the development, or units within it, where appropriate, or on the refinancing of the property following its completion. The customer is not normally required to make payments during the term of the loan. The loans are secured by a legal charge over the site and/or property together with other charges and warranties related to the build.

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

	2023	**2023**	**2022**	**2022**
	By value	**By number**	**By value**	**By number**
LTGDV	**%**	**%**	**%**	**%**
50% or less	8.2	6.1	7.9	5.1
50% to 60%	17.3	21.7	17.0	21.7
60% to 65%	37.7	33.0	45.0	39.1
65% to 70%	25.5	27.4	22.2	27.2
70% to 75%	5.8	7.4	5.8	6.2
Over 75%	5.5	4.4	2.1	0.7
	100.0	100.0	100.0	100.0

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

35. CREDIT RISK (CONTINUED)

The average LTGDV cover at the year end was 63.1% (2022: 62.1%).

LTGDV is calculated by comparing the current expected end of term exposure with the latest estimate of the value of the completed development based on surveyors' reports. The focus on residential property development within the portfolio means that asset values will generally move in line with the UK residential property market.

At 30 September 2023, the development finance portfolio comprised 230 accounts (2022: 276) with a total carrying value of £747.8m (2022: £719.9m). Of these accounts only 15 were included in Stage 2 at 30 September 2023 (2022: nine), with twelve accounts classified as Stage 3 (2022: nil). In addition, one acquired account had been classified as POCI (2022: one). An allowance for this loss was made in the IFRS 3 fair value calculation.

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

	2023	**2022**
	%	**%**
East Anglia	4.4	2.8
East Midlands	11.8	11.7
Greater London	11.8	10.5
North	0.8	1.2
North West	0.4	0.1
South East	34.0	46.3
South West	21.3	13.0
West Midlands	6.2	7.1
Yorkshire and Humberside	6.6	6.0
Total England	97.3	98.7
Northern Ireland	-	-
Scotland	2.7	1.3
Wales	-	-
	100.0	100.0

Asset finance and motor finance

Asset and motor finance lending includes finance lease and hire purchase arrangements, which are accounted for as finance leases under IFRS 16. The average contractual life of the asset finance loans was 49 months (2022: 52 months) while that of the motor finance loans was 68 months (2022: 67 months), but historical behaviour suggests that a significant proportion of customers will choose to settle their obligations early.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

35. CREDIT RISK (CONTINUED)

Asset finance customers are generally small or medium sized businesses. The nature of the assets underlying the Group's asset finance lending by gross carrying value is set out below.

	2023 %	2022 %
Commercial vehicles	41.9	37.4
Construction plant	30.9	33.2
Manufacturing	6.3	6.1
Technology	4.8	4.9
Other vehicles	4.7	4.7
Refuse disposal vehicles	3.4	3.7
Agriculture	2.1	2.4
Print and paper	1.6	1.3
Other	4.3	6.3
	100.0	100.0

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

Structured lending

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

Summary details of the structured lending portfolio are set out below.

	2023	2022
Number of active facilities	9	8
Total facilities (£m)	235.7	220.5
Carrying value (£m)	169.0	178.7

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

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

At 30 September 2023 one of these facilities was identified as Stage 2 with the remainder in Stage 1. At 30 September 2022, all of these facilities were identified as Stage 1.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

35. CREDIT RISK (CONTINUED)

RLS, CBILS and BBLS

Loans under these schemes have the benefit of guarantees underwritten by the UK Government, which launched them as a response to the impact of Covid on UK SMEs.

CBILS and BBLS were launched in 2020 and remained open for new applications until March 2021. RLS was launched in April 2021 as a successor scheme and has subsequently been extended twice. It is currently expected to be available for new lending until June 2024.

The Group offered term loans and asset finance loans under the CBIL scheme. Interest and fees were paid by the UK Government for the first twelve months and the government guarantee covers up to 80% of the lender's principal loss after the application of any proceeds from the asset financed (if applicable).

Loans under the BBL scheme are six year term loans at a standard 2.5% per annum interest rate. The UK Government paid the interest on the loan for the first twelve months and provides lenders with a guarantee covering the whole outstanding balance.

The Group offers term loans and asset finance loans under the RLS. Interest and fees are payable by the customer from inception. The Government guarantee covers up to 80% of the lender's principal loss, after the application of any proceeds from the asset financed (if applicable), on applications received before 1 January 2022 and up to 70% for applications received thereafter.

The Group's outstanding RLS, CBILS and BBLS loans at 30 September 2023 were:

	2023 £m	2022 £m
RLS		
Term loans	1.0	0.6
Asset finance	36.0	41.5
Total RLS	37.0	42.1
CBILS		
Term loans	12.6	18.3
Asset finance	14.5	23.6
Total CBILS	27.1	41.9
BBLS	3.1	4.0
	67.2	88.0
Total term loans	16.7	22.9
Total asset finance	50.5	65.1
	67.2	88.0

At 30 September 2023, £0.7m of this balance was considered to be non-performing (2022: £0.6m).

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

35. CREDIT RISK (CONTINUED)

Unsecured consumer loans

The Group disposed of almost all its unsecured consumer loan portfolio during the year ended 30 September 2022 (note 5). It retains an interest only in a limited number of unsecured accounts excluded from the sale.

Almost all the Group's unsecured consumer loan assets were part of purchased debt portfolios where the consideration paid was based on the credit quality and performance of the loans at the point of the transaction. Collections on purchased accounts remained in excess of those implicit in the purchase prices until the point of sale in June 2022.

Arrears performance

The number of accounts in arrears by asset class, based on the most commonly quoted definition of arrears for the type of asset, at 30 September 2023 and 30 September 2022, compared to the industry averages at those dates published by UK Finance ('UKF') and the FLA, was:

	2023 %	2022 %
First mortgages		
Accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	0.34	0.15
Buy-to-let accounts excluding receiver of rent cases	0.15	0.11
Owner-occupied accounts	2.93	2.79
UKF data for mortgage accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	0.69	0.41
Buy-to-let accounts excluding receiver of rent cases	0.64	0.39
Owner-occupied accounts	0.89	0.80
All mortgages	0.84	0.72
Second charge mortgage loans		
Accounts more than 2 months in arrears		
All accounts	23.48	21.33
Post-2010 originations	2.42	1.88
Legacy cases (pre-2010 originations)	26.58	24.45
Purchased assets	30.10	27.71
FLA data for second mortgage loans	6.30	7.50
Motor finance loans		
Accounts more than 2 months in arrears		
All accounts	1.08	2.07
Originated cases	1.07	1.58
Purchased assets	1.32	8.94
FLA data for consumer point of sale hire purchase	3.60	3.40
Asset finance loans		
Accounts more than 2 months in arrears	0.23	0.08
FLA data for business lease / hire purchase loans	0.60	0.80

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

35. CREDIT RISK (CONTINUED)

No published industry data for asset classes comparable to the Group's other books has been identified. Where revised data at 30 September 2022 has been published by the FLA or UKF, the comparative industry figures above have been amended.

Arrears information is not given for development finance, structured lending or invoice finance activities as the structure of the products means that such a measure is not appropriate.

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

The number of accounts in arrears will naturally be higher for legacy books, such as the Group's legacy second charge mortgages and residential first mortgages than for comparable active ones, as performing accounts pay off their balances, leaving arrears accounts representing a greater proportion of the total.

The figures shown above for second charge mortgage loans incorporate purchased portfolios which generally include a high proportion of cases in arrears at the time of purchase and where this level of performance is allowed for in the discount to current balance represented by the purchase price. However, this will lead to higher than average reported arrears.

Acquired assets

A significant proportion of the Group' second charge mortgage balances and, historically, almost all its unsecured consumer loan assets are, or were, part of purchased debt portfolios, where the consideration paid was based on the credit quality and performance of the loans at the point of the transaction. No additional loans to customers treated as POCI were acquired in the year ended 30 September 2022 or the year ended 30 September 2023.

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

In the debt purchase industry, Estimated Remaining Collections ('ERC') is commonly used as a measure of the value of a portfolio. This is defined as the sum of the undiscounted cash flows expected to be received over a specified future period. In the Group's view, this measure may be suitable for heavily discounted, unsecured, distressed portfolios (which will be treated as POCI under IFRS 9), but is less applicable for the types of portfolio in which the Group has invested, where cash flows are higher on acquisition, loans may be secured on property and customers may not be in default. In such cases, the IFRS 9 amortised cost balance, at which these assets are carried in the Group balance sheet, provides a better indication of value.

NOTES TO THE FINANCIAL INFORMATION - CAPITAL AND FINANCIAL RISK

For the year ended 30 September 2023

35. CREDIT RISK (CONTINUED)

However, to aid comparability, the 84 and 120 month ERCs value for the Group's purchased consumer loan assets, are set out below. These are derived using the same models and assumptions used in the EIR calculations. ERCs are set out both for all purchased consumer portfolios and for those classified as POCI under IFRS 9.

	2023 £m	2022 £m	2021 £m
All purchased consumer assets			
Carrying value	58.6	75.3	185.2
84 month ERCs	68.9	88.6	221.2
120 month ERCs	73.4	94.2	245.2
POCI assets only			
Carrying value	17.7	21.4	113.2
84 month ERCs	24.5	29.9	143.9
120 month ERCs	27.8	33.0	163.4

Amounts shown above are disclosed as loans to customers (note 13). They include first mortgages, second charge mortgage loans and, in the amounts shown for 2021 unsecured consumer loans.

The reduction in the year ended 30 September 2022 primarily reflects the disposal of the Group's unsecured consumer lending assets (note 5).

NOTES TO THE FINANCIAL INFORMATION – BASIS OF PREPARATION

For the year ended 30 September 2023

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

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

36. ACCOUNTING POLICIES

The preliminary financial information has been prepared on the basis of the accounting policies used in the production of the financial statements for the year. For the year ended 30 September 2023 the Group has prepared its Annual Report and Accounts using the same accounting polices set out in its 2022 accounts.

The Group is required, by the Companies Act 2006 and the Listing Rules of the FCA, to prepare its financial statements for the year ended 30 September 2023 in accordance with UK-adopted international accounting standards. In the financial years reported on this also means, in the Group's circumstances, that the financial statements also accord with IFRS as approved by the International Accounting Standards Board.

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

Adoption of new and revised reporting standards

In the preparation of the 2023 financial statements, no accounting standards have been applied for the first time.

Standards not yet adopted

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

Going concern basis

The going concern basis has been adopted in the preparation of this preliminary financial information. The reasons for the adoption of this basis are set out in note 39.

NOTES TO THE FINANCIAL INFORMATION - BASIS OF PREPARATION

For the year ended 30 September 2023

37. CRITICAL ACCOUNTING JUDGEMENTS

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

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

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

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

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

More information on the definition of SICR adopted is given in note 15.

(b) Definition of default

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

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

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

More information on the Group's definition of default adopted is given in note 15.

NOTES TO THE FINANCIAL INFORMATION - BASIS OF PREPARATION

For the year ended 30 September 2023

37. CRITICAL ACCOUNTING JUDGEMENTS (CONTINUED)

(c) Classification of financial assets

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

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

Financial assets are classified as held at amortised cost, at fair value through OCI, or at fair value through profit and loss.

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

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

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

Therefore, the Group has classified its customer loan assets as carried at amortised cost. There were no significant changes in the nature of the Group's products, nor in the business models in which they are held, during the year.

38. CRITICAL ACCOUNTING ESTIMATES

Certain balances reported in the financial statements are based wholly or in part on estimates or assumptions made by the directors. There is, therefore, a potential risk that they may be subject to change in future periods. The most important of these, those which could, if revised significantly in the next financial year, have a material impact on the carrying amounts of assets or liabilities are:

NOTES TO THE FINANCIAL INFORMATION - BASIS OF PREPARATION

For the year ended 30 September 2023

38. CRITICAL ACCOUNTING ESTIMATES (CONTINUED)

(a) Impairment losses on loans to customers

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

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

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

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

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

In evaluating the potential impact of the economic situation at 30 September 2023 there is little recent history against which to benchmark likely customer behaviour. Interest rates have risen to higher levels, at a more rapid rate than at any time in recent history. UK base rates had reached 5.25% at the balance sheet date, a level they had not touched since April 2008, since when significant regulatory intervention in the UK's lending markets has taken place. There have also been significant changes in product structures in that period, including the growth of longer term fixed-rate mortgage lending in recent years. All of these make the historical record of behaviours in higher interest rate environments an uncertain guide to the likely impact of current rate levels.

There is also little agreement between economic forecasters as to the future direction of the UK economy, exacerbated by the potential impact of the general election which must be held within the next eighteen months. At the same time, the level to which economic pressures on customers have yet to manifest themselves in credit metrics is still unclear, with credit performance across the markets in which the Group is active being better than some expected over the past year, but considerable uncertainty as to whether this represents a more benign outcome, or merely a delay in credit issues emerging beyond what was anticipated. Together, these factors make forecasting credit behaviour in current conditions particularly challenging.

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

NOTES TO THE FINANCIAL INFORMATION - BASIS OF PREPARATION

For the year ended 30 September 2023

38. CRITICAL ACCOUNTING ESTIMATES (CONTINUED)

In order to provide forward looking economic inputs to the modelling of the ECL, the Group must derive a set of scenarios which are internally coherent. The Group addresses these requirements using four distinct economic scenarios chosen to represent the range of possible outcomes. These scenarios at 30 September 2023 have been derived in light of the current economic situation, at that date, modelling a variety of possible outcomes as described in note 18.

As noted above, there remains a significant range of different opinions amongst economists about the longer-term prospects for the UK, although these have converged, to some extent, over the twelve months since 30 September 2022, when the impact of the September 2022 mini-budget had significantly broadened the range of plausible outcomes.

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

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

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

In addition to uncertainty represented by the economic scenarios, the Group recognises that economic situations can arise which lie outside the range of potential positions considered as a basis for its IFRS 9 approach to impairment when the current models were built. The current forecast scenarios, which include higher rates of interest and inflation than in the historically observed data, represent situations where its models may not be able to fully allow for potential economic impacts on its loan portfolios. It therefore assessed, for each class of asset, whether any adjustment to the normal approach was required to ensure sufficient provision was created and also reviewed other available data, both from account performance and customer feedback to form a view of the underlying reasons for observed customer behaviours and of their future intentions and prospects.

As a result of this exercise additional requirements for provision were identified, to compensate for potential model weakness and to allow for economic pressures in the wider economy which cannot be identified by a modelled approach. By their nature such adjustments are less systematic and therefore subject to a wider range of outturns. The nature and amounts of these judgemental adjustments are set out in note 15.

The position after considering all these matters is set out in notes 15 to 17, together with further information on the Group's approach. The economic scenarios described above and their impact on the overall provision are set out in note 18, while sensitivity analyses on impairment provisioning are set out in note 19.

(b) Effective interest rates

In order to determine the EIR applicable to loans and borrowings an estimate must be made of the expected life of each asset or liability and the cash flows relating thereto, including those relating to early redemption charges together with any initial fees receivable from the customer or procurement fees payable to a mortgage broker or other introducer.

NOTES TO THE FINANCIAL INFORMATION - BASIS OF PREPARATION

For the year ended 30 September 2023

38. CRITICAL ACCOUNTING ESTIMATES (CONTINUED)

Where an account may have differing interest charging arrangements in different phases of its contractual life, such as the Group's buy-to-let mortgage accounts which have a fixed interest rate for a set period and then revert to a variable rate set by the Group (the 'reversionary rate'), the behavioural life and the expected level of the reversionary rate will have a significant impact on the overall EIR. For each portfolio a model is in place to ensure that income is appropriately spread.

For loan accounts such as those in the Group's mortgage portfolios where borrowers typically repay their balances before the contractual repayment date, the estimated life of the account will be dependent on customer behaviour. The customer may choose to sell their property and redeem the mortgage at any point, but may also choose to refinance their account, if a more attractive alternative is available, based on the interest rate they are being charged at that point in time, or expect to be charged in the future. The behavioural life of the loan may therefore by influenced by levels of activity in the residential property market, or by the nature and pricing of alternative funding sources, at each point in the loans life and these are likely to vary over time.

For loans which have a fixed-rate period, the length of that period will have a significant behavioural impact, with many customers choosing to consider their positions at the point at which the fixed rate expires, influenced by the market conditions then prevailing. The future forecast future choices of customers currently on fixed-rate products at this point therefore has a significant impact on the EIR modelling for these assets.

Where loans are more likely to run to contractual term, and interest rates are less likely to vary over that term, as is the case for the majority of the Group's motor finance and asset-backed SME lending, the determination of an EIR model is less judgemental, and reflects principally the spreading of known fees and commissions.

The Group models lives for each of its asset classes, based on its current expectation of future borrower behaviour, and uses these profiles, together with its expectations of future reversionary interest rates, to determine the correct EIR to be applied to each account. The underlying estimates are based on historical data, adjusted for expected for changes, and reviewed regularly. The accuracy of the EIR applied would therefore be compromised by any differences between actual repayment profiles and charging rates and those predicted, which in turn would depend directly on customer behaviour and market conditions.

The Group therefore keeps its models under review and refines its modelling in the light of any emerging deviations from expected behaviour. These are particularly likely where the current or expected economic environment differs from historic scenarios for which relevant data observations are available. This is currently the case, with market mortgage rates at far higher levels than have been seen in many years. In such cases management consider carefully the impacts which any new conditions may have on customer behaviour and reversionary rates and reflect them in the model as appropriate, revisiting these assumptions regularly as observable data becomes available, with a detailed exercise to analyse any emerging themes taking place every six months as part of the half year and year end results processes.

For purchased loans the EIR calculation will involve estimating the likely future credit performance of the accounts at the time of acquisition as well as the customers' payment behaviour. In the initial modelling historical data obtained from the vendor will be examined, with assumptions revisited through the asset lives based on actual and expected customer behaviour.

NOTES TO THE FINANCIAL INFORMATION - BASIS OF PREPARATION

For the year ended 30 September 2023

38. CRITICAL ACCOUNTING ESTIMATES (CONTINUED)

The application of these estimates results in an overall increase in the carrying value of the Group's loans to customers, including POCI accounts, at 30 September 2023 of £20.5m.

To illustrate the potential variability of the estimate, the amortised cost values were recalculated by changing one factor in the EIR calculation and keeping all others at their current levels.

- Currently the average behavioural life used in the buy-to-let modelling for non-legacy assets, which have an average fixed period of 49 months, was 83 months.

  A reduction of the assumed average lives of all loans secured on residential property by three months would reduce balance sheet assets by £9.3m (2022: £13.3m), while an increase of the assumed asset lives of such assets by three months would increase balance sheet assets by £9.2m (2022: £13.3m). £8.8m of both the increase and decrease related to non-legacy buy-to-let assets.

  A reduction of the assumed average lives of all loans secured on residential property by six months would reduce balance sheet assets by £18.5m (2022: £25.8m), while an increase of the assumed asset lives of such assets by six months would increase balance sheet assets by £18.4m (2022: £25.8m). £17.5m of both the increase and decrease related to non-legacy buy-to-let assets.

- The EIR calculation is based on management estimates of the reversionary rates which would be charged to customers after the end of their fixed rate periods.

  If it was assumed that the maximum reversionary rate which could be charged in future was 6.00%, then the value of the non-legacy buy-to-let loan book would be decreased by £3.0m (2022: £nil).

  If it was assumed that the maximum reversionary rate which could be charged in future was 8.00%, then the value of the non-legacy buy-to-let loan book would be increased by £3.9m (2022: £nil).

- Where fixed rate buy-to-let assets redeem before the end of their fixed rate period, an early redemption charge is made, and an estimate for the impact of these charges must be included in the EIR calculation.

  An increase of 50% in the number of five year fixed rate buy-to-let loan assets assumed to redeem before the end of the fixed rate period would increase balance sheet assets by £9.6m (2022: £8.8m).

- A reduction (or increase) in estimated cash flows from purchased loan assets (principally buy-to-let first mortgage loans and second charge consumer loan assets) of 5% would reduce (or increase) balance sheet assets by £1.6m (2022: £2.0m). Such assets now represent only £58.8m of the Group's loan portfolio (2022: £75.8m).

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

38. CRITICAL ACCOUNTING ESTIMATES (CONTINUED)

(c) Impairment of goodwill

The carrying value of goodwill recognised on acquisitions is verified by use of an impairment test based on the projected cash flows for the CGU, based on management forecasts and other assumptions described in note 22, including a discount factor.

The accuracy of this impairment calculation would therefore be compromised by any differences between these forecasts and the levels of business activity that the CGU is able to achieve in practice. As the Group forecasts are based on the Group's central economic scenario, any variance from this will potentially impact on the valuation. This test will also be affected by the accuracy of the discount factor used.

The sensitivity of the impairment test to reasonably possible movements in these assumptions is discussed in note 22.

39. GOING CONCERN

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

Particular focus is given to the Group's financial forecasts to ensure the adequacy of resources available for the Group to meet its business objectives on both a short term and strategic basis. The guidance requires that this assessment covers a period of at least twelve months from the date of approval of these financial statements.

Financial and capital forecasting

The Group has a formalised process of budgeting, reporting and review. The Group's planning procedures forecast its profitability, capital position, funding requirement and cash flows. Detailed plans are produced for two year periods with longer-term forecasts covering a five year period which include detailed income forecasts. These plans provide information to the directors which is used to ensure the adequacy of resources available for the Group to meet its business objectives, both on a short-term and strategic basis.

The forecast is updated every six months, and the directors have based their going concern assessment of the forecast for the period beginning on 1 October 2023.

The Group makes extensive use of stress testing in compiling and reviewing its forecasts. This stress testing approach was reviewed in detail during the year as part of the annual ICAAP cycle, where testing considered the impact of a number of severe but plausible scenarios. During the planning process, sensitivity analysis was carried out on a number of key assumptions that underpin the forecast to evaluate the impact of the Group's principal risks.

NOTES TO THE FINANCIAL INFORMATION - BASIS OF PREPARATION

For the year ended 30 September 2023

39. GOING CONCERN (CONTINUED)

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

- An increase in buy-to-let volumes. This examined the impact of higher volumes at a reduced yield on profitability and illustrated the extent to which capital resources and liquidity would be stretched due to the higher cash and capital requirements
- Higher funding costs. Higher cost on all new savings deposits, both front book and back book throughout the forecast horizon. This scenario illustrates the impact of a significant, prolonged margin squeeze on profitability, and whether this would cause significant impacts on any capital, liquidity or encumbrance ratios
- Higher buy-to-let redemption rates for buy-to-let mortgages reaching the end of their fixed rate period. This illustrates the potential risk inherent in the five-year fixed rate business
- Increased economic stress on customers. As well as modelling the impact of each of the economic scenarios set out in note 18 across the forecast horizon, the severe economic scenario was also modelled over the five-year horizon. To ensure this represented a worst-case scenario all other assumptions were held steady, although in reality adjustments to new business appetite and other factors would be made
- Combined downside stress. The IFRS 9 downside economic scenario described in note 18 was modelled out for the plan horizon along with a plausible set of other adverse factors to the business model, creating a prolonged tail-risk

These stresses did not take account of management actions which might mitigate the impact of the adverse assumptions used. They were designed to demonstrate how such stresses would affect the Group's financing, capital and liquidity positions and highlight any areas which might impact the Group's going concern status. Under all these scenarios, the Group had the ability to meet its obligations over the forecast horizon and maintain a surplus over its regulatory requirements for both capital and liquidity through normal balance sheet management activities.

As part of the ICAAP process the Group also assessed the potential operational risks it could face. This was done through the analysis of the impact and cost of a series of severe but plausible scenarios. This analysis did not highlight any factors which cast doubt on the Group's ability to continue as a going concern.

The Group begins the forecast period with a strong capital and liquidity position, enabling the management of any significant outflows of deposits and / or reduced inflows from customer receipts. Overall the forecasts, even under reasonable further levels of stress show the Group retaining sufficient equity, capital, cash and liquidity throughout the forecast period to satisfy its regulatory and operational requirements.

NOTES TO THE FINANCIAL INFORMATION - BASIS OF PREPARATION

For the year ended 30 September 2023

39. GOING CONCERN (CONTINUED)

Availability of funding and liquidity

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

The Group's retail deposits of £13,265.3m (note 23), raised through Paragon Bank, are repayable within five years, with 82.9% of this balance (£10,990.5m) payable within twelve months of the balance sheet date. The liquidity exposure represented by these deposits is closely monitored; a process supervised by the ALCO. The Group is required to hold liquid assets in Paragon Bank to mitigate this liquidity risk. At 30 September 2023 Paragon Bank held £2,589.7m of balance sheet assets for liquidity purposes, in the form of central bank deposits. A further £150.0m of liquidity was provided by an off balance sheet long / short transaction, bringing the total to £2,739.7m.

Paragon Bank manages its liquidity in line with the Board's risk appetite and the requirements of the PRA, which are formally documented in the Board's approved ILAAP, updated annually. The Bank maintains a liquidity framework that includes a short to medium term cash flow requirement analysis, a longer-term funding plan and access to the Bank of England's liquidity insurance facilities, where pre-positioned assets would support drawings of £1,715.4m. Holdings of the Group's own externally rated mortgage backed loan notes can also be used to access the Bank of England's liquidity facilities or other funding arrangements. At 30 September 2023 the Group had £1,205.6m of such notes available for use, of which £986.9m were rated AAA. The available AAA notes would give access to £769.8m if used to support drawings on Bank of England facilities.

The Group's securitisation funding structures, provide match funding for part of the asset base. Repayment of the securitisation borrowings is restricted to funds generated by the underlying assets and there is limited recourse to the Group's general funds. Recent and current loan originations are financed through retail deposits and may be refinanced through securitisation where this is appropriate and cost-effective. While the Group has not accessed the public securitisation market during the year, the market remains active with strong levels of demand and the Group maintains the infrastructure required to access it.

The earliest maturity of any of the Group's bond debt is the £112.5m retail bond, due August 2024. No central bank debt is payable until 2025.

The Group's access to debt is enhanced by its corporate BBB+ rating, confirmed by Fitch Ratings in February 2023, and its status as an issuer is evidenced by the BBB- investment grade rating of its £150.0m Tier-2 bond. It has regularly accessed the capital markets for warehouse funding and corporate and retail bonds over recent years and continues to be able to access these markets.

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

The Group's cash analysis, which includes the impact of all scheduled debt and deposit repayments, continues to show a strong position, even after allowing scope for significant discretionary payments and capital distributions.

As described in note 34 the Group's capital base is subject to consolidated supervision by the PRA. The most recent review of the Group's capital position and management systems, during the year ended 30 September 2021, resulted in a reduction of the minimum capital level. Its capital at 30 September 2023 was in excess of regulatory requirements and its forecasts indicate this will continue to be the case.

NOTES TO THE FINANCIAL INFORMATION - BASIS OF PREPARATION

For the year ended 30 September 2023

70. GOING CONCERN (CONTINUED)

Going concern assessment

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

After performing this assessment, the directors concluded that there was no material uncertainty as to whether the Group and the Company would be able to maintain adequate capital and liquidity for at least twelve months following the date of approval of these financial statements and consequently that it was appropriate for them to continue to adopt the going concern basis in preparing the financial statements of the Group and the Company.

40. FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

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

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

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

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

The Group had no financial assets or liabilities in the year ended 30 September 2023 or the year ended 30 September 2022 carried at fair value and valued using level 3 measurements, other than contingent consideration amounts.

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

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

NOTES TO THE FINANCIAL INFORMATION - BASIS OF PREPARATION

For the year ended 30 September 2023

40. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

(a) Assets and liabilities carried at fair value

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

	Note	2023	2022
		£m	£m
Financial assets			
Derivative financial assets	20	615.4	779.0
		615.4	779.0
Financial liabilities			
Derivative financial liabilities	20	39.9	102.1
Contingent consideration	25	-	2.2
		39.9	104.3

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

Derivative financial assets and liabilities

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

In order to determine the fair values, the management applies valuation adjustments to observed data where that data would not fully reflect the attributes of the instrument being valued, such as particular contractual features or the identity of the counterparty. The management reviews the models used on an ongoing basis to ensure that the valuations produced are reasonable and reflect all relevant factors. These valuations are based on market information, and they are therefore classified as level 2 measurements. Details of these assets are given in note 20.

Contingent consideration

The value of the contingent consideration balances shown in note 25 are required to be stated at fair value in the accounts. These amounts are valued based on the expected outcomes of the performance tests set out in the respective sale and purchase agreements, discounted as appropriate. The most significant inputs to these valuations are the Group's forecasts on future activity relating to business generated by operational units acquired, business derived as a result of the vendor's contacts or other goodwill and any other new business flows which are or might be attributable to the acquisition agreement, which are drawn from the overall Group forecasting model. As such, these are classified as unobservable inputs and the valuations classified as level 3 measurements.

NOTES TO THE FINANCIAL INFORMATION - BASIS OF PREPARATION

For the year ended 30 September 2023

40. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

(b) Assets and liabilities carried at amortised cost

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

	Note	2023 Carrying amount £m	2023 Fair value £m	2022 Carrying amount £m	2022 Fair value £m
Financial assets					
Cash	12	2,994.4	2,994.4	1,930.9	1,930.9
Loans to customers	13	14,874.3	14,524.0	14,210.3	13,898.4
Sundry financial assets		46.0	46.0	35.4	35.4
		17,914.7	17,564.4	16,176.6	15,864.7
Financial liabilities					
Short term bank borrowings		0.2	0.2	0.4	0.4
Asset backed loan notes		28.0	28.0	409.3	409.3
Secured bank borrowings		-	-	586.0	586.0
Retail deposits	23	13,265.3	13,177.3	10,669.2	10,592.9
Corporate and retail bonds		258.2	234.8	261.5	254.4
Sale and repurchase agreements		50.0	50.0	-	-
Other financial liabilities		608.8	608.8	491.2	491.2
		14,210.5	14,099.1	12,417.6	12,334.2

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

Cash, sale and repurchase agreements, bank loans and securitisation borrowings

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

While the Group's asset backed loan notes are listed, the quoted prices for an individual note may not be indicative of the fair value of the issue as a whole, due to the specialised nature of the market in such instruments and the limited number of investors participating in it.

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

NOTES TO THE FINANCIAL INFORMATION - BASIS OF PREPARATION

For the year ended 30 September 2023

40. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

Loans to customers

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

Corporate debt

The Group's retail and corporate bonds are listed on the London Stock Exchange and there is presently a reasonably liquid market in the instruments. It is therefore appropriate to consider that the market price of these borrowings constitutes a fair value. As this valuation is based on a market price, it is considered to be a level 1 measurement.

Retail deposits

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

Sundry assets and liabilities

Fair values of financial assets and liabilities disclosed as sundry assets and sundry liabilities are not considered to be materially different to their carrying values.

These assets and liabilities are of relatively low value and may be settled at their carrying value at the balance sheet date or shortly thereafter.

APPENDICES TO THE FINANCIAL INFORMATION

E APPENDICES TO THE ANNUAL REPORT

For the year ended 30 September 2023

Additional financial information supporting the amounts shown in the management report but not forming part of the preliminary financial information.

A. UNDERLYING RESULTS

The Group reports underlying profit excluding fair value accounting adjustments arising from its hedging arrangements and certain one-off items of income and costs relating to asset sales and acquisitions.

The fair value adjustments arise principally as a result of market interest rate movements, outside the Group's control. They are profit neutral over time and are not included in operating profit for management reporting purposes. They are also disregarded by many external analysts.

The transactions relating to the asset disposals and acquisitions do not form part of the day-to-day activities of the Group and, therefore, their removal provides greater clarity on the Group's operational performance.

This definition of 'underlying' has been chosen following consideration of the needs of investors and analysts following the Group's shares, and because management feel it better represents the underlying economic performance of the Group's business.

	Note	2023 £m	2022 £m
Profit on ordinary activities before tax		199.9	417.9
Add back: Fair value adjustments	9	77.7	(191.9)
Profit on disposal of loans	5	-	(4.6)
Underlying profit		277.6	221.4

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

	2023 £m	2022 £m
Underlying profit	277.6	221.4
Tax on underlying result	(66.4)	(51.8)
Underlying earnings	211.2	169.6
Basic weighted average number of shares (note 11)	224.1	242.7
Underlying earnings per share	94.2p	69.9p

Tax has been charged on the underlying profit at 23.9%, being the effective rate at which would result from the exclusion of the adjusting items from the corporation tax calculation (2022: 23.4%).

E APPENDICES TO THE ANNUAL REPORT

For the year ended 30 September 2023

A. UNDERLYING RESULTS

Underlying return on tangible equity is derived using underlying earnings calculated on the same basis shown above. Tangible equity is calculated excluding the impacts of fair value hedging.

	Note	2023 £m	2022 £m
Underlying earnings		211.2	169.6
Amortisation and derecognition of intangible assets		3.6	2.0
Adjusted underlying earnings		214.8	171.6
Opening underlying tangible equity			
Equity		1,417.3	1,241.9
Intangible assets	22	(170.2)	(170.5)
Balance sheet impact of fair values	20	(216.7)	(8.8)
Deferred tax thereon		53.2	(2.2)
		1,083.6	1,060.4
Closing underlying tangible equity			
Equity		1,410.6	1,417.3
Intangible assets	22	(168.2)	(170.2)
Balance sheet impact of fair values	20	(230.8)	(216.7)
Deferred tax thereon		32.8	53.2
		1,044.4	1,083.6
Average underlying tangible equity		1,064.0	1,072.0
Underlying RoTE		20.2%	16.0%

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For the year ended 30 September 2023

B. INCOME STATEMENT RATIOS

NIM and cost of risk (impairment charge as a percentage of average loan balance) for the Group are calculated as shown below. Not all net interest is allocated to segments and therefore total segment net interest in these tables will not equal net interest for the Group.

Year ended 30 September 2023

	Note	Mortgage Lending £m	Commercial Lending £m	Group Total £m
Opening loans to customers	13	12,328.7	1,881.6	14,210.3
Closing loans to customers	13	12,902.3	1,972.0	14,874.3
Average loans to customers		12,615.5	1,926.8	14,542.3
Net interest	2	277.6	135.7	448.9
NIM		2.20%	7.04%	3.09%
Impairment provision charge	8	10.4	7.6	18.0
Cost of risk		0.08%	0.39%	0.12%

Year ended 30 September 2022

	Note	Mortgage Lending £m	Commercial Lending £m	Group Total £m
Opening loans to customers	13	11,829.6	1,573.1	13,402.7
Closing loans to customers	13	12,328.7	1,881.6	14,210.3
Average loans to customers		12,079.2	1,727.3	13,806.5
Net interest	2	251.2	111.2	371.2
NIM		2.08%	6.44%	2.69%
Impairment provision (release) / charge	8	4.6	9.4	14.0
Cost of risk		0.04%	0.54%	0.10%

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

E APPENDICES TO THE ANNUAL REPORT
For the year ended 30 September 2023

C. COST:INCOME RATIO

Cost:income ratio is derived as follows:

	2023 £m	2022 £m
Cost – operating expenses	170.4	153.0
Total operating income	466.0	393.0
Cost / Income	36.6%	38.9%

Underlying cost: income ratio is derived as follows:

	2023 £m	2022 £m
Cost – as above	170.4	153.0
Income – as above	466.0	393.0
Less: profit on disposal of loans	-	(4.6)
	466.0	388.4
Underlying cost income ratio	36.6%	39.4%

E APPENDICES TO THE ANNUAL REPORT

For the year ended 30 September 2023

D. DIVIDEND COVER

For the purposes of dividend policy, the Group defines dividend cover based on basic earnings per share, adjusted where considered appropriate, and dividend per share. This is the most common measure used by financial analysts.

For the current and preceding years the Board has determined that is appropriate to exclude the post-tax impact of fair value (losses) / gains from its calculation. The dividend cover for the year, subject to the approval of the 2023 final dividend at the AGM in March 2024 is therefore as set out below.

	Note	2023	2022
Earnings per share (p)	11	68.7	129.2
Attributable fair value gains (p)		34.7	(79.1)
Attributable tax thereon (p)		(9.2)	21.4
Adjusted earnings (p)		94.2	71.5
Proposed dividend per share in respect of the year (p)	29	37.4	28.6
Dividend cover (times)		2.52	2.50

E. NET ASSET VALUE

	Note	2023	2022
Total equity (£m)		1,410.6	1,417.3
Outstanding issued shares (m)	26	228.7	241.4
Treasury shares (m)	28	(10.1)	(3.6)
Shares held by ESOP schemes (m)	28	(4.0)	(3.9)
		214.6	233.9
Net asset value per £1 ordinary share		£6.57	£6.06
Tangible equity (£m)	34	1,242.4	1,247.1
Tangible net asset value per £1 ordinary share		£5.79	£5.33

CAUTIONARY STATEMENT

Sections of this announcement, including but not limited to the Introduction and the Management Report may contain forward-looking statements with respect to certain of the plans and current goals and expectations relating to the future financial condition, business performance and results of the Group. These statements can be identified by the fact that they do not relate strictly to historical or current facts. They use words such as 'anticipate', 'estimate', 'expect', 'intend', 'will', 'project', 'plan', 'believe', 'target' and other words and terms of similar meaning in connection with any discussion of future operating or financial performance but are not the exclusive means of identifying such statements. These have been made by the directors in good faith using information available up to the date on which they approved this report, and the Group undertakes no obligation to update or revise these forward-looking statements for any reason other than in accordance with its legal or regulatory obligations (including under the UK Market Abuse Regulation, UK Listing Rules and the Disclosure Guidance and Transparency Rules of the Financial Conduct Authority ('FCA')).

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

These factors include, but are not limited to: material impacts related to foreign exchange fluctuations; macro-economic activity; the impact of outbreaks, epidemics or pandemics, and the extent of their impact on overall demand for the Group's services and products; potential changes in dividend policy; changes in government policy and regulation (including the monetary, interest rate and other policies of central banks and other regulatory authorities in the principal markets in which the Group operates) and the consequences thereof; actions by the Group's competitors or counterparties; third party, fraud and reputational risks inherent in its operations; the UK's exit from the EU; unstable UK and global economic conditions and market volatility, including currency and interest rate fluctuations and inflation or deflation; the risk of a global economic downturn; social unrest; acts of terrorism and other acts of hostility or war and responses to, and consequences of those acts; technological changes and risks to the security of IT and operational infrastructure, systems, data and information resulting from increased threat of cyber and other attacks; general changes in government policy that may significantly influence investor decisions (including, without limitation, actions taken in support of managing and mitigating climate change and in supporting the global transition to net zero carbon emissions); societal shifts in customer financing and investment needs; and other risks inherent to the industries in which the Group operates.

Nothing in this announcement should be construed as a profit forecast.