Paragon Banking Group PLC

IFRS 9 Transition Report - 1 October 2018

paragon

CONTENTS

CAUTIONARY STATEMENT

Sections of this document may contain forward-looking statements with respect to certain of the plans and current goals and expectations relating to the future financial condition, business performance and results of Paragon Banking Group PLC and its subsidiaries ('the Group'). These have been made by the directors in good faith using information available up to the date on which they approved this document. 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. There are a number of factors that could cause actual future financial conditions, business performance, results or developments to differ materially from the plans, goals and expectations expressed or implied by these forward-looking statements and forecasts. Nothing in this document should be construed as a profit forecast.

BASIS OF PREPARATION

The financial information in this document has been prepared on a consolidated basis for the Group as a whole on the basis of International Financial Reporting Standards ('IFRS'), incorporating IFRS 9 and its consequential amendments to other standards including IFRS 7, as endorsed by the EU and including transitional arrangements for regulatory capital as appropriate. All other accounting policies are unchanged from those published in the Annual Report and Accounts for the year ended 30 September 2018 ('the Accounts'). Comparative information for the accounting periods prior to adoption will not be restated, as permitted by IFRS 9. This document is unaudited.

Terminology used in this report is consistent with that used in the Accounts. Copies of the Accounts are available on the Group's website at www.paragonbankinggroup.co.uk.

1. EXECUTIVE SUMMARY

This section sets out

- An overview of key impacts on transition to IFRS 9
- A summary of the principal impacts on the Group's financial position
- How these changes will affect the Group's reporting going forward

OVERVIEW OF KEY IMPACTS ON TRANSITION TO IFRS 9

IFRS 9 – Financial Instruments ('IFRS 9' or 'the Standard') largely replaces the requirements of the existing financial instruments standard, IAS 39 - 'Financial Instruments: Recognition and Measurement'. It addresses the areas of recognition, bases of valuation, income recognition methods, impairment and hedging for financial instruments and, from the current financial year, is the standard governing the Group's accounting for Loans to Customers, Borrowings and Derivative Financial Assets and Liabilities. Only the rules relating to the Group's portfolio hedging arrangements will remain subject to IAS 39.

The Group will first publish financial information prepared in accordance with the Standard in its half yearly report for the six months ending 31 March 2019 and its financial statements for the year ending 30 September 2019. Many of the current rules applying to the Group are repeated in broadly similar form in the new standard. In particular, the amortised cost basis of valuation and the related effective interest rate ('EIR') method of income recognition remain largely unchanged. The greatest impact from the new standard is likely to be on impairment provisions, but the requirements addressing classification and measurement and hedging also change.

The purpose of this document is to provide an overview of the impact of the transition to IFRS 9 on the Group and the associated impact on its balance sheet and capital position.

SUMMARY OF IMPACT

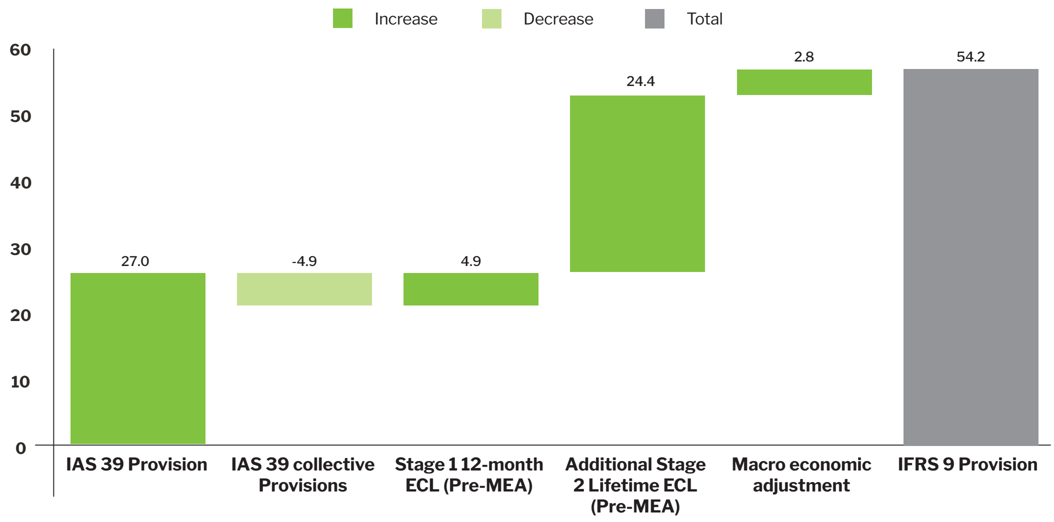
As previously disclosed in the Accounts, the transition to IFRS 9 will result in an increase in impairment provision of approximately £27 million. The principal impacts are set out below:

	IAS 39	IFRS 9	Change	Change
	£m	£m	£m	%
Loans to customers				
Mortgages	10,473.5	10,449.5	(24.0)	(0.2)%
Commercial Lending	1,133.2	1,131.3	(1.9)	(0.2)%
Idem Capital	521.1	519.8	(1.3)	(0.2)%
Total	12,127.8	12,100.6	(27.2)	(0.2)%
Equity	1,095.9	1,073.9	(22.0)	(2.0)%

	IAS 39	IFRS 9	Change
Captial ratios			
CET 1 Ratio*	13.8%	13.5%	(0.3%)
Total Capital Ratio*	16.2%	15.8%	(0.4%)
UK Leverage Ratio*	6.4%	6.3%	(0.1%)

*Capital ratios set out above are calculated on a fully loaded basis.

The changes from the IAS 39 basis are analysed in more detail in the diagram below.



The difference between the IAS 39 provision shown above and the £107.4 million reported in the accounts for the year ended 30 September 2018 is a result of the application of provision to write off part-redeemed accounts under the new IFRS 9 write off criteria on transition.

The Group continues to further develop, calibrate and test its IFRS 9 provisioning process in the light of actual credit outcomes. Where these findings impact on the calculations at 1 October 2018, further amendments to these results may be required. Any such changes are, however, not expected to be significant.

NEXT STEPS

The Group will present its half yearly accounts for the six months ended 31 March 2019 and its Annual Accounts for the year ended 30 September 2019 on the basis of IFRS 9. These reports will also include the revised and further disclosures required by IFRS 7 for entities reporting under IFRS 9. The Group will continue to develop this reporting in the light of emerging market practice and industry guidance.

In particular, the Group will be considering the report of the Taskforce on Disclosures about Expected Credit Losses, “Recommendations on a comprehensive set of IFRS 9 Expected Credit Loss Disclosures”, published in November 2018. This taskforce comprised representatives of investors and the largest banks in the UK and was sponsored by the PRA, FCA and FRC. While these recommendations are aimed at very large banks, the Group will adopt those appropriate to its business model and mix.

2. BACKGROUND

This section sets out

- The requirements of the Standard affecting the Group
- Tax impacts of these changes
- Transition relief available for capital purposes
- Other accounting and reporting changes required

IFRS 9 applies to the Group from 1 October 2018. Its principal provisions applying to the Group, their impacts and other consequent changes are set out below.

CLASSIFICATION

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

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

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

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

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

Therefore, the changes from the classification under IAS 39 are not expected to be significant for the Group, with its loan balances still being carried at amortised cost.

MEASUREMENT

Impairment

IFRS 9 changes the basis of recognition of impairment of financial assets from an incurred loss to an expected credit loss ('ECL') approach for financial assets held at amortised cost. This introduces a number of new concepts and changes to the approach required by IAS 39.

ECLs are based on an assessment of the probability of default ('PD') and loss given default ('LGD'), discounted to give a net present value. The estimation of ECL should be unbiased and probability weighted, considering all reasonable and supportable information, including forward looking economic assumptions and a range of possible outcomes. This has the effect of recognising losses on loans earlier than at present, as IAS 39 requires provisions to be made only at the point where a loss event has actually occurred and there is objective evidence of credit impairment.

IFRS 9 also requires that companies calculate impairment under a variety of differing economic scenarios and combine these on a weighted average basis to arrive at the final provision, rather than base calculations on a central forecast, as is generally the case under IAS 39.

IFRS 9 assigns loans into three stages: those where there has been no significant increase in credit risk ('SICR') since origination ('Stage 1 cases'); those where there has been a significant increase in credit risk ('Stage 2 cases') and loans which are credit impaired ('Stage 3 cases'). SICR is measured relative to the credit risk at the point at which the asset is first recognised, normally the advance or purchase date. It is not, therefore, an absolute measure.

The impairment provision on Stage 1 accounts is equal to the present value of ECLs expected to arise as a result of defaults in the twelve months following the balance sheet date ('12-month ECLs'). Impairment on other cases represents the present value of lifetime ECLs.

The effect of IFRS 9 on the profit and loss account of an entity is to recognise provision charges earlier than would have been recognised under IAS 39. Therefore, annual impairment charges on growing portfolios will be higher under IFRS 9 than they were under the previous standard, although the total amount of loss posted on any case over time will be broadly similar. However, IFRS 9 restricts the posting of interest on credit impaired cases, so for these cases both interest income and impairment are reduced from their IAS 39 values.

IFRS 9 also changes the definition of written off accounts to correspond more directly to potential future recovery, rather than administrative procedures.

Other

There are no other significant changes to the on-going measurement of the Group's financial assets and financial liabilities. In particular, where assets are held at amortised cost, interest continues to be recognised on an EIR basis, except on credit impaired assets where the restriction noted above reduces interest income to the EIR income calculated on the net, rather than the gross loan balance.

HEDGE ACCOUNTING

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

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

CASH FLOW REPORTING

The introduction of IFRS 9 will have no impact on the amounts reported in the cash flow statement of the Group.

COMPARATIVE INFORMATION

There is no requirement to restate comparatives under IFRS 9 and the Group does not intend to do so. Instead the requirements of IFRS 9 will be applied retrospectively by adjusting the balance sheet as at 1 October 2018 and presenting the difference as a movement in reserves. In addition, in order to provide more helpful information to users, the Group intends to present 1 October 2018 information calculated in accordance with IFRS 9 with its 30 September 2019 financial statements.

TAXATION

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

CAPITAL

The Prudential Regulation Authority ('PRA') has announced that firms will be allowed to spread the impact of IFRS 9 on regulatory capital over a five year period after transition. Firms taking advantage of this relief will also have to publish capital information as if the relief was not available, referred to as the fully loaded basis.

The majority of UK firms who have indicated their intentions have stated that they are taking advantage of this transitional relief and the Group will also do so.

IFRS 7 DISCLOSURE

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

This will therefore require significant amendments to the disclosures presented as notes 9 (credit risk), 36 to 38 (loans and impairment) and 40 (derivatives and hedging) in the Accounts.

The Group will take account of guidance produced by industry bodies as well as emerging market practice in drafting these disclosures.

IFRS 15

The Group is also required to adopt IFRS 15 - `Revenue from Contracts with Customers' in its accounts for the year ending 30 September 2019. However, the impact of this standard is restricted to certain items disclosed within other income in the Accounts and as the majority of these items are charged at the time a service is provided, the impact on the consolidated accounts will not be significant.

3. EXPECTED CREDIT LOSS APPROACH

This section sets out

- The Group's approach to estimation of ECL
- The approach to staging of the portfolios
- Significant definitions and assumptions used
- The approach to the derivation and use of forward-looking information
- The governance arrangements surrounding the ECL calculations

EXPECTED CREDIT LOSS

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

PD on both a 12 month and lifetime basis is 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.

LGD for each account is derived by calculating a value for exposure at the point of default (which will include consideration of future interest, account charges and receipts) and reducing this for security values and costs of recovery. These calculations allow for the 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. In these cases, which represent a small proportion of the total portfolio, alternative approaches are adopted. These rely on internal credit monitoring practices and professional credit judgement.

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

APPROACH TO STAGING

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

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

- On initial recognition, and for assets where there has not been an SICR, provisions will be made in respect of losses resulting from the level of credit default events expected in the twelve months following the balance sheet date. These accounts would be largely unprovided for under IAS 39, although some cases with adverse qualitative indicators might have been addressed by a collective emergence provision. Such provisions under IAS 39 were designed to cover assets where a loss event had occurred before the reporting date, but this event had not yet affected performance.
- Where a loan has experienced an SICR, even though this may not lead to a conclusion that the loan is credit impaired, provisions will be made based on the ECLs over the full life of the loan. This is likely to lead to an increase in provision in general, though the IAS 39 emergence provision would have also addressed some of this risk.
- For credit impaired assets, provisions will be made on the basis of lifetime expected credit losses, taking account of forward-looking economic assumptions and a range of possible outcomes. Under IAS 39, provisions are based on the asset's carrying value and the present value of the estimated future cash flows. Despite IAS 39 not explicitly taking account of alternative economic scenarios, it is likely that provisions for loans in this condition will be broadly similar to their existing values.

Credit impaired assets are identified either through quantitative measures or by operational status. Assets may also be assigned to Stage 3 if they are identified as credit impaired as a result of management review processes.

- For assets which were purchased or originated as credit impaired ('POCI') accounts (i.e. considered as credit impaired at the point of first recognition), such as certain of the Group's acquired assets in Idem Capital, the required treatment is largely similar under IAS 39 and IFRS 9.

In terms of the Group's credit management processes, Stage 1 cases will fall within the appropriate customer servicing functions, Stage 2 cases will be subject to account management arrangements while Stage 3 cases will be subject to recovery or similar processes, though these broad categorisations may vary between different product types.

In the Group's buy-to-let mortgage business, all cases where a receiver of rent has been appointed to manage the mortgaged property on the customers behalf are assigned to at least stage 2 and will have a provision based on a PD of 100%. This is notwithstanding the fact that the majority of such cases are fully up to date.

WRITE OFFS

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

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

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

SIGNIFICANT ASSUMPTIONS

The most significant assumptions and definitions forming inputs to the Group's provision calculation for any given asset are set out below:

Definition of default	Used in PD modelling. 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.
Identification of SICR	SICR 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.
Use of forward-looking information	The economic inputs to the model, where the central forecast represents the scenario used in the Group's planning process and the alternative scenarios are based on versions of this as well as the Bank of England's stress scenario. More detail is provided on the Group's use of forward-looking information below.

USE OF FORWARD-LOOKING ECONOMIC INFORMATION

IFRS 9 requires entities to consider the impact of future economic conditions in calculating provisions. A variety of scenarios is required as it is likely that the impacts of positive and negative variances around a central economic forecast are asymmetric.

In order to provide the forward-looking economic inputs for the IFRS 9 impairment calculation, 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.

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.

Models for different portfolios may not use all of the variables, however the set, as a whole, is defined for the Group and must be consistent.

In developing its economic scenarios, the Group considers analysis from reputable external sources to form a general market consensus which informs its central scenario. These sources include forecasts produced by the Office of Budget Responsibility ('OBR') and the PRA as well as private sector economic research bodies. The central scenario is the economic forecast used within the Group for planning purposes and represents its expectation of the most likely outcome. The upside and downside scenarios are less likely variants developed from this base case. The final scenario, the severe downside scenario, represents a protracted slump and is derived from the Bank of England's annual stress testing scenarios.

The economic variables comprising each scenario, and the estimates used at 30 September 2018 in the central scenario for the five years commencing 1 October 2018, are set out below:

Economic variable	Measure	5 year average
Gross Domestic Product ('GDP')	Annual increase	1.6%
House Price Index ('HPI')	Annual increase	3.0%
Bank Base Rate ('BBR')	Average rate	1.2%
Consumer Price Inflation ('CPI')	Annual increase	2.1%
Unemployment	Average rate	3.9%
Secured lending	Annual change	3.2%
Consumer credit	Annual change	8.6%

The weightings applied to the scenarios are: central scenario – 40%, upside scenario – 30%, downside scenario – 25% and severe downside scenario – 5%

The economic variables may be applied in different ways for different models, or parts of models, with leads or lags applied as indicated by statistical analysis.

The impact of the use of multiple economic scenarios on the ECL is shown below

	Central scenario ECL £m	ECL incorporating multiple economic scenarios £m	Difference £m
Mortgages	34.1	36.1	2.0
Commercial Lending	6.3	6.6	0.3
Iem Capital	11.0	11.5	0.5
Total	**51.4**	**54.2**	**2.8**

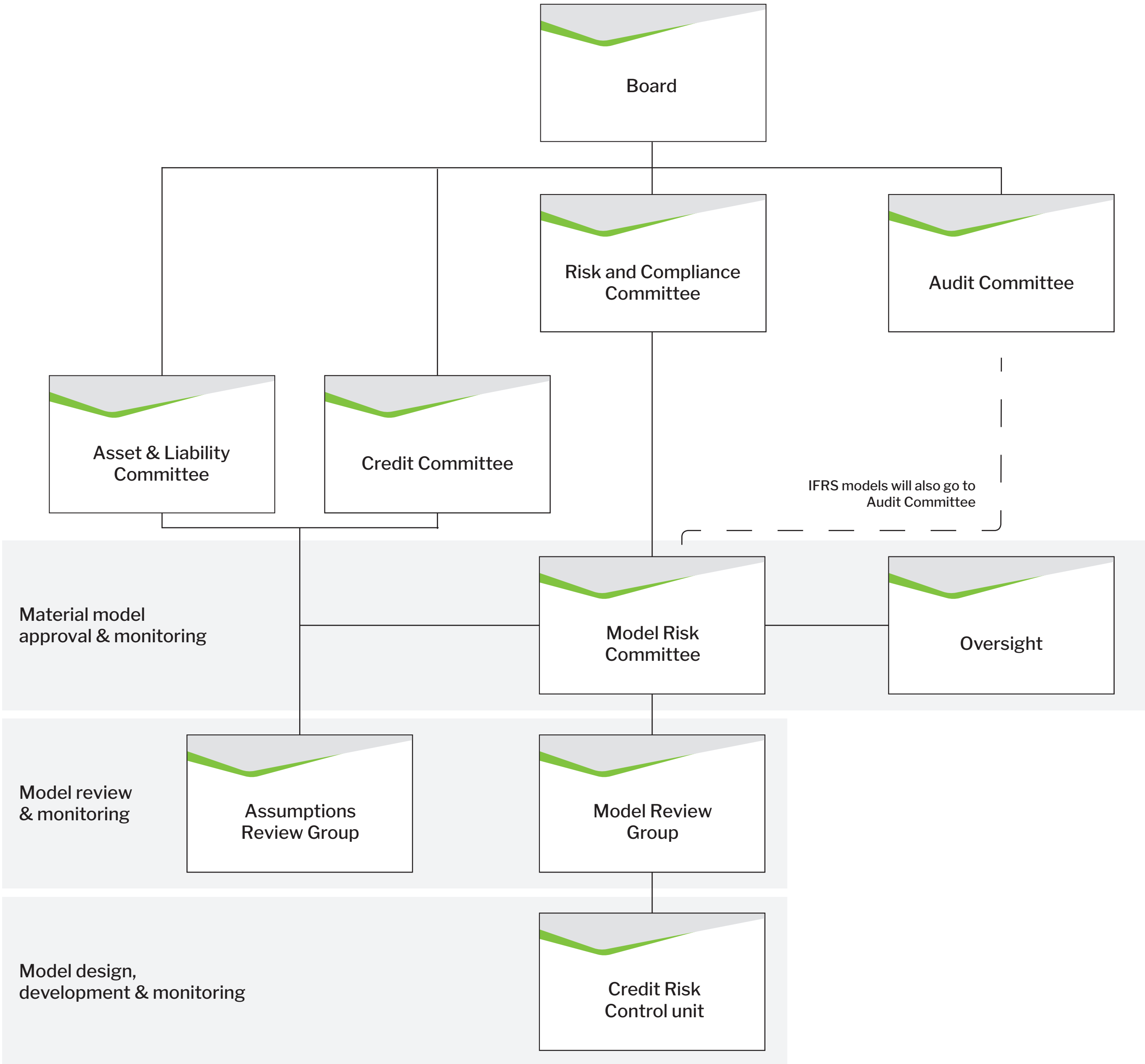
Economic scenarios are updated on a six monthly basis as part of the Group's planning cycle, unless economic or business changes suggest a more frequent update is required.

Implementation Project

During the year, the Group has continued its project to ensure compliance with the IFRS 9 requirements. The project includes finance, analysis and credit risk personnel, is sponsored by the Chief Financial Officer ('CFO') and reports regularly to the Audit Committee. Model builds and ongoing validation are subject to the oversight of the Model Risk Committee ('MRC').

Model Governance

A Model Governance Framework is in place which outlines roles and responsibilities at the development, review and reporting stages and is summarised below. The Model Governance Framework is intended to provide a structured and disciplined approach to the management of model risk on an ongoing basis, thereby supporting the achievement of the Group's strategic objectives.



Financial Reporting

IFRS 9 provision levels are reviewed by senior finance personnel including the CFO on a monthly basis. Outputs and supporting data will be provided to the Board and Audit Committee of the Group on a formal basis, semi-annually before the half year or annual accounts are approved, as part of the financial reporting process.

4. BALANCE SHEET IMPACT

This section sets out

- The impact of IFRS 9 on the Group's balance sheet
- An analysis of the gross exposure and IFRS 9 impairment provision by stages

The following table sets out the impact of IFRS 9 on the consolidated balance sheet at 1 October 2018. All IFRS 9 transitional adjustments are driven by changes in impairment provisions between IAS 39 and IFRS 9 and the related tax adjustments.

	IAS 39 30 September 2018 £m	**IFRS 9 Transition Adjustment £m**	**IFRS 9 1 October 2018 £m**
Assets			
Cash – central banks	895.9	-	895.9
Cash – retail banks	414.7	-	414.7
Loans to customers	12,127.8	(27.2)	12,100.6
Fair value adjustment from portfolio hedging	(24.1)	-	(24.1)
Derivative financial assets	855.7	-	855.7
Trade receivables	2.2	-	2.2
Other assets exposed to credit risk	14.2	-	14.2
Other assets not exposed to credit risk	228.7	-	228.7
Total assets	14,515.1	(27.2)	14,487.9
Liabilities			
Borrowings	13,253.6	-	13,253.6
Derivative financial liabilities	4.7	-	4.7
Sundry liabilities	114.4	-	114.4
Current tax liabilities	21.4	-	21.4
Deferred tax liabilities	5.6	(5.2)	0.4
Retirement benefit obligations	19.5	-	19.5
Total liabilities	13.419.2	(5.2)	13,414.0
Called up share capital	281.6	-	281.6
Reserves	918.3	(22.0)	896.3
Own shares	(104.0)	-	(104.0)
Total equity	1,095.9	(22.0)	1,073.9
Total Liabilities and equity	14,515.1	(27.2)	14,487.9

The treatment of the Group's loans to customers balances is considered further below.

Cash balances, 'Trade receiveables' and 'Other assets exposed to credit risk' are classified as financial assets accounted for at amortised cost and are therefore subject to the impairment provisions of IFRS 9. However these assets are principally UK sovereign exposures (including exposures to the Bank of England) and exposures to highly rated banks. The ECLs on these counterparties are considered to be minimal. The value, tennor and potential for default of the other exposures is such that insufficient provision to show the table is calculated.

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

Other assets not exposed to credit risk include property, plant and equipment, goodwill and other intangible assets and prepayments. These are not classified as financial assets and hence are not affected by the introduction of IFRS 9.

Deferred tax is provided on the increased provision amounts, which are expected to be allowable for corporation tax purposes in the ten years following transition, at a rate of 19%, reflecting tax rates currently applying to the Group. The amount of tax relief ultimately received may vary from this figure depending on the tax rates applicable in the future and the company in which the relief is received.

ANALYSIS OF LOANS TO CUSTOMERS

All of the Group's loans to customers which are accounted for as Financial Instruments are held at amortised cost. Under IAS 39, such assets were designated as 'loans and receivables', but were also accounted for on the amortised cost basis. Finance lease balances are accounted for in accordance with IAS 17. Accounting for finance lease receivables will transfer to IFRS 16 on the introduction of that standard, but this will not cause significant changes to accounting by lessors.

The table below presents the gross loans to customers balances, ECL provisions and respective coverage ratios for each of the Group's segments under IFRS 9 at 1 October 2018.

			IFRS 9		
	Stage 1	**Stage 2***	**Stage 3**	**POCI**	**Total**
	£m	**£m**	**£m**	**£m**	**£m**
Gross loan book					
Mortgages	9,961.6	491.2	21.1	11..7	10,485.6
Commercial Lending	1,106.4	9.3	4.7	17.5	1,137.9
Idem Capital	278.9	48.7	11.0	192.7	531.3
Total assets	11,346.9	549.2	36.8	221.9	12,154.8
Impairment Provision					
Mortgages	0.3	28.0	7.8	-	36.1
Commercial Lending	4.2	0.7	1.7	-	6.6
Idem Capital	0.4	2.1	9.0	-	11.5
Total	4.9	30.8	18.5	-	54.2
Net loan book					
Mortgages	9,961.3	463.2	13.3	11.7	10,449.5
Commercial Lending	1,102.2	8.6	3.0	17.5	1,131.3
Idem Capital	278.5	46.6	2.0	192.7	519.8
Total	11,342.0	518.4	18.3	221.9	12,100.6
Coverage ratio					
Mortgages	-	5.70%	36.97%	-	0.34%
Commercial Lending	0.38%	7.52%	36.17%	-	0.58%
Idem Capital	0.14%	4.31%	81.81%	-	2.16%
Total	0.04%	5.61%	50.27%	-	0.45%

*Stage 2 balances are analysed in more detail below.

POCI balances included in the Commercial Mortgages segment arise principally from M&A activity, where those assets were identified as credit impaired at the point of acquisition when the acquired portfolios as a whole were evaluated.

Idem Capital loans include acquired consumer and motor finance loans together with legacy (originated pre-2010) second charge mortgage and unsecured consumer loans. Legacy assets and 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.

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, accounts more than one month in arrears, which are automatically deemed to have an SICR and buy-to-let mortgages where a receiver of rent ('RoR') has been appointed by the Group to manage the property on the customer's behalf. RoR accounts in Stage 2 may be fully up to date, and such accounts would not have been provided for under IAS 39.

	< 1 month arrears	> 1 month arrears	RoR cases	Total
	£m	£m	£m	£m
Gross loan book				
Mortgages	306.3	68.7	116.2	491.2
Commercial Lending	4.0	5.3	-	9.3
Idem Capital	8.8	39.9	-	48.7
Total	319.1	113.9	116.2	549.2
ELC Provision				
Mortgages	0.9	1.0	26.1	28.0
Commercial Lending	-	0.7	-	0.7
Idem Capital	0.2	1.9	-	2.1
Total	1.1	3.6	26.1	30.8
Net loan book				
Mortgages	305.4	67.7	90.1	463.2
Commercial Lending	4.0	4.6	-	8.6
Idem Capital	8.6	38.0	-	46.6
Total	318.0	110.3	90.1	518.4
Coverage ratio				
Mortgages	0.29%	1.46%	22.46%	5.70%
Commercial Lending	-	13.21%	-	7.53%
Idem Capital	2.27%	4.76%	-	4.31%
Total	0.34%	3.16%	22.46%	5.61%

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.

5. CAPITAL IMPACT

This section sets out

- The impact on the Group's regulatory capital from the adoption of IFRS 9
- The Group's capital ratios at 1 October 2018 calculated on the new basis

The anticipated impact of IFRS 9 in the Group's capital and leverage ratios has been taken into account in the capital planning process, which indicates the Group maintaining a healthy capital position in the short to medium term.

The Group's regulatory capital position, calculated under the EU Capital Requirements Regulation ('CRR'), under IFRS 9 is affected in the following ways:

- The reduction in reserves caused by increased provisions, net of associated future tax relief, reduces shareholders equity and hence regulatory capital
- The reduction in loans to customers generates a consequential reduction in risk weighted assets ('RWA'), the amount of which will vary by asset type
- Collectively assessed emergence provisions under IAS 39 qualified as tier 2 capital, with £4.9 million being included in capital at 30 September 2018 in respect of such provisions. No such provisions are made under IFRS 9, therefore total capital is reduced.

While this maximum exposure represents the potential loss which might have to be accounted for by the Group, the terms on which the Group's loan assets are funded limit the amount of principal repayments on the Group's securitised and warehouse borrowings in cases of capital losses on assets, significantly reducing the effective shareholder value at risk.

	IAS 39	IFRS 9 Impact	IFRS 9 Fully loaded	Transition relief	IFRS 9 Transitional	Net IFRS 9 Impact after transitional relief
	30 September 2018		1 October 2018		1 October 2018	
	£m	£m	£m	£m	£m	£m
Capital resources						
Shareholders' equity	1,095.9	(22.0)	1,073.9	20.9	1,094.8	(1.1)
Regulatory adjustments and deductions	(205.1)	-	(205.1)	-	(205.1)	-
CET1 capital	890.8	(22.0)	868.8	20.9	889.7	(1.1)
Tier 2 capital	154.9	(4.9)	150.0	-	150.0	(4.9)
Total captial	1,045.7	(26.9)	1,018.8	20.9	1,039.7	(6.0)
RWA	6,445.3	(11.0)	6,434.3	10.5	6,444.8	(0.5)
CET1 capital ratio	13.8%	(0.3%)	13.5%	0.3%	13.8%	-
Total capital ratio	16.2%	(0.4%)	15.8%	0.3%	16.1%	(0.1)%
Leverage ratio	6.4%	(0.1%)	6.3%	0.1%	6.4%	-

The Group calculates RWA for credit exposures using the Standardised Approach ('SA') and RWA for operational risk using the Basic Indicator Approach ('BIA').

The impact on the Group's CET1 capital ratio before transitional relief (i.e. on a 'fully loaded' basis) at 1 October 2018 is a reduction of 0.3 percentage points to 13.5%. The Group has elected to take advantage of the 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 will allow for a 95% add back to CET1 capital and risk weighted assets in the financial year ending 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. After applying the transitional relief, the impact on the Group's capital position at 1 October 2018 is minimal.

Leverage Ratio

The increase in impairment provisions reduces total leverage exposure at 1 October 2018, on the basis set for UK firms by the PRA, by £27.2 million from £13,892.2 million (as shown in note 4(d) to the Accounts) to £13,865.0 million. Together with the reduction in tier 1 capital shown above, this results in a 0.1 percentage point decrease in the Group's leverage ratio from 6.4% to 6.3% on a fully loaded basis. The impact at 1 October 2018 on a transitional basis is minimal, with the ratio remaining at 6.4%. These remain in excess of the PRA target of 3.25%.

6. ACCOUNTING POLICIES

This section sets out

- The Group's revised accounting policies, following the introduction of IFRS 9

The Group expects to prepare its annual financial statements for the year ending 30 September 2019 on the basis of the same accounting policies as those set out in note 4 to the Accounts, except that the policies relating to loans to customers ((h), (i) and (j)) will be revised as set out below to reflect the adoption of IFRS 9, in respect of the year ending 30 September 2019 only. Existing policies will be used in the preparation of the comparative amounts for the year ended 30 September 2018.

LOANS TO CUSTOMERS

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

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

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

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

FINANCE LEASE RECEIVABLES

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

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

IMPAIRMENT OF LOANS AND RECEIVABLES

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

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

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

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

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

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

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

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

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

7. GLOSSARY

This section sets out

- A listing of defined terms used in the document.

12-month ECLs	ECLs arising as a result of defaults taking place in the twelve months following the balance sheet date
BIA	Basic Indicator Approach
CET1	Core Equity Tier 1
CFO	Chief Financial Officer
CPI	Consumer Price Index
CRR	Capital Requirements Regulation – EU Regulation 575/2013
ECL	Expected Credit Loss
EIR	Effective Interest Rate
EU	European Union
FCA	Financial Conduct Authority
FRC	Financial Reporting Council
Fully loaded	Fully loaded capital measures are calculated before taking advantage of transitional reliefs
Held to Collect	A business model where a firm holds assets with the objective of collecting cash flows arising from them, rather than disposing of them
IAS	International Accounting Standard(s)
IAS 17	IAS 17 - 'Leases', issued December 1997 and revised December 2003
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard(s)
IFRS 16	IFRS 16 - 'Leases' issued January 2017
LGD	Loss Given Default
Macro hedge	Portfolio fair value hedge of interest rate risk
MRC	Model Risk Committee
OBR	Office of Budget Responsibility
PAF	Paragon Asset Finance
PD	Probability of Default
PLC	Public Limited Company
POCI	Purchased or Originated Credit Impaired (assets)
PRA	Prudential Regulation Authority (of the Bank of England)
RoR	Receiver of Rent (appointed under the Law of Property Act)
SA	Standardised Approach (for credit risk)
SICR	Significant Increase in Credit Risk compared to the point of first recognition (origination or acquisition)
SPPI	Solely Payments of Principal and Interest
Stage 1 cases	Customer accounts where there has not been a SICR since initial recognition.
Stage 2 cases	Customer accounts where there has been a SICR since initial recognition, but are not considered to be credit impaired
Stage 3 cases	Customer accounts which are considered to be credit impaired
The Bank	Paragon Bank PLC
The Company	Paragon Banking Group PLC
The Group	The Company and all of its subsidiary undertakings
UK	United Kingdom

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