A. Strategic Report

The business and its performance in the year

A1. Chair of the Board's introduction

> **We are able to enter the new financial year with increased strength and confidence...**
>
> **Fiona Clutterbuck,** Chair of the Board

Dear Shareholder

The year you will read about in this annual report was a challenging one, but despite that, the Group delivered exceptional results. The Covid pandemic continued to impact the UK throughout the year, with considerable uncertainty remaining as the year closed and we face the prospect of a second winter with the virus. However, many of the worst fears of twelve months ago for the progress of the pandemic failed to materialise, and we are able to enter the new financial year with increased strength and confidence.

In compiling this report, we have tried to explain both the unfolding of the Group's strategy, and the continuing impact of the pandemic, in a way that enables you, and all our other stakeholders to thoroughly understand our developing business and its financial results for the year. I hope you find it useful.

The business and its purpose

The Group's purpose is to support the ambitions of the people and businesses of the UK by delivering specialist financial services. We do not seek to compete with mass market banks, but instead focus on customers who will value an expert approach, and who may otherwise be underserved by the banking sector as a whole.

Our business is managed through three lending divisions, Mortgage Lending, Commercial Lending and Idem Capital, with each division offering a range of specialist lending propositions. These are principally funded through our retail deposit base, supplemented with wholesale and central bank borrowings.

Despite the impact of the pandemic, all our businesses continued to make progress on their strategic aims, developing new products, systems and approaches. Our people delivered these enhancements while coping with changes in working practices throughout the year, as government advice changed. Through the second half of the year new lending grew strongly across the business and the performance of the loan book remained robust, even as the impact of government support began to recede.

The Group's ability to provide support for our people, customers and intermediaries throughout the pandemic demonstrates the resilience of our proposition.

The Group's business model and purpose are described more fully in Section A2

Results

The Group's new lending in the year was £2.6 billion, a significant increase from £2.0 billion in 2020 despite some constraint on volumes in the first half of the year. The savings deposit base continued to grow, reaching £9.3 billion, from £7.9 billion at 30 September 2020, a green Tier-2 Bond was issued, and the Bank of England TFSME programme continued to be accessed.

The Group achieved its highest ever underlying profit in the year, at £194.2 million, increased from £120.0 million in the previous year, partly as a result of provisions unwinding as the economic outlook became more positive. Profit before tax on the statutory basis increased to £213.7 million from £118.4 million, with the difference between the two measures a result of the impact of interest rate fluctuations on hedging instruments.

Underlying earnings per share ('EPS') increased to 59.3 pence (2020: 36.5 pence) and statutory EPS increased to 65.2 pence (2020: 36.0 pence). Underlying RoTE was 14.7% (2020: 9.8%), 16.2% on the statutory basis (2020: 9.7%), all reflecting the growth in earnings year-on-year.

Regulatory capital has remained strong during the period, with the year end Core Equity Tier 1 ('CET1') ratio reaching 15.4% (2020: 14.3%) and the capital surplus also increasing as a result of a positive capital review by the regulator. Group liquidity was also maintained at a healthy level.

The financial results and operational performance are reviewed in Section A3

Stakeholders

The Group takes its responsibility to all stakeholder groups very seriously and we acknowledge our duties as a corporate citizen. During the Covid pandemic our priorities have been to protect the interests of customers, employees and suppliers as well as preserving shareholder value.

I continue to be hugely impressed by the resilience of our people in the face of the pandemic and I found it very helpful to hear some of their stories first-hand at the Group's People Forum. I was therefore pleased that we could announce enhanced holiday provision for all our employees during the year.

Diversity continues to be a focus of our employment policies and the additional impetus given to this agenda by the establishment of the Equality, Diversity and Inclusion ('EDI') Network in its first year of operation has been very welcome. Towards the end of the year I was gratified to receive the news that the Group has achieved its first phase targets under the Women in Finance initiative, and continued to meet the expectations of the FTSE Women Leaders project. I am confident that these will form a solid basis for the Group's further development in this area.

The Group continued to progress its climate change agenda across a number of fronts. Green products have been developed in various parts of the business, data-gathering and analysis has been enhanced and we have contributed to various industry initiatives in the year. The Group became a TCFD Supporter during the year and disclosures in this annual report have been developed as we move towards the introduction of TCFD into the UK Listing Rules.

The Group will also publish its first sustainability report, the 'Responsible Business Report' during December 2021.

Social responsibility and citizenship issues are discussed in Section A6

Governance

The Group continues to operate under the UK Corporate Governance Code, complying with its provisions in the year. As I have now served on the Board for more the nine years, I will be stepping down once a new Chair has been appointed, and an appropriate handover has taken place.

I was pleased to welcome Peter Hill, the former Chief Executive of the Leeds Building Society, to the Board during the year as an independent non-executive director and Chair of the Risk Committee. His long experience in the UK financial services sector will be very valuable to us.

Finlay Williamson stepped down from the Board in December 2020, having overseen the development of the risk processes of Paragon Bank, and later the Group, from the Bank's earliest days. I thank him for his contribution.

The ongoing Covid crisis has continued to put pressure on Board members, both through increased workloads and also from the impact of new working methods, and therefore I was delighted to meet my colleagues in person for the first time in many months towards the end of the year. I would like to thank them all for their commitment over this difficult period.

Corporate governance is discussed in Section B3

Risk

The Group continues to focus on the strategic development of its risk management processes, with the Enterprise Risk Management Framework ('ERMF') a particular area of focus in the year. The continuing evolution of working arrangements in response to Covid, and the consequent adaptation of control processes, made it a priority to ensure that risk management within the Group was maintained.

The impact of new products and the Group's participation in government-backed lending schemes also saw new processes and controls brought into the risk framework. The Group's management of risk remains strong and ready to face any future challenges, whether from Covid or other factors.

The Risk Management report is set out in Section B8

Shareholder returns

The Group is committed to maintaining the strength of its capital base, whilst providing appropriate returns to shareholders. The trading performance through the year remained strong and the results of the latest regulatory review endorsed the effectiveness of our capital management processes and governance. During the year, following significant capital stress testing, the Board was able to declare an interim dividend at the half year, and announce a share buy-back programme of up to £40.0 million at the same time.

Having reviewed the capital position at the year end, the Board concluded that a final dividend for the year of 18.9 pence per share can be declared, subject to shareholder approval, bringing the total dividend for the year to 26.1 pence per share, and giving a dividend cover of 2.5 times, broadly in line with policy. It also authorised up to £50.0 million of share buy-backs, in addition to the £2.2 million required to complete the £40.0 million programme announced in June 2021. We would like to thank our shareholders for their continuing support during the year.

Conclusion

As I noted above, this is likely to be the last time I write to you as Chair of the Board, and I find myself reflecting on the changes I have seen since joining the Board in September 2012. In that period the Group has received its banking licence, building a £9 billion deposit franchise from scratch; new lending in the Group's buy-to-let mortgage operation has increased almost ten-fold; significant development finance and SME lending operations have been established; and operating profit more than doubled.

More recently, the Covid crisis has demonstrated the Group's operational robustness and its ability to respond rapidly to new situations, developing new processes, systems and ways of working. This is a tribute to the culture and spirit of the Group's people and the strength of the relationships on which the business is based. In my view this is the best demonstration of our ability to live the values of fairness, professionalism, integrity, humour, commitment, creativity, teamwork and respect, and of the positive results that these bring.

I would like to take this opportunity to thank my colleagues on the Board, past and present, for their challenge and counsel. I must also thank the Group's managers and people both for their support for me personally during my tenure, and for their efforts on behalf of the business.

The underlying fundamentals of the Group's business are sound, our business plans and capital base are robust, and despite the short-term economic uncertainties, I believe that the Group is well placed to move forward.

I wish the Group all possible success for its future and hope that my successor as Chair, whoever they may be, finds the position as rewarding as I have.

Fiona Clutterbuck
Chair of the Board
7 December 2021

A2. Business model and strategy

Paragon at a glance

Paragon is a specialist banking group. We offer a range of savings products and provide finance for landlords, small businesses and property developers in the UK. Listed on the London Stock Exchange, we are a FTSE 250 company, headquartered in Solihull, employing almost 1,450 people.

Our operations are organised into three divisions and new lending is funded largely by retail deposits.

Our operations

Mortgage Lending

We provide mortgage finance for UK landlords to support growth in the Private Rented Sector ('PRS'), giving people choice and flexibility in housing tenure.

See pages 18 and 19

Commercial Lending

We support UK small businesses operating across a range of sectors with finance to help them grow. This includes finance for property developers, motor finance and structured lending facilities for non-bank lenders.

See pages 20 to 23

Idem Capital

We acquire and service UK loan portfolios from other financial institutions.

Funding

Since gaining our banking licence in 2014, our principal source of funding for new lending has been through our range of savings products offered to UK savers. Other funding for lending is derived from the efficient use of Bank of England funding schemes, while securitisation continues to fund elements of the book and is used tactically. Central funding is provided through corporate and retail bonds.

See pages 16 and 17

Headquarters
Solihull, West Midlands

Our purpose

Paragon's purpose is to support the ambitions of the people and businesses of the UK by delivering specialist financial services.

This provides the foundation for everything we do and today we are helping more than 400,000 customers to achieve their ambitions.

We have helped the UK to develop a thriving private rented sector over the last 25 years, supporting landlords up and down the country to invest in and build valuable businesses that deliver flexibility for those who choose to rent, homes for students and for people who simply can't afford to buy their own home.

We are helping property developers turn unused sites into new housing, addressing the continuing housing shortage in the UK, and small and medium sized businesses deliver post-pandemic recovery. We're supporting savers to reach personal goals – providing them with better returns to save towards a holiday or a deposit for a house.

As a specialist bank, we focus on lending to customers who require specialist products in markets typically underserved by larger high street banks. This approach requires us to be experts in these areas, and we seek to know more than our competitors about our customers and the markets in which we operate, the products and services we offer, and the risks we incur. We see specialisation as what makes us different and as our competitive advantage, and it runs through our business model and strategy.

This strategy relies on the quality of our people. By living our purpose, we can help them achieve their own ambitions to grow and develop, to enjoy a successful career and to build strong foundations for their own lives.

Our values

We have a strong and unique culture underpinned by eight essential values, which we strive to live up to every day. These values underpin how we operate, what we stand for and how we work together to achieve our goals. We believe that living our values helps us succeed in fulfilling our purpose.

Fairness

To work together to ensure fair outcomes for all our customers

Professionalism

To maintain the highest standards and deliver our products and services with care and accuracy

Integrity

To be honest and open in everything we do

Humour

To ensure we have fun while achieving success!

Commitment

To drive the business forward with determination and to do so with effort and enthusiasm

Creativity

To identify and create new business opportunities and apply creative and effective solutions to problems

Teamwork

To work in harmony and collectively towards the delivery of our overall objective

Respect

To treat people as individuals and listen to their views

Our strategy

Our strategy is driven by our purpose and helps us achieve our vision to become the UK's leading technology-enabled specialist bank and an organisation of which our employees are proud.

We focus on specialist customers and aim to deliver long-term sustainable growth and shareholder returns through a low risk and robust model. We have five clear strategic priorities that help us deliver our strategy, underpinned by three strategic pillars.

Our strategic priorities

Growth

We are focused on growing our lending in specialist market segments where customers are underserved by the large high street banks. Using our expert knowledge and experience, we aim to grow both organically and by acquisition, in a low-risk robust manner, that allows us to balance our stakeholder needs while moving towards sustainable long-term returns.

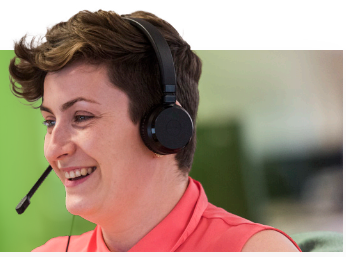
Diversification

We are continually developing our range of savings and specialist lending products, in both existing and new markets, to grow our business and to help us succeed in becoming the UK's leading technology-enabled specialist bank. We are also seeking to reduce barriers to growth in UK banking through our move toward an Internal Ratings Based ('IRB') approach to capital measurement and a growing and increasingly segmented funding strategy.

Our strategic pillars

A customer focused culture

Expert knowledge and experience, supported by proprietary insight, data and analytics ensuring a deep understanding of our specialist customers and markets.



A dedicated team

An experienced, skilled and engaged workforce, and a unique culture underpinned by eight values.

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. These risks and the steps the Group takes to safeguard against them are discussed in more detail in Section B8.

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.

Strategic
Changes to business model or environmental factors may lead to an inappropriate or obsolete strategy or strategic plan.

Capital
Insufficient capital to operate effectively and meet minimum requirements.

Digitalisation

The transformation of our technology is focused on implementing sophisticated, digitally-enabled, cloud-based platforms that will allow us to deliver outstanding customer service, become more efficient and support decision making, whilst retaining the flexible and specialist capabilities that our customers desire. Advances in technology are also helping us expand our addressable market and reach new customers directly and through intermediaries and partnerships.

Capital management

A strong and diverse balance sheet is fundamental to the Group's success and forms one of our three strategic pillars. Management of capital is a critical lever as we invest to grow our business and people while evolving our technology, risk, governance and enterprise frameworks with a goal of delivering a sustainable return on tangible equity in excess of 15%.

Sustainability

For Paragon, sustainability means reducing the impact that our operations have on the environment, ensuring we have a positive effect on our stakeholders and communities, doing the right thing and delivering sustainable lending through the products we offer and markets in which we operate, enabling our customers to meet their own targets. Strong environmental, social and governance ('ESG') qualities are embedded in the Group's culture and values, and influence every aspect of our business.

Strong financial foundations

Prudentially strong, with a low-risk approach to lending, reducing volatility of earnings and enhancing sustainability of dividends.

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

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

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

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

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

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

Our business model

Our business model is designed to allow us to add value by focusing on meeting the specialist needs of a broad range of customers, while positioning ourselves to deliver returns for shareholders and meet our broader obligations to society.

WHAT WE DO...

A broad funding base

We fund our assets using a variety of sources and take care to secure competitive funding over an appropriate term to underpin our assets, meet working capital requirements and maintain a strong financial position.

- Retail deposits
- Securitisation
- Bond issuance
- Central bank funding

USING OUR CORE STRENGTHS...

Customer expertise

We have a deep understanding of our customers and their markets, designing products to meet their needs and continually striving to exceed their expectations.

650 million+ items of customer data analysed each month

Risk management

We lend conservatively, based on detailed credit assessments of the customer and underlying loan collateral, to minimise the risk of non-payment and portfolio losses.

Net release of impairment provision **£4.7 million**

Technology

We are utilising technology to improve productivity and access new markets, and are well placed to take advantage of digital changes to expand our addressable customer base.

New asset finance portal for intermediaries launched during 2021 to increase automation and efficiency

Management expertise

We have an experienced management team with a through-the-cycle track record.

Average length of service for the executive management team is **16 years**

TO DELIVER VALUE TO ALL OUR STAKEHOLDERS...

Shareholders

Creating long-term shareholder value through growing profits and dividends.

See page 41

Dividend per share **26.1p**

Employees

Helping all our people develop their career and reach their potential.

See page 62

Average training per employee in 2021: **4.6 days** ('CIPD' average 2.8 - 3.2 days)

Society

Helping the UK economy grow and supporting the communities in which we operate.

See page 72

Charitable contributions in 2021: **£39,600**

Our section 172 statement can be found on pages 92 to 98.




Lending on diversified loan assets

We focus on building our asset base by originating new loans, developing new products and diversifying into new markets.

- Buy-to-let mortgages
- Residential development loans
- SME lending
- Motor finance

Cost control

Distributing loan products principally via third party brokers, collecting savings deposits online and operating mainly from a centralised location means we run a cost-efficient business.

Underlying cost: income ratio
41.7%

Our people

We are committed to helping all our employees reach their potential and recognise the importance of development and diversity in maintaining a skilled and engaged workforce.

Gold Investors in People accreditation

INVESTORS IN PEOPLE | Gold

Culture

Our core values underpin the way we do business and how we interact with our customers and other stakeholders, with a focus on treating customers fairly.

96% of employees agreed there is a clear and consistent set of values and behaviours that underpin how we operate[1]

Strong financial foundations

We efficiently utilise capital and debt positions to maintain balance sheet strength.

CET1 ratio
15.4%

Customers

Providing tailored lending products, expertise and working with intermediaries to help our customers achieve their ambitions.

See pages 17 and 19

+58 Net promoter score ('NPS') for savings account opening

Environment

Continually reducing our environmental impact and designing products that support positive environmental change.

See page 70

100% of electricity used in 2021 at sites for which we are responsible was from renewable sources.

[1]Paragon employee survey 2021

In focus:

Savings

Throughout 2021, the pandemic continued to have a sizeable impact on the savings market. Despite household deposits reaching record highs, switching levels reduced. Despite these market conditions, the savings business grew the value of its deposits by 18% year-on-year, outpacing the overall market growth considerably. This is a testament to our strong product proposition, our growing leadership within the ISA space, and our adaptive response to a fast-changing market.

Michael Helsby, Strategic Development Director

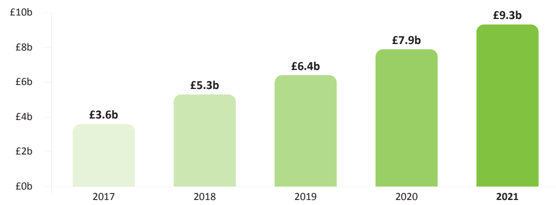
Our principal source of funding for new lending is our range of savings products offered to UK savers. The savings arm of the business entered its seventh year in 2021 and the total volume of retail deposits has continued to grow and now stands at £9.3 billion, a 18.4% growth year-on-year.

The growth of Paragon's savings deposits has consistently outperformed industry average, shown through Bank of England data.

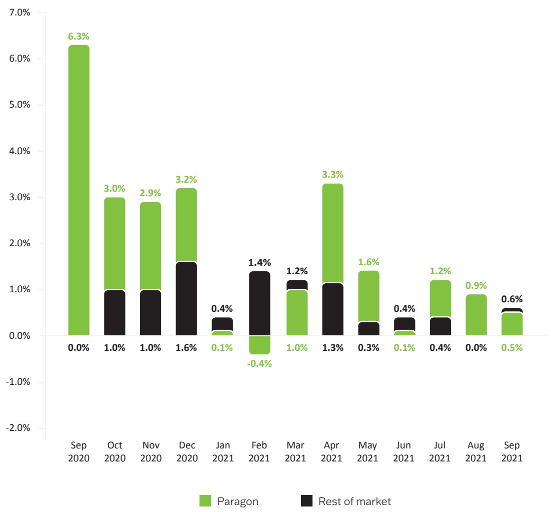
From September 2020 to September 2021, Paragon deposits grew by 18.4%. This compares to total growth of 10% over the same period within the market.

Volume of retail deposits

£9.3 billion



Paragon vs Rest of market monthly stock growth (Source: Bank of England)



Products

Paragon's product offering remains simple – we offer straightforward products at competitive rates. These range from fixed term products to easy access, including notice and defined access accounts and ISAs.

ISA leadership

Last year we launched Wallet and Flexible ISA features across our portfolio to allow savers to split their yearly ISA allowance across a range of ISAs held with Paragon. Through these flexible features, we have carved out a point of difference that targets proactive savers who benefit the most from the tax efficiency of those products.

During 2021, our market share of ISA stock increased by 11% in the twelve months to September 2021. This performance bucked the industry trend, with Bank of England data showing that the cash ISA market stalled in the past 12 months...

Distribution

Customers typically apply for our products through our own website after initially finding our products listed on price comparison websites, mentioned by expert commentators or included in best buy tables.

In the last year, we have continued to work with deposit platforms, targeting those considered to provide the best strategic fit, while also engaging with regulators to help shape the future of that business model. We broadened our network of partners, offering savings products to Aviva customers through Aviva Save and also successfully launched our pilot SME business savings proposition via a deposit platform as we continue to extend our distribution and product range to support growth ambitions.

Market

The UK household savings market is estimated at £1.4 trillion. Paragon's share of this market now stands at 0.66%, a small increase of 0.04% from last year.

The pandemic has created a mixed landscape for savings providers. The climate of financial uncertainty brought on by the pandemic had a profound impact on household deposits and created a division amongst UK savers. Whilst many households were at a financial disadvantage due to Covid, others were able to supplement their savings, aided by reduced opportunities for consumer spending.

As a result, deposits increased and have continued at higher levels than the pre-pandemic average throughout 2021, however the bulk of these savings continue to reside with the incumbent current account providers. At the same time, switching levels have been lower than previous years, due to increased inertia amongst savers in a low-rate environment.

The fixed rate bond market has also reduced by 11% over the course of the pandemic, while the value of Paragon's fixed rate bonds has grown by 10% in the last year. Paragon's performance once again belied the industry trend.

Customers

In order to monitor customer satisfaction and identify areas for improvement, we ask every new customer why they choose to save with us. We also display customer feedback sourced through the independent service ratings provider Feefo on our website. Our average Feefo customer rating stands at 4.5/5, which is based on more than 1,300 reviews in the last year.

We survey our savers at three stages of the customer journey: when they open a new account, at the maturity of a fixed rate product and if they close an account.

feefo

Existing customers

NPS **+52** Net promoter score for customers with maturing products

84% of customers were satisfied with the customer service they received when their fixed rate product matured and 89% would take out another savings account with Paragon in the future.

Amongst customers that were leaving Paragon, 86% found the process of withdrawing their funds easy or very easy. 73% reported being very satisfied with the customer service they received and 80% indicated they would consider us in the future.

Net promoter score +52 for maturity accounts where fixed rate period ended based on an online survey of 3,408 savings customers between 1 October 2020 and 30 September 2021 (total respondents to this survey were 3,541). Net Promoter Score of +58 for new savings account opening process based on an online survey of 4,290 savings customers between 1 October 2020 and 30 September 2021 (total respondents to this survey were 4,457).

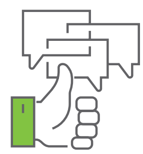
New customers

NPS **+58** Net promoter score for account opening

76% of new customers reported being very satisfied with the customer service that they received, with 87% finding the account opening process easy or very easy.

Amongst new customers, **89%** chose Paragon because we offered the highest rate of interest, however the FSCS guarantee, online access and the easy application process were also popular reasons.

88% of new customers would consider taking another savings account with Paragon



87% of new customers find the account opening process easy

Customer feedback

"No fuss, very efficient, in fact haven't had a better ISA opening experience.... ever and I've opened quite a few. Thank you for making it so easy..."

In focus:

Buy-to-let mortgages

> The long-term trend of growing demand for privately rented homes has accelerated over the past year. With the way we live so significantly impacted by the Covid pandemic, demand for buy-to-let mortgages will be driven by fundamental changes to our society and Paragon will continue to support professional landlords to make the investment needed to ensure housing supply meets demand.
>
> **Richard Rowntree,** Managing Director, Mortgages

We offer buy-to-let mortgage finance for landlords operating in the UK's Private Rented Sector ('PRS').

Our expertise in property valuation and risk assessment means we are trusted by a significant proportion of professional landlords and are well placed to support those investing in complex properties or operating through corporate structures.

Our prudent approach to underwriting and surveying expertise means we play an active part in maintaining high standards in accommodation and improving energy efficiency. Our business proposition means we are naturally aligned to professional landlords and we work to increase knowledge amongst this community. Our position as a conduit between property investors and regulators means we are a trusted voice in conversations aimed at improving the sector.

70,000+
buy-to-let accounts

4.0%
share of all new buy-to-let mortgages in the UK

£11.4 billion
buy-to-let loan assets

25 years of buy-to-let

2021 saw the 25th anniversary of the official launch of buy-to-let mortgages. Paragon was one of the pioneers of buy-to-let lending and has played an integral part in creating a finance product that has helped transform the PRS since the 1990s. We have an unrivalled level of expertise in the market and have become a leading authority on the sector.

> Paragon has helped a wide range of landlords to grow their businesses, originating £25.4 billion of buy-to-let mortgages since 1996...

Supporting diverse property investment

Abdulkader Kadri is a full-time landlord with a portfolio consisting of eight properties. Six of these properties are classed as houses in multiple occupation (HMOs) which he lets to a mix of domestic and international students attending the University of East Anglia.

He thinks that buy-to-let remains a sound investment and plans to purchase more buy-to-let properties over the next 12 months to diversify his portfolio.

> **With such high demand for property in the UK, investors need to think differently and the possibility of converting commercial premises into residential properties is interesting. I know that Paragon specialises in this type of mortgage, which is suited to the more complex properties and larger portfolios; I'm currently renewing one of my mortgages with them and would definitely consider Paragon in future as I grow my business...**

Market

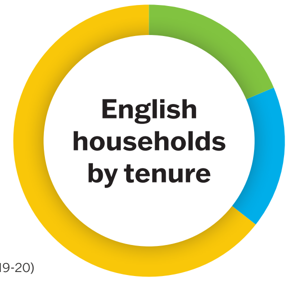
The PRS is an essential component of the UK's housing market, providing affordable and stable homes for people that cannot afford to buy or those that desire greater flexibility and choose to rent.

These aspects, combined with a series of economic, social and demographic changes, have driven considerable expansion of the PRS since the turn of the millennium. The UK PRS is made up of almost five million households today, accounting for just under 20% of homes. This makes the PRS the second most common housing tenure after owner-occupation.

Private rented sector:
4.4 million (18.7%)

Social rented sector:
4.0 million (16.7%)

Owner-occupiers:
15.4 million (64.6%)



(Source: MHCLG English Housing Survey 2019-20)

Total lending for UK buy-to-let mortgages
£45.1 billion

57%
of landlords reported increased tenant demand over the past three months

24.8 million
households in the UK by 2028

21%
increase in the number of build-to-rent homes completed, under construction or in planning

Market trends

In the 12 months to 30 September 2021, UK buy-to-let mortgage lending totalled £45.1 billion, an increase of 20% on 2020, including 112,000 loans for new house purchase, nearly double the previous year (Source: UK Finance).

In the quarter ended 30 September 2021, an all-time high of 57% of landlords reported increased tenant demand over the past three months. This marked a continuation of the trend for rising tenant demand seen throughout 2021, following the low of 14% recorded in the quarter ended 30 June 2020 (Source: BVA BDRC).

Market outlook

The latest data published by the Office for National Statistics ('ONS') in 2018 estimated that by 2021 there would be 23.6 million households in the UK. This is expected to grow to 24.8 million by 2028 and 26.3 million by 2038.

The British Property Federation published figures in Q1 2021 highlighting a 21% increase in the number of build-to-rent ('BTR') homes completed, under construction or in planning compared to the same period in 2020. With this equating to 188,456 homes, it is expected that even with such substantial growth, BTR will supplement buy-to-let over the coming years and both property types can coexist to help tackle the UK's housing shortage.

Residential property is currently responsible for around a quarter of UK emissions and the PRS will need to build on the progress it has made during the past decade to become more sustainable. Although the proportion of PRS homes rated with Energy Performance Certificate ('EPC') ratings of C or above is higher than the owner-occupied market, Paragon and other lenders will need to support landlords with finance to facilitate significant investment in enhancing the energy efficiency of PRS stock.

Customers

We have extensive experience in serving the specialist section of the buy-to-let mortgage market and have supported landlords to grow large and diverse portfolios - 59% of Paragon landlords own four or more properties and 72% are experienced landlords with more than 10 years' experience.

59%
of Paragon landlords own four more more properties

In Q3 2021, a typical landlord's portfolio:

consisted of 6.9 properties **valued at an average of £192,000** each[1]

achieved a gross rental income of **£57,000 per annum**[1]

generated an **annual income of £8,300** per property[1]

was worth **£1.3 million**[1]

[1](Source: Paragon/BVA BDRC Landlord panel Q3 2021)




In focus:

Development finance

> Demand continues to significantly outstrip supply for housing and SME developers are delivering the type of homes that people want to live in. Activity has accelerated since the market reopened last year and that strength has continued throughout 2021. Looking forward, the energy performance of homes will grow in prominence and that puts the new build sector in a strong place.
>
> **Robert Orr,** Managing Director, Paragon Development Finance

Our development finance business provides competitive and flexible financing solutions targeted at SME property developers.

We support developers with a successful track record who are delivering an attractive product, correctly priced, in the right locations. Our highly experienced team is based in London, as well as locations across the north of England, offering tailored funding solutions to our clients.

Our team has increased by 200% since 2018 with the recruitment of experienced and driven individuals to enhance our customer offering.

Market

The UK property market and rate of housebuilding drive the opportunities for development finance. The general economic conditions within the UK influence activity in the residential development sector, alongside interest rates, lifestyle choices, UK Government targets for new homes and Help to Buy schemes.

The UK Government has set a target of 300,000 new homes per year

Relaunched in April 2021 with 5% deposit for first-time buyers

75-80%
lower carbon emissions in new homes by 2025

Market trends

Demand for new homes in the UK continues to exceed supply, driven by expansion and forecast household formation. The UK Government has set a target of 300,000 new homes per year, yet housebuilding activity currently falls below that – 194,063 homes were completed in England and Wales in the year ended March 2021.

To accelerate the number of new homes being constructed, the UK Government announced the Planning Bill in the May 2021 Queen's Speech. One of the Bill's aims is to facilitate more housebuilding by smaller developers. Thirty years ago smaller builders were responsible for around 40% of new homes built, but currently this figure is only 12%.

The Help-to-Buy scheme was relaunched by the UK Government in April 2021 to help first-time buyers with a 5% deposit to buy a home. Regional price caps have been introduced as part of the new phase of the scheme so that buyers can only use the initiative to purchase a home costing no more than 1.5 times the average first time buyer property price in their region. The scheme runs until 2023.

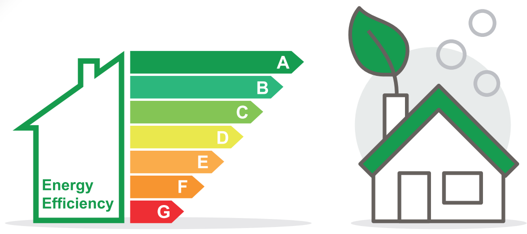
As part of its response to the consultation on the Future Homes Standard, the UK Government has set out plans to radically improve the energy performance of new homes, with all homes to be highly energy efficient, with low carbon heating and be zero carbon ready by 2025. These homes are expected to produce 75-80% lower carbon emissions compared to current levels.

Products

We focus on residential development loans and support experienced developers involved in multi-unit residential, new build, conversion or refurbishment projects. We provide loans ranging between £0.4 million and £35.0 million and we lend up to 70% of the gross development value ('GDV'). To encourage developers to build the most energy efficient properties, we have launched a Green Homes initiative, offering a financial incentive for developments constructing EPC A-rated homes.

NEW

Green Homes initiative



We have launched a Green Homes initiative, offering a financial incentive to developments constructing **EPC A-rated homes**.

Customers

Stephens + Stephens

Lend: £16.6 million

The Cornwall-based husband and wife company Stephens+Stephens is developing 74 luxury apartments on the site of the former Fistral Bay Hotel in Newquay. Paragon's funding has supported the acquisition of the site and the development costs of the scheme.

"We enjoy a strong relationship with the team at Paragon; they understand our business and our requirements and are able to act quickly and efficiently...

Watford Riverwell (Family Housing) LLP

Lend: £25.5 million

Paragon provided a total gross facility of £25.5 million to support the acquisition of land and the development of 85 new homes as part of the Watford Riverwell scheme, the largest regeneration project in Watford transforming more than 60 acres of land to the south of Watford General Hospital and Watford Football Club.

"Paragon has been a key partner, understanding our requirements completely and showing the expertise needed to progress the funding efficiently and within a tight timeframe...

Customer feedback

"Paragon is a company we have worked with over a number of years. Their relationship driven approach fits perfectly with us; they fully understand our business and what we are trying to achieve...




In focus:

SME lending

Over the course of 2021, we have continued to support our customers and have remained open for business throughout. We became one of the first new lenders to be accredited to offer the Recovery Loan Scheme and have assisted thousands of customers and brokers with their post-pandemic recovery. We are now seeing signs of recovery within the asset finance market and will continue to help businesses with their bespoke funding needs as they plan for the future.

John Phillipou, Managing Director, SME lending

Paragon entered the SME finance market in 2015 and we have continued to expand our offering to small businesses over the last six years with the acquisition of the asset finance broker Premier Asset Finance Limited in 2016 and Iceberg in 2018.

We provide a range of finance solutions for SMEs covering a wide array of sectors, including agriculture, aviation, construction, business equipment, manufacturing, technology and vehicles, including electric vehicles.

Our expert SME lending teams have deep and specialist knowledge, not only in finance but also in the asset categories within which they operate.

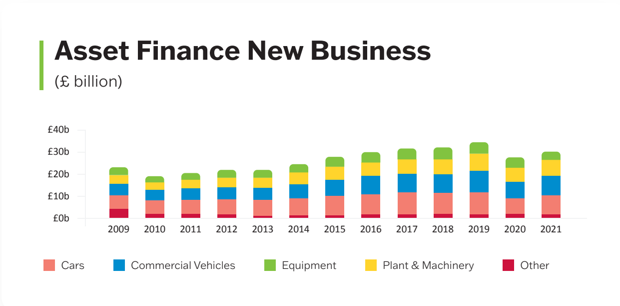
We offer a range of finance types to fund assets including hire purchase, finance leases, operating leases and commercial loans. We also offer refinancing solutions.

Market

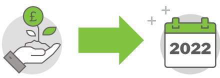
The SME lending market is broad, and Paragon is focussed on specific asset classes.

The general economic conditions within the UK which influence activity in these markets and other key drivers include:

- Supply issues and manufacturing delays created by the pandemic
- The rate of new work in industries such as construction
- Government regulations and trading restrictions
- Advances in technology and SME growth
- Environmental concerns and the drive towards fuel efficiency

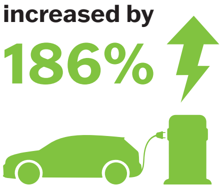


The chart above sets out new business volumes in the UK asset finance market as a whole, as reported by the Finance and Leasing Association ('FLA').



90% of asset finance providers expect new business growth over the next 12 months

Electric car sales increased by 186%



Market trends

The total asset finance new business market grew by 6% in September 2021 compared with the same month in 2020.

In the twelve months to September 2021, new business was 10% higher than in the same period in 2020.

The plant and machinery finance and business equipment finance sectors reported new business up in September 2021 by 31% and 21% respectively, compared with the same month in 2020. By contrast, IT equipment finance new business fell by 24% over the same period.

The FLA's Q4 2021 industry outlook survey shows that 90% of asset finance providers expected new business growth over the next twelve months.

In the nine months to September 2021, new business volumes in the new car market were 9% higher than in the same period in 2020, while they were 11% higher for the same period in the used car market.

Electric passenger car sales increased by 186% in 2020 and today there are an estimated 300,000 electric vehicles on the road in the UK and 600,000 plug-in hybrids.

The growth of the electric vehicle market is expected to continue as the ban on new petrol and diesel vehicle sales, due in 2030, approaches. By the end of 2021, it is estimated that one in ten new cars in the UK will be electric[1] with a total of 260,000 electric car sales forecast for 2022.

[1] Data from the Society of Motor Manufacturers and Traders (SMMT)

Supporting our customers

During the past 18 months, our lending lines have remained open, and we have supported thousands of our customers and brokers through the pandemic, helping those worst impacted with forbearance while also supporting their recovery and post-pandemic growth through our lending activity. 98% of those customers are no longer in forbearance.

To support our business customers as they recover and grow following the pandemic, we were accredited to the government-backed Recovery Loan Scheme ('RLS'). We were one of the first lenders to be accredited and will provide asset finance funding of up to £2 million under the scheme.

£70.1 million

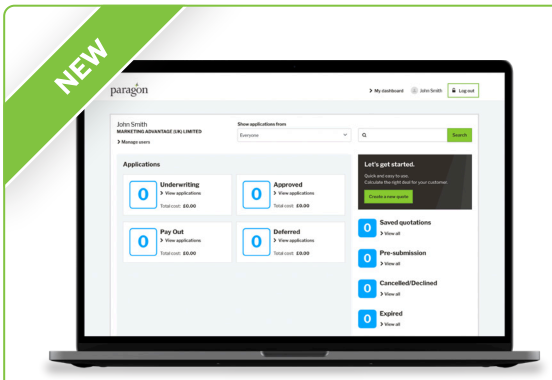
Total CBILS and BBLS lending
- including £44.2 million in the last financial year

£20.0 million

Total lending through RLS between April 2021 and September 2021

> **Our business offering is multi-disciplined and complex so it's very important for us to work with funders who understand our businsess model. As our business grows, it is key for our partners to have known our business pre-Covid and understand our journey and growth plans for the future...**

Del Bhanot, Director at KKB Group



Digital solution launched for introducers

During 2021 we launched a new asset finance portal initially for intermediaries, to automate and speed up the client journey, with increased accuracy, real time tracking and a simple three step application process. This is part of a £10 million investment into new IT infrastructure that is being delivered over the next three years, to deliver a step change in capabilities and capacity.

> **£10 million investment into new IT infrastructure that is being delivered over the next three years...**

Customers

Alkmonton Dairy

Paragon provided Alkmonton Dairy Farm with the funding to invest in the infrastructure to process and bottle milk from its farm and supply its local community directly.

> **There is no doubt that starting a new business in the middle of a pandemic was daunting, but I'm so glad we took the plunge! We've had a great response from the local community. We know sustainability and provenance are really important to our customers, and it's great to be able to offer them locally sourced produce...**
>
> **The team at Paragon was really easy to deal with and took the time to understand our business and what we were hoping to achieve, which made the process of securing funding really seamless...**

Jo Harris, co-owner of Alkmonton Dairy

Sustainability

Sustainability is one of our key strategic priorities and influences every aspect of our business. We aim to use our influence and resources wisely and understand our responsibilities towards society and the environment. We understand that climate change is one of the greatest challenges facing society and take care to identify, manage and minimise our impact on the environment.

Earlier this year we set up a Sustainability Committee to further embed sustainability considerations across Paragon as well as to provide a platform for discussion and debate on emerging ESG issues.

We have published our inaugural sustainablility report, the Responsible Business Report, which explains our progress on the main ESG issues for our business and our stakeholders. We have divided our responsibilities into the following areas and more detailed information on each of them can be found in the report, available on our website.

Helping customers

Our customers are the lifeblood of our business and, as a specialist bank, we use our expertise to develop and structure products, services, and support to meet their needs and help them achieve their ambitions. We are committed to delivering good customer outcomes in line with our values and treating customers fairly throughout our business.

A dedicated customer insight team augments our customer understanding and enables us to improve our overall customer experience.

Our customer commitment is underpinned by a wide range of conduct policies and standards, from product governance to complaints handling and distribution to remediation.

Customer satisfaction scores

88%
of savers would consider taking another savings account with Paragon

91%
of mortgage intermediaries satisfied with the ease of obtaining a query response from Paragon during the offer process

100%
employees completed customer vulnerability training during 2021.

feefo
4.5/5 Feefo review score from savings customers.

46%
year-on-year reduction in emissions since 2017

100% renewable electricity at controlled sites

Operational footprint

We operate in mortgage, consumer, and commercial finance markets and therefore the overall environmental impact of our operations is low, however we are committed to identifying, measuring, and managing how our actions affect the environment and finding ways to reduce their negative impact.

Building a strong team

We employ almost 1,450 people across the UK who work together to help our customers achieve their ambitions. To build a more sustainable future, we need a team with a diverse mix of people and skills, where everyone feels welcome and able to succeed.

We are exceptionally proud of our culture which underpins how we do things at Paragon and helps us recruit and retain the best people for our business. In our recent employee survey 95% of employees agreed they are proud to tell people they work for Paragon and 96% agreed there is a clear and consistent set of values and behaviours that underpin how we operate.

87%
Employee engagement
(2017: 81%)

INVESTORS IN PEOPLE | Gold

+24
Employee NPS
(2017: -3, Industry norm: +21)

Contributing to our communities

Positively impacting society by giving back to the communities in which we live and work has always been important at Paragon. We aim to be an energetic and valuable contributor to these communities and our commitment includes active involvement in a range of community volunteering and charity partnerships.

- Through our community volunteer scheme, every Paragon employee is provided with a day each year to volunteer for specific initiatives that help with education and tackling poverty
- Each year, employees select a charity of the year and a dedicated Charity Committee made up of employee volunteers organise a variety of fundraising activities, which also bring people together and support our values and culture. In 2021, employees raised more than £30,000 for Alzheimer's Society

Lending sustainably

We support the UK's ambition to reduce greenhouse gas emissions to net zero by 2050 and want to help our customers meet their environmental responsibilities and to understand the impact of our lending on the climate.

TCFD | TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

We are taking steps to manage climate related financial risks associated with our lending. During 2021, we:

- Issued our first green bond, the first UK bank to do so, raising £150 million of green capital which has begun to be allocated to mortgages on properties with an EPC rating of at least B
- Launched a range of green mortgage products, specifically for properties with an EPC rating A to C, and motor finance products for electric vehicles
- Offered tailored finance for green assets to our SME customers and brokers to support their sustainability plans and introduced a green homes initiative to support housebuilders

Doing business responsibly

Being a responsible business and doing the right thing for our stakeholders is engrained in how we do business at Paragon. We actively promote good practice on a range of important issues and expect the same from our suppliers and other business partners.

- We are a signatory to the UK's Prompt Payment Code ('PPC'), administered by the Office of the Small Business Commissioner, to ensure suppliers are treated fairly in respect of payment terms and receive payment on time
- Our Supplier Code of Conduct sets out our overall approach to supplier engagement and the standards of behaviour we expect from our suppliers, and we have robust processes and controls in place to ensure all elements of our procurement cycle are managed responsibly
- We ensure our employees understand the different rules and regulations we must adhere to in order to support our customers properly and operate fairly. A series of mandatory learning courses were launched in 2021

Nigel Terrington
Chief Executive Officer

> **The Group has delivered record profits and an outstanding operational performance reflecting the strength of its franchise, the resilience of its operating platform and the commitment and professionalism of its people...**

A3. Chief Executive's review

Introduction

The Group has delivered record profits and an outstanding operational performance reflecting the strength of its franchise, the resilience of its operating platform and the commitment and professionalism of its people.

The Group's business model has been designed, using its extensive through-the-cycle experience, to be resilient in its operational performance and to maintain a strong balance sheet. Having developed an effective working approach at the onset of the crisis, the business was well placed to deal with the changing Covid conditions, particularly over the winter months, maintaining new business activities and paying close attention to the needs of our customers, employees and business partners as the situation developed.

This testing period brought out the best in our people and has given us the opportunity to demonstrate the fundamentals of the Group as we continue to generate improved returns and strong growth rates.

Despite the operational challenges the lockdowns brought, we have strengthened our franchise by building stronger relationships with customers, intermediaries and other business partners. Alongside this, we have delivered a number of key technology developments during the year. We also have an active change programme in progress, designed to optimise customer journeys, operational efficiencies and data and control needs across the business. The delivery of these, together with accessing the capacity and efficiencies they bring, will form a core part of our strategy in continuing to drive strong growth in a prudent manner in the UK's specialist financial services markets.

Financial performance

The Group delivered a strong financial performance reflecting the improvements in the UK economy and strong underlying trading. A combination of strong loan growth, improving net interest margins, tight cost control and a reversal of some of the Covid-related impairments enabled underlying profits to increase by 61.8% to £194.2 million.

Impairments for expected credit losses fell materially from their 2020 level, ending 2021 with a £4.7 million write-back compared to the £48.3 million charge in 2020 and an £8.0 million charge in 2019, before the imact of Covid. Notwithstanding this impairment volatility, pre-provision profits were up 12.6% on their 2020 level at £189.5 million. With the credit for impairments in the year, and strong fair value gains reflecting yield curve movements, overall reported profits before tax were 80.5% higher than their 2020 equivalent at £213.7 million.

Basic earnings per share were 65.2 pence on a statutory basis and 59.3 pence on a underlying basis. We continue to operate with a 40% dividend pay-out policy, which results in a dividend for the year of 26.1 pence, reflecting the strong underlying performance, impairment releases and fair value movements.

Trading performance

The Mortgage Lending and Commercial Lending divisions have each outperformed expectations during 2021, delivering strong new business flows, low arrears and finishing the period with record pipelines.

In Mortgage Lending, where we celebrated 25 years of serving the Private Rented Sector ('PRS'), we have continued to see strong demand from professional landlords, who generated 97% of new buy-to-let completions in the year. Total buy-to-let completions exceeded £1.6 billion in the year, generating an 8% increase in balances to £11.4 billion. Strong house price inflation and stable arrears have created a lower impairment requirement year-on-year and the portfolio remains conservatively leveraged with an average loan to value ('LTV') of 61.2% and only 1.9% of the portfolio having an LTV over 80%. The pipeline at the year end exceeded £1 billion, boding well for continued strong flows into the new financial year. With our half-year results we announced the cessation of lending on second charge mortgages, with the business being unattractive at our chosen risk appetite. All employees were offered redeployment in the wider business, with only six choosing the alternative of voluntary redundancy.

New business flows in Commercial Lending exceeded £0.97 billion, up 22.9% on their 2020 levels and above their 2019 equivalent. The growth was strongest in development finance, where new advances rose 32.5%, year-on-year, reflecting the continued high demand for residential property development in the UK and the Group's investment in expanding the relationship team. The development finance year end pipeline was up 63.2% from its equivalent level in 2020. SME lending saw a 17.0% increase in origination flows, but these remain below the pre-Covid equivalent given sector-wide challenges and the broad take-up of government-backed loans under the CBILS, BBLS and RLS during the year. However, growth was strongest in the longer-term, asset-secured part of the operation. The new portal delivered during the year leaves the business well placed to seize opportunities going forward as this sector recovers. Motor Finance volumes were broadly flat year-on-year, but this disguises a strong second-half recovery and strong momentum being carried through to 2022. Finally, our structured lending team has now refocused its attentions from account management to business development, driving portfolio growth and adding new facilities during the second half of the year.

Capital and funding

The past year has seen a material change in our funding structure, with our savings proposition delivering an 18.4% growth in balances at attractive rates. System enhancements during the year enabled increased levels of deposits to be sourced from third party platforms, while the SME savings market was accessed for the first time. During March 2021 we became the first UK bank to successfully issue a Green Tier-2 Bond, at a coupon of almost 3% less than the bond it was replacing. We have also refinanced the majority of our legacy securitisation structures, substantially repaid borrowings under the Bank of England Term Funding Scheme ('TFS') and drawn further on the Term Funding Scheme with additional incentives for SMEs ('TFSME'). Overall, the Group's cost of funds has dropped by 39 basis points from its 2020 level.

The refinancing of the legacy securitisations removed over £400 million of derivative assets from the Group's balance sheet against which regulatory capital had previously been carried, reducing capital requirements. The refinancing also facilitated the transition of the bulk of the Group's LIBOR-linked loan exposures to a Term SONIA basis. For all remaining LIBOR-linked assets an exit strategy is in place and the Group's remaining LIBOR-linked liabilities were either transitioned during the financial year, or a transition methodology has been agreed with the relevant counterparties.

With the strong capital position at the half-year, the Group declared an interim dividend in line with its guidance (being one half of the previous year's final dividend) and also announced a share buyback of up to £40.0 million, with £37.5 million (excluding costs) being utilised by the year end. This programme will be completed in the early part of the new financial year, and in December 2021 the Board authorised a futher buy-back programme of up to £50.0 million, acknowledging the Group's continuing capital strength.

We also benefitted from revised total capital requirements following the regular supervisory review undertaken by the PRA in late 2020. This saw our total capital requirement ('TCR') fall from 10.8% to 8.9% and contributed to a continued strong surplus over regulatory requirements at 30 September.

The Group submitted its buy-to-let Phase 2 IRB application modules to the PRA during the year. The process remains protracted, but we continue to receive constructive engagement from the PRA. In addition to further phases of the buy-to-let accreditation, our preparations to submit an IRB application for our development finance business, which represents the next stage in the IRB roadmap are well advanced.

Business model developments

Key developments during the year include the completion and roll-out of our Commercial Lending portal and the introduction of auto-decisioning to SME lending. We have also developed a new digital system for our surveyors, established a single payment platform across our banking relationships and implemented Mambu, a cloud-based core banking module, for managing our portfolio of savings platform relationships. Complementing these completed developments, our teams are actively managing process improvements in our Mortgage Lending division, embedding Mambu into development finance, reviewing post-completion systems across the Group and broadening the scope of our savings proposition to support additional future capacity.

People

Our people have made a remarkable effort during the past year, working flexibly to support the business and showing great agility as the operating and working environment has changed. Against this backdrop, the wellbeing of our people has been a primary consideration for the Board and has been demonstrated through numerous initiatives and regular engagement to ensure that effective feedback and communications were maintained throughout the year.

Our 2021 employee survey demonstrated exceptional levels of engagement, with an engagement score of 87% and an employee NPS of +24, where +21 is the industry norm. 95% of our people agreed that they are proud to say that they work at Paragon.

I am pleased to confirm that the Group has also met all its diversity targets under the Women in Finance Charter, set in 2017, while the Group's EDI network, designed to ensure Paragon is a fully inclusive employer, was launched in the year. The new network has already contributed to a number of Group initiatives in this area.

Having spent much of the year with a working-from-home focus, the Group is now undertaking a series of hybrid working pattern trials, designed to optimise the efficiency, control, flexibility and wellbeing features of our longer-term operating model.

Sustainability

Climate change and sustainability considerations have been highlighted during 2021. Against a backdrop of creating the appropriate focus and governance around the Group, we launched the first green capital bond to be issued by a UK bank in March 2021, to replace our existing Tier-2 bond. The establishment of the Green Bond Framework and associated deployment commitments reflect the importance of the sustainability agenda within the Group.

A new Sustainability Committee was established in the year. Products to promote more energy-efficient properties have been launched in both the buy-to-let mortgage and development finance areas. Our motor finance operation began lending on electric vehicles after the year end, following substantial preparatory work during the year. There has also been material board engagement regarding the actions the Group needs to take to support the UK's path to net-zero by 2050.

Internally the Group relocated its London operations to more energy-efficient premises, reducing its carbon footprint while affirming its commitment to office-based working and the City as a physical venue for doing business.

The requirements of the Taskforce on Climate-related Financial Disclosures ('TCFD') become binding on the Group in 2022. Our disclosures for 2021 are materially enhanced and substantially meet these standards, and we have signed up as a TCFD supporter. Alongside the annual report and accounts we are publishing our first separate sustainability report, the Responsible Business Report, which will be accessible via the Group's website.

Outlook

Despite the challenging environment, Paragon leaves its 2021 financial year with strong lending pipelines, an increasingly diversified funding structure and strong capital resources to continue to take advantage of opportunities going forward, both organic and potentially through further acquisitions, if appropriate. We are accelerating our investment in technology, enhancing our customer proposition while preserving the key specialisms that are embedded within our operating model. Careful consideration of impairment coverage levels leaves us appropriately provisioned in the event of future macro-economic volatility or idiosyncratic examples of Covid-related scarring amongst our customers. With a CET1 ratio of 15.4% and good progress being made with our IRB applications, our capital position remains strong, supporting further growth and returns to stakeholders.

Nigel Terrington
Chief Executive Officer
7 December 2021

A4. Review of the year

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
A4.1	A4.2	A4.3	A4.4	A4.5

A4.1 Business review

The Group reports its results analysed between three segments, based on product type, origination, and servicing capabilities. This organisational and management structure has been in place throughout the year.

New business advances and investments in the year, together with the year-end loan balances, by division, are summarised below:

	Advances in the year		Net loan balances at the year end	
	2021	2020	**2021**	2020
	£m	£m	**£m**	£m
Mortgage Lending	**1,630.0**	1,259.7	**11,608.7**	10,819.5
Commercial Lending	**971.5**	790.8	**1,568.8**	1,514.8
Idem Capital	**-**	-	**225.2**	297.1
	2,601.5	2,050.5	**13,402.7**	12,631.4

The Group's total loan balance increased by 6.1% in the year following a 3.7% increase in the preceding twelve months. This highlights the Group's ability to continue to pursue its strategy despite the economic impacts of Covid through the last eighteen months. Total advances increased 26.9% as the economy bounced back from the pandemic and exceeded the pre-pandemic levels of 2019, despite lockdowns and other Covid-related restrictions continuing to impact during the year.

A4.1.1 Mortgage Lending

The Group's Mortgage Lending division principally provides buy-to-let mortgages secured on UK residential property to specialist landlords. The buy-to-let mortgage sector celebrated its 25th anniversary in the year and the Group was one of the first lenders in this market. This gives the Group an unparalleled understanding of this form of mortgage and the landlord customer base it targets.

During the period the Group also offered loans to non-specialist landlords and limited numbers of owner-occupied first and second charge mortgages on residential property.

However, during the year it withdrew from the second charge market entirely, to increase its buy-to-let focus.

In all its offerings, the Group targets niche markets where its focus on detailed case-by-case underwriting and its robust and informed approach to property risk differentiate it from both mass market and other specialist lenders.

Housing and mortgage market

During the year the housing market in the UK continued to be affected by the Covid pandemic and the associated relief schemes including payment holidays, effective prohibitions on some forms of enforcement action and the continuing availability of stamp duty holidays, which were extended until June 2021. While the period over which payment holidays were available was extended, the maximum relief was capped at six months and the immediate impact of such holidays began to reduce as borrowers reached their maximum allocation. Lockdowns and social distancing requirements at various points in the year also put practical constraints on the operation of the housing market.

Activity in the residential property market recovered in the year, boosted by the stamp duty holiday. Transactions for the year reported by HMRC, at 1,562,000, were 58.3% higher than the 987,000 in the previous year. In their September 2021 Residential Market Survey, RICS noted positive activity levels in the market and a stable outlook for property sales.

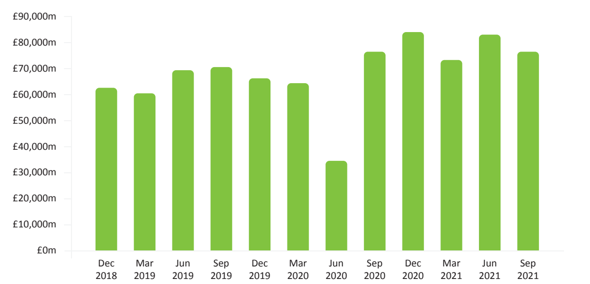
Despite the year beginning with a pessimistic outlook for property prices from some forecasters, house prices saw strong growth in the period, with the Nationwide House Price Index recording a year-on-year increase of 10.0% to September 2021. RICS forecast continuing growth in the short to medium term, with demand outstripping supply, however, Nationwide amongst other forecasters, remain cautious as to the medium-term outlook as reliefs unwind, and the Group continues to position itself conservatively.

New mortgage lending in the market was strong in the year, with the Bank of England reporting new approvals of £317.3 billion in the year ended 30 September 2021, a 31.0% increase on the £242.3 billion reported for the previous financial year and a higher value than any year since 2007. Particularly high volumes were seen in the months leading up to June 2021, when stamp duty reliefs began to be withdrawn.

Quarterly UK mortgage approval data for the last three financial years is set out below.

Quarterly mortgage approvals

(Bank of England)



At 30 September 2021 the UK Finance ('UKF') survey of mortgage market arrears and possessions reported arrears remaining at historically low levels, despite the phasing out of Covid reliefs. Indeed, in a significant number of cases, customers had been able to reduce arrears during the pandemic. Possessions remained very low, with the majority relating to cases already in serious difficulties before the onset of Covid. Based on its research, UKF concluded that the availability of payment holidays fulfilled the purpose of enabling borrowers to stay out of arrears through the pandemic.

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

Specialist landlords form the largest part of the Group's target market. Such landlords typically let out four or more properties, run their portfolio as a business and have a high level of personal day-to-day involvement.

The Group considers that the experience of its 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. This has proved to be the case in the Covid pandemic to date, with customers engaging quickly to manage any risks they faced.

The Group is amongst a small number of specialist lenders addressing this sector, which is underserved by many of the larger lenders. Some constraint in supply was seen during the pandemic, with certain non-bank lenders withdrawing from the market, although by the end of the year most had resumed activity.

New issuance of buy-to-let mortgages followed the trend in the wider property and mortgage markets. New advances reported by UKF, at £45.1 billion for the year ended 30 September 2021, were 14.8% higher than for the previous year (2020: £39.3 billion). This included an 86.3% increase in house purchase activity with an 8.4% reduction in remortgage activity. Some of this increase was driven by an increase in the number of amateur landlords, seeking investments offering returns not available elsewhere, but the activity amongst professionals was also strong.

In the lettings market RICS' September 2021 UK Residential Market Survey reported rising tenant demand coupled with a scarcity of new landlord instructions driving an increase in rents. ARLA Propertymark, in its September 2021 PRS Report, identified 75% of tenants as having experienced year-on-year increases in rent (2020: 58%) while RICS members continue to predict, on average, rent increases of 3% over the coming year. This continuing demand will benefit affordability and cash flows for the Group's landlord customers.

Landlord confidence measures reached a five-year high in the third quarter of the 2021 calendar year. Independent research carried out for the Group reported that on all five measures of confidence surveyed: rental yields, capital gains expectations, the future of their own business, the prospects for the sector as a whole and the UK financial markets more generally, optimism was higher than at any time since 2016. Larger landlords were particularly confident about prospects for their businesses, with 56% feeling 'good' or 'very good'.

The proportion of landlords in the survey reporting increasing tenant demand had reached the highest level since the survey began, with six out of ten landlords reporting rising tenant demand, and 30% reporting significant increases. Only 2% of landlords in the survey reported missing a mortgage payment, and only one of the landlords surveyed anticipated missing one in the next three to six months.

Demand for HMO ('house in multiple occupancy') lets remained strong. Despite concerns as to whether student demand might be particularly affected by the effects of Covid, this did not transpire in the year, with strong lettings even where lectures were being delivered online.

The UKF analysis of arrears and possessions also provided analysis of buy-to-let cases, showing a similar picture to the wider mortgage market, with a significant uptake of payment holidays serving to keep arrears and possessions low, even after these reliefs had expired.

All these factors provide a strong indication of the current strength of the buy-to-let mortgage market and the opportunities for the Group going forward.

Mortgage Lending activity

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

	2021	2020
	£m	£m
Originated assets		
Specialist buy-to-let	**1,562.2**	1,119.0
Non-specialist buy-to-let	**52.2**	86.4
Total buy-to-let	**1,614.4**	1,205.4
Owner-occupied	**1.5**	0.3
Second charge	**14.1**	54.0
	1,630.0	1,259.7

Total mortgage originations in the Group increased by 29.4%, following a 19.7% fall in the preceding year. Activity exceeded the £1,564.4 million of new advances achieved in 2019, before the Covid outbreak, demonstrating the impact of real growth, rather than just a Covid bounce-back on the Group's mortgage business.

Buy-to-let

Advances continue to be focused on specialist buy-to-let, the main focus of the division's activity. New lending of these products increased by 39.6% following the 14.9% fall in the 2020 financial year. The £1,562.2 million of completions was also 22.8% higher than the result for 2019, prior to the pandemic, demonstrating the strength of the Group's proposition.

Specialist buy-to-let comprised 95.8% of the division's advances, reflecting the sharpening of focus on this area. Other mortgage lending remains modest in comparison, with advances declining by 51.8%, in large part due to the Group's exit from the non-core second charge market during the year. The new business pipeline, being the loans passing through the underwriting process, stood at a record £1,008.1 million at the year-end, 8.8% higher than a year earlier (2020: £926.7 million), providing a strong platform for growth into the 2022 financial year.

The Group sources the majority of its new buy-to-let lending through specialist intermediaries, and it continues to invest to ensure the service offered to them is excellent. During the year the Group's regular surveys of its intermediaries showed 91% were satisfied with the ease of obtaining a response from the Group (2020: 91%), delivering an NPS at offer stage of +43 (2020: +56).

Two thirds (66%) of brokers dealing with the Group rated its service as better than that provided by other lenders (2020: 68%). Paragon Mortgages was also named as 'Best Professional Buy-to-let Lender' at the 2021 Your Mortgage awards – the ninth time it has won this title.

During the period the business launched a long-term, in-depth, end-to-end transformation programme to restructure processes and enhance systems, increase the effectiveness of the operation and upgrade the offering to both customers and intermediaries. This represents a significant commitment of time and resources to the future of the business, with enhancements starting to come online from the 2022 financial year.

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.

During the year the Group launched its first range of green buy-to-let mortgages. These market-leading products have a maximum 80% loan-to-value ratio and offer lower interest rates for energy efficient properties with EPC ratings of C or higher. While initially limited to certain property types, this lending was extended to all properties within the Group's lending criteria in October 2021.

The UK Government has identified the provision of more energy efficient housing as a prime objective in its response to climate change, with EPC levels being set as one of the principal benchmarks to be used. It has announced a target of upgrading as many homes as possible in the PRS to an EPC rating of C or higher. In order to achieve this, there is an expectation that lenders will set minimum quality thresholds, and advantage customers with more energy efficient properties, as is the case with the Group's green mortgage products.

The Group has also designated EPC grades as a principal metric for evaluating climate change risk in its mortgage book and has continued to develop systems to analyse this data and to ensure that it has reliable and up-to-date information on as much of its book as possible, including legacy cases. It is unfortunate that some public information sources are not currently configured in a way which easily facilitates in-life monitoring and analysis or allows customers in need of support in improving their properties to be indentified.

The Group's latest analysis identified EPC grades for 88.3% of its mortgage book by value at 30 September 2021 (2020: 85.1%). Of these 98.4% were graded E or higher (2020: 98.1%) with 37.6% rated A, B or C (2020: 37.7%). The year-on-year movements are principally a result of refining the data, with 39.7% of new originations in the year having one of the top three grades (94.2% coverage).

The Group's advances volumes on green buy-to-let lending, which have increased by 27.7% in the year, are set out below.

	2021	2020
	£m	£m
EPC rated A or B	**134.3**	112.7
EPC rated C	**443.4**	339.8
EPC rated A to C	**577.7**	452.5
Coverage (England and Wales)	**93%**	94%

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. At 30 September 2021, approximately 2.5% by number of properties securing the Group's buy-to-let mortgages in England and Wales were considered to be at medium or high risk of flooding from the sea or rivers, based on data from the Environment Agency (2020: 2.2%).

The Group continues to refine and develop its use of both internal and external data to manage climate change risk. However, it recognises the important part that the development of reliable and easily accessible information sources by the UK authorities must play in quantifying these exposures. It would therefore welcome any initiatives by the UK Government to enhance national reporting as part of its own response to climate change.

The business is currently working with the Green Finance Institute on a number of industry initiatives to develop standards for mortgage products which would encourage energy and carbon efficiency for the future, and this work continues to inform the development of the Group's own buy-to-let product range. Given that RICS has highlighted cost as one of the principal barriers to energy efficiency improvements in residential property, the provision of financial solutions will be key to the achievement of climate goals.

Further information on these metrics and the Group's wider climate change agenda is given in the Section A6.4.

Other lending

Other first and second charge mortgage lending is ancillary to the Group's main buy-to-let focus and is carefully managed to ensure that only lending with appropriate risks which provides an acceptable return on capital is undertaken.

Lending in the Group's second charge mortgage operation was scaled back in summer 2020 in response to Covid, with people transferred to provide support to other business areas, and lending remaining low in the first half of the year. The Group took this opportunity to review the long-term strategic potential of second charge lending in light of its capital requirements and the Group's overall risk appetite and announced its withdrawal from this market in May 2021. Completions in the year were £14.1 million compared to £54.0 million in 2020.

The Group's exposure to first charge residential lending is strictly limited, given the yields available in this market at acceptable levels of risk, and a limited demand for products where its specialist approach is cost-effective and adds value. The opportunities for the Group in this area principally relate to complex propositions, which will arise on an opportunistic basis, including lending to the existing professional landlord customer base.

Performance

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

	2021 £m	2020 £m
Post-2010 assets		
First charge buy-to-let	**7,379.0**	6,202.5
First charge owner-occupied	**35.6**	51.2
Second charge	**148.1**	182.6
	7,562.7	6,436.3
Legacy assets		
First charge buy-to-let	**4,045.3**	4,381.3
First charge owner-occupied	**0.7**	1.9
	11,608.7	10,819.5

At 30 September 2021, the total net mortgage portfolio was 7.3% higher than at the start of the financial year, reflecting strong lending and retention performance in spite of the on-going impacts of Covid. The balance of post-2010 buy-to-let lending grew by 19.0% and it now represents 63.6% of the division's total loan assets (2020: 57.3%).

The annualised redemption rate on buy-to-let mortgage assets, at 6.9% (2020: 6.6%), has continued at a low level, partly due to the continued seasoning of five-year fixed rate loans, partly to customers adopting a cautious approach to remortgaging during Covid, but also as a result of the Group's strategic initiatives to retain customers whose mortgage accounts reach the end of their fixed rate period.

Covid-related payment holidays were granted on 13,503 of the Group's buy-to-let accounts which were still live at the year end, representing 19.9% of the book by number. 5,165 of these holidays were extended (7.6%), but all of them had expired by 30 September 2021.

Arrears on the buy-to-let book increased in the year to 0.21% (2020: 0.15%), although part of the increase is attributable to the suppression of arrears by payment holidays at the previous year end. Arrears on post-2010 lending were at 0.09% (2020: 0.03%). Despite the small increases, these arrears remain very low compared to the national buy-to-let market, with UKF reporting arrears of 0.45% across the buy-to-let sector at 30 September 2021 (2020: 0.52%).

While the principal credit metrics for the buy-to-let mortgage portfolio have remained positive throughout the year, the extent to which these have been influenced by UK Government interventions, such as furlough payments and other income support, underpinning tenant rental payments, funding from government-backed loan schemes accessed by landlords and the stamp duty holiday, cannot be established from data available. We remain confident in our lending but, as these initiatives begin to be withdrawn, the long-term prospects will be subject to a higher than normal level of uncertainty.

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. This approach relies on a detailed and thorough assessment of the value and suitability of the property as security and this approach to valuation, including the use of a specialist in-house valuation team, provides it with significant security in the face of economic stress.

The loan-to-value coverage in its buy-to-let book, at 61.2% (2020: 65.8%) represents significant security, enhanced over the year by the generally rising levels of house prices. Levels of interest cover and stressed affordability in the portfolio remain substantial, leaving customers well placed to develop their businesses going forward.

Second charge arrears increased to 1.18% from 0.62% in the year, reflecting the increased seasoning and size of the portfolio and the effect of payment holidays on the 2020 measure. Of the live second charge accounts at the year end 470, representing 17.9% of the book by number, had been given payment holidays during the pandemic, with 256 of those extended (9.8%). No payment holidays remained in place at the year end.

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. The Group's receiver of rent team was able to manage tenant rental flows and occupancy levels through the various pandemic restrictions in the year, to ensure good outcomes for customers and their tenants. At the year end 553 properties were managed by a receiver on the customer's behalf, a reduction of 11.2% since 2020 (2020: 623 properties). Almost all these cases currently relate to pre-2010 lending, with cases being resolved on a long-term basis.

Outlook

The division's operations were affected by Covid in the year, however, the buy-to-let mortgage portfolio continued to grow, with strong credit performance, despite the circumstances. The year end pipeline was at record levels, signposting strong completions into the new financial year. In the wider market, transactions are increasing, tenant demand is strong and rental projections are encouraging, with positive landlord and broker sentiment.

These combine to provide an outlook for the Mortgage Lending business in which it should be able to accelerate out of the pandemic and generate high quality assets and returns for the Group, while contributing to the development and renewal of the nation's housing stock.

A4.1.2 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:

- SME lending, providing leasing for business assets and unsecured cash flow lending for professional services firms, amongst other products
- Development finance, funding smaller, mostly residential, property development projects
- 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 managing director, supported by a specialist team with a strong understanding of their market. The principal competitors for each of the business lines 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.

The SME sector has been the focus of government-mandated support programmes throughout the pandemic including payment reliefs from lenders, VAT deferral schemes and the provision of loans under the Coronavirus Business Interruption Loan Scheme ('CBILS'), Coronavirus Large Business Interruption Loan Scheme ('CLBILS'), Bounce Back Loan Scheme ('BBLS') and Recovery Loan Scheme ('RLS'). These reliefs have resulted in significant increases in cash balances held in the sector, which makes long-term prospects more difficult to gauge.

During the period the Group has continued to enhance operational functionality in this area, developing technological solutions and investing in systems, particularly focussing on administration systems for SME lending and development finance. These enhancements should provide benefits for both customer service and in the procuration processes, enabling potential customers or their brokers to access appropriate finance solutions more easily and efficiently, while providing the Group with the information needed to support increasingly technologically advanced decision-making and the adoption of an IRB capital model for this business.

The division continues to develop its approach to green financing, where funding can be deployed in support of more climate conscious business activities, such as supporting local authorities in replacing refuse collection fleets with greener vehicles. Work is also in progress to classify the environmental impacts of lending in accordance with the UK's Green Taxonomy, although the Group's lending conncected to 'brown' industries (those with a high environmental impact) has already been assessed as low.

Commercial Lending activity

The Commercial Lending segment saw a 22.9% increase in new business during the year following the 18.3% reduction in 2020. Development finance continued its growth trajectory while SME lending also grew, particularly in its longer term asset finance product lines. Motor finance operated at a reduced level through the early part of the year, but returned strongly to the market in the spring.

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.

	2021	2020
	£m	£m
Development finance	**510.4**	385.3
SME lending	**336.9**	288.0
Structured lending	**24.0**	7.6
Motor finance	**100.2**	109.9
	971.5	790.8

The impact of this new business has been to increase the Group's overall Commercial Lending exposure by 3.6% in the year to £1,568.8 million (2020: £1,514.8 million).

Development finance

The continuing growth of the Group's development finance business saw it reach the milestone of £1.5 billion of total lending over the last three years, with 13,000 new homes financed in that time. Enhancements to the product range and the expansion of the relationship team continued thoughout the current year, which alongside an active market, helped drive volumes higher.

The Group's target customer is a small to medium-sized developer of UK residential property. Projects currently in progress have an average development value of £7.8 million against which the Group has extended average facilities of £5.0 million, giving a substantial level of security cover. These projects are generally focussed on the more liquid parts of the residential market (houses and smaller blocks of flats), avoiding developments with high unit values.

The development finance business remained robust throughout the period, although Covid-related restrictions and supply chain issues meant that many projects progressed more slowly than they might have done in normal times, especially in the first half of the year. This, however created an element of pent-up demand moving into the second half with advances, pipeline and enquiries strengthening as the year progressed. Market sentiment appears positive with developers generally optimistic about the future, despite the short-term supply issues.

While the business has been historically concentrated in the English Home Counties, with 63.6% of balances at the year end located in London and the South East (2020: 67.0%), the Group's strategic objective is to lend more widely across the UK. Central London property hot-spots have generally been avoided with approximately 4% of the balance located in this area.

During the year the product range was expanded to include finance for projects in the £0.4 million to £1.0 million range, widening its potential market to include smaller, growing developers as they expand their businesses as well as expanding options for existing customers. It also reintroduced lending of up to 70% of total development value, suspended in response to the pandemic, for the highest quality propositions. Together these will expand the range of projects the business is able to consider.

Following the end of the year, the business launched a Green Homes Initiative to promote the development of energy efficient properties, by halving exit fees if EPC ratings of A are achieved on 80% or more of units within a development, incentivising developers to meet the demand for greener properties and to support the UK's net zero target.

The Group's customers have remained resilient through the Covid pandemic with delays minimised and completed projects being taken to market. To safeguard its investments, the Group engages independent monitoring surveyors to review progress and costs on a regular basis through the build phase of each project.

The volume of new proposals being received increased steadily during the second half of the year, with the increased amounts of undrawn approvals, at record levels at the year end, providing a springboard for the beginning of the new financial year. Undrawn amounts on live facilities at 30 September 2021 at £500.4 million were 31.4% higher than at the previous year end (2020: £380.9 million) while the post-offer pipeline of £298.6 million was 74.1% higher (2020: £171.5 million).

During the year, the business invested in both people and systems, while increasing its national and regional coverage with the recruitment of experienced specialist relationship directors and portfolio managers. These initiatives will support the further growth and broadening of the business going forward.

The Group has also made progress on the development of an IRB capital model for this business, which should reduce the cost of capital in the longer term, as well as enhancing capital discipline.

The performance of the development finance business through the pandemic has demonstrated the attractiveness of the proposition going forward. The demand for new housing in the UK shows no sign of reducing and smaller developers, who have historically struggled with credit availability, will be needed if the country's needs are to be met. Sentiment in the market looks positive entering the new financial year and the Group's business model, its investment in systems and people and the developments in its product range mean it is well-placed to support the aspirations of its developer customers and to help support housing provision across the UK.

SME lending

The SME lending business continued to perform well in the face of Covid-related constraints throughout the financial year, although certain business lines were particularly affected by either reduced economic activity, logistical difficulties in equipment sourcing, payment deferrals reducing the need for finance or the availability of cost-effective CBILS and BBLS funding. Lending strengthened considerably in the second half of the year, with the growth in longer term asset backed lending particularly encouraging for income.

Research carried out for the Group during the second half of the year suggested that 92% of UK SMEs were confident about their ability to bounce back from Covid, while 22% had already seen their turnover return to pre-Covid levels. Cash flow was identified as the principal issue for most SMEs, with UK Government support accessed by the majority. Levels of available cash remained the principal concern for SMEs looking forward.

This confidence in the sector led to a 17.0% growth In the Group's SME lending advances in the year, although the performance varied across product types. Generally all lines reported a stronger second half, with the economy opening up and business confidence beginning to increase.

In the division's core asset leasing business volumes increased by 19.3% to £198.2 million, excluding government-backed balances (2020: £166.1 million), with business levels strengthening towards the end of the period. This reflects the performance of the asset finance market in general, with the Finance and Leasing Association ('FLA') reporting depressed volumes through the winter months and business picking up through the summer. Investment in operating leases has also continued with £13.0 million of assets acquired in the period (2020: £12.9 million).

The Group continued to advance loans under the UK Government-sponsored British Business Bank's CBILS and BBLS programmes to support SMEs potentially affected by the Covid pandemic, until those schemes closed for new applications in March 2021. The Group has been authorised to take part in the follow-on RLS programme and began lending under this scheme in the second half of the year. RLS loans have the benefit of an 80% government guarantee (after the proceeds of any business assets are applied for leasing balances), but unlike CBILS lending, customers will be required to meet interest payments from the outset of the loan.

The existing RLS scheme closes for new offers from 31 December 2021 and will be replaced by a scheme with a 70% government guarantee. The Group expects to use these schemes to provide support to SME customers until 30 June 2022, the currently expected end date of the schemes. The Group's lending in this area has been primarily focussed on its existing customers, and the majority of both BBILS and RLS lending has been on asset-secured products.

During the year £64.2 million was advanced under schemes backed by a government guarantee (2020: £25.9 million), of which £50.4 million was asset leasing business. The Group continues to closely monitor the portfolio for any adverse indications, particularly at the point at which customers, rather than the Government, are expected to commence payments.

Short-term lending to professional services firms outside the government supported schemes fell by 21.6% to £62.0 million (2020: £79.1 million). Despite this fall in volumes, this represents a recovery in the second half of the year following twelve months of very low volumes during the pandemic. This resulted from both the deferral of tax balances, where customers had typically taken out short term loans to spread the impact, and of the wide availability of cheap CBILS and BBLS lending in the market. The second half of the year saw the impact of these factors diminishing and lending moving back towards pre-Covid levels with the underlying requirement for finance remaining for the longer term.

The Group has continued to invest in system improvements to create efficiency gains in this business throughout the year despite the pandemic. Enhancements to the new lending process were rolled out in April, offering improvements for customers and brokers including the launch of a new finance broker portal, providing enhanced functionality, in response to extensive research amongst the broker community.

The finance broker portal, which provides significant benefits in terms of process automation and response speed was rolled out to a larger population following the year end and the reengineering programme will continue into the new financial year, enhancing controls, operational agility and the customer experience.

With the FLA quarterly industry outlook survey showing 90% of providers expecting new business growth in the next twelve months, growing confidence in the customer base, a strengthening new business pipeline and system developments, the Group is optimistic for the future prospects for the business.

Structured lending

The Group's structured lending exposure has seen an increased level of activity in the year, with several new facilities agreed, diversifying the business' exposures, and the overall balance increasing.

Structured lending facilities generally fund non-bank lenders of various kinds providing the Group with increased product diversification. The facilities are constructed to provide a buffer for the Group in the event of default in the ultimate customer population. The Group's experienced account managers have received regular reporting on the performance of the security assets and they maintained a high level of contact with the Group's customers throughout the Covid crisis to safeguard its position.

The Group has a number of well-progressed additional facilities in the pipeline, with an expectation of more drawings in the new financial year. These include new asset classes, spreading the risk inherent in such lending. The Group continues to actively seek new opportunities in this field, with a particular interest in facilities linked to green initiatives.

Motor finance

The Group's motor finance business is a focussed operation targeting propositions which are not addressed by mass-market lenders, including specialist makes and vehicle types, such as light commercial vehicles, motorhomes and caravans.

During the first part of the year the Group operated tighter lending criteria and temporarily diverted resources from the new business teams in the area to support the wider Group's customer servicing requirements through the pandemic, including the provision of payment reliefs. In the second half the Group relaunched its proposition with a renewed focus as dealerships began to open and market activity increased.

Following the year end the operation extended its lending criteria to include battery electric cars for the first time, following consultation with dealers and brokers. This will help to support the UK's move away from petrol and diesel powered vehicles.

The Group's advances in the year reflect this operational strategy, with £100.2 million of completions in the year, a broadly similar level to the £109.9 million achieved in 2020. However, this represents a significant post-Covid recovery with £71.4 million of advances in the second half of the year, compared to £28.8 million in the first half and £35.1 million in the second half of 2020. This returns completions to the level seen in the first half of 2020, before the outbreak when advances of £74.8 million were made.

This Group's performance follows the trajectory of the wider motor finance market, with the FLA reporting falling volumes until February 2021, before a recovery began to take hold in March.

Performance

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

	2021	2020
	£m	£m
Asset leasing	**468.7**	478.0
Professions finance	**33.1**	22.3
CBILS, BBLS and RLS	**83.8**	25.2
Invoice finance	**20.9**	13.5
Unsecured business lending	**10.3**	15.0
Total SME lending	**616.8**	554.0
Development finance	**608.2**	609.0
Structured lending	**118.9**	94.9
Motor finance	**224.9**	256.9
	1,568.8	1,514.8

Credit quality in the development finance book has been good, and the overall performance of the projects has been in line with expectations, with the pandemic having no significant impact on the disposal of completed developments. Accounts are regularly monitored and graded on a case-by-case basis by the Credit Risk function. At 30 September 2021 only one account had been identified as at risk of loss, a long standing legacy case. While the impact of Covid on development finance projects has been limited to issues relating to the progress of some projects, rather than credit concerns, the Group recognises the potential impact of increased economic uncertainty and execution risk on its portfolio.

The average loan to gross development value for the portfolio at the year end, a measure of security cover, was 61.7% (2020: 63.1%), which gives the Group a substantial buffer if any project encounters problems. No new serious credit issues arose during the financial year and a number of problem cases identified in prior periods were resolved.

Credit performance in the division's finance leasing portfolios generally remains relatively stable, with arrears in asset leasing at 0.27% and motor finance at 2.30% (2020: 1.75% and 1.76% respectively), however there have been a small number of cases where serious credit issues have been identified and the sector is expected to display more volatile credit performance as government support initiatives unwind.

Of the division's live motor finance accounts at 30 September 2021, 1,507 cases (9.5%) had been granted payment holidays during the course of the pandemic with 312 (2.0% of cases) of those holidays extended. None of these payment holidays remained in place at the year end.

In SME lending 2,570 of the live accounts at 30 September 2021 had been granted payment holidays with 316 of those extended, of which 28 remained in place at the year end.

The majority of CBILS and BBLS lending remained in its initial twelve-month period where interest payments were met by the UK Government throughout the financial year. Payments from customers began to fall due in the second half of the financial year on a limited number of accounts in the first tranches of lending, and the Group has appropriate systems, processes and resource in place to deal with any issues as they arise. Of the guaranteed portfolio, £5.0 million (2020: £4.6 million) comprises fully guaranteed BBLS loans.

With the exception of a small number of irregularly submitted applications, where claims have been submitted under the guarantee scheme, the Group has yet to encounter any serious credit issues with its CBILS and BBLS portfolios. Any emerging payment behaviours will be kept under close scrutiny.

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 in line with expectations, with generally improved metrics across the book and only one loan remaining in IFRS 9 Stage 2 at the year end.

Outlook

The Group's Commercial Lending division has emerged from Covid well placed for future growth. Work to develop products, systems and services has been ongoing throughout the pandemic and the year ended with increased pipelines and building momentum.

With sentiment largely positive in the division's customer base, and new, green product ranges launched in the new year, the Group is optimistic for its prospects in the Commercial Lending space.

A4.1.3 Idem Capital

The Idem Capital segment contains the Group's acquired loan portfolios, together with its pre-2010 legacy consumer accounts. These include mostly second charge and unsecured consumer loans. The division's success rests on understanding assets, strong analytics, advanced servicing capabilities and the efficient use of funding.

When considering portfolios for acquisition the Group currently focusses on specialist loan portfolios which might augment its own organic origination activities. This model is essentially opportunistic and the flow of appropriate opportunities to the market is both limited and sporadic, even in a normal economic environment.

The Group carefully considers the capital requirements for any potential acquisition, particularly where the asset types offered require relatively large amounts of regulatory capital to be held. It also evaluates the potential for conduct risk issues to arise in portfolios which may contain more vulnerable customers. The Group will only pursue transactions where it considers that its wider capabilities in specialist administration and funding can provide a real benefit and where the projected return is attractive in comparison to the other opportunities for the deployment of its capital.

The Idem Capital back book includes consumer lending portfolios where customers may have historically rescheduled their debt repayments and its processes aim to generate fair outcomes for all customers, recognising any vulnerabilities. This aim has formed a principal focus in the Group's response to Covid in respect of such customers.

New business

Although the UK loan portfolio market remained active in the period, the impact of Covid continued to depress activity levels, and complicated the pricing and execution of potential deals, discouraging vendors from coming to market.

During the period, no portfolio acquisitions were completed (2020: none) although the division undertook a limited number of reviews of opportunities that were ultimately not progressed.

The main focus of the business in the year was the careful management of its existing books and ensuring that appropriate processes and systems are in place to address the Covid outbreak with customers, many of whom were already identified as vulnerable or who had developed vulnerabilities as a result of the ongoing pandemic.

Performance

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

	2021	2020
	£m	£m
Second charge mortgage loans	**133.6**	171.9
Unsecured consumer loans	**87.2**	109.7
Motor finance	**4.3**	15.5
	225.2	297.1

Balances in the segment have continued to decline as outstanding amounts are collected on existing portfolios, with no additions in the period. Cash flows remained strong across all books, despite the on-going effects of Covid on consumers. This level of collections resulted in, the 120 month Estimated Remaining Collections ('ERC'), a measure of future expected cash flows, on acquired consumer assets falling to £245.2 million at 30 September 2021 (2020: £313.7 million).

Arrears on the segment's secured lending business have risen to 24.3% (2020: 18.8%). These arrears levels remain higher than the average for the sector, but this reflects the seasoning of the balances, while the continuing upward trend reflects the redemption of performing accounts. This book contains a significant number of accounts which are currently making full monthly payments but had missed payments at some point in the past, inflating the arrears rate. Average arrears for secured lending of 8.6% at 30 September 2021 were reported by the FLA (2019: 8.4%).

Of the division's live secured lending accounts at 30 September 2021, 1,270 cases (14.1%) had been granted payment holidays during the course of the pandemic with 578 (6.4% of cases) of those holidays extended. In the motor finance portfolio 463 live cases (15.6%) had received a payment holiday with 136 (4.6%) having been extended. No payment holidays remained in place at the year end.

None of the live Idem Capital loan portfolios were regarded as materially underperforming at the year end, with cash generation continuing to hold up. The Group monitors actual cash receipts from acquired portfolios against those forecast in the pre-purchase evaluation of the portfolio. Up to 30 September 2021 these collections were 109.8% of those forecast to that point (2020: 109.8%).

The Group continues to invest in systems and people to ensure that Idem Capital customers receive an efficient and effective service which delivers fair outcomes. Given the nature of the books, particular attention is given to providing training, and establishing processes to ensure that vulnerable customers are identified, and their needs are addressed

Outlook

The Group's strategy for the Idem Capital business is to consider only those opportunities which would enhance its overall positioning, provide attractive returns and represent a productive use of capital. These will be essentially opportunistic, and there is no volume target.

In the meantime, the division will continue to focus on its commitment to providing appropriate outcomes for its existing customers as it has done throughout the Covid pandemic and ensuring any vulnerability issues are carefully addressed.

A4.2 Funding

The Group is principally funded by retail deposits but also accesses a variety of other funding sources. This maintains an adaptable and sustainable funding position as the business and its operating environment develop. The Group is therefore able to access cost-effective funding despite issues in any particular funding market, as well as raising funding for strategic initiatives on a timely basis.

Throughout the period the Group raised the majority of its new funding through the retail deposit market, where demand for deposit products has remained strong, with consumers trending towards saving rather than spending in the year, either through increased prudence or merely through the reduction in 'big-ticket' spending opportunities caused by lockdowns and other Covid-related measures. It has also continued to draw on the Bank of England TFSME scheme to support its lending to SME customers.

The Group's funding at 30 September 2021 is summarised as follows:

	2021	2020	2019
	£m	£m	£m
Retail deposit balances	**9,300.4**	7,856.6	6,391.9
Securitised and warehouse funding	**1,246.0**	3,928.3	5,206.9
Central bank facilities	**2,819.0**	1,854.4	994.4
Tier 2 and retail bonds	**386.1**	446.6	446.1
Total on balance sheet funding	**13,751.5**	14,085.9	13,039.3
Off balance sheet central bank facilities	**-**	-	109.0
Other off balance sheet liquidity facilities	**150.0**	150.0	-
	13,901.5	14,235.9	13,148.3

The Group's retail deposit balance grew by 18.4% in the year to £9,300.4 million (2020: £7,856.6 million), representing over two thirds (67.6%) of balance sheet funding (2020: 55.8%), with wholesale borrowings continuing to reduce over the year.

At 30 September 2021 the proportion of easy access deposits, which are repayable on demand, was 24.1% of total on-balance sheet funding (2020: 16.8%). This increase is partly a result of market sentiment with savers reluctant to commit funds to term deposits in a low rate environment, and partly as a result of the Group's maturing liquidity policy. This percentage remains low compared to the rest of the banking sector and can be expected to rise going forward.

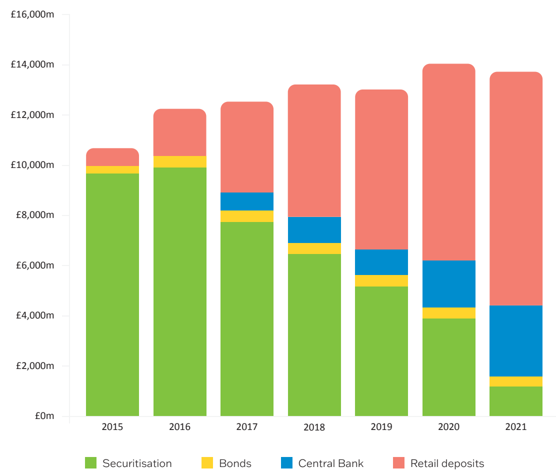
With the generally uncertain economic outlook, the Group has maintained a cautious approach to liquidity in the period. Some loosening of policy took place in the period in response to the gradual opening up of the UK economy, but at the end of the year the Group still had £1,236.5 million of cash available for liquidity and other purposes (2020: £1,701.1 million). The Group's contingent liquidity policy will be kept under review as the ultimate outcome of the Covid crisis becomes clearer and longer-term trends become more evident, but the Group intends to maintain a conservative approach.

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, using 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

(30 September 2015 - 2021)



The Group's response to the withdrawal of the London Interbank Offered Rate ('LIBOR'), due at the end of the calendar year, is well progressed. While the London Interbank Offered Rate ('LIBOR') had been the principal benchmark rate used by the Group, a transition to other, risk-free rates, notably rates linked to the Sterling Overnight Index Average ('SONIA'), has been ongoing for more than two years.

No new LIBOR-linked derivative contracts have been entered into since February 2020 and remaining LIBOR-linked derivatives will transition to SONIA in accordance with the International Swaps and Derivatives Association ('ISDA') protocol. Meanwhile, all the Group's LIBOR-linked borrowings have either been retired, transitioned or have an agreed transition process in place.

A transition process for the Group's principal LIBOR-linked asset class, legacy buy-to-let mortgages, was communicated to customers and completed in the second half of the year. Other LIBOR-linked assets have either been transitioned, have an agreed transition methodology or are expected to fall due before the LIBOR transition date. Overall, the Group considers that it is well placed to meet the withdrawal deadline of 31 December 2021.

A4.2.1 Retail funding

The Group considers the retail deposit market to be a reliable, scalable and cost-effective source of funding, which has remained fully functional throughout the Covid crisis. The Group's offering has been centred on sterling household deposits, although it began to access the SME sterling deposit market in the year.

A variety of products are offered, including term deposits, ISAs and easy access accounts and the business accesses the market through a variety of in-house and external channels. 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').

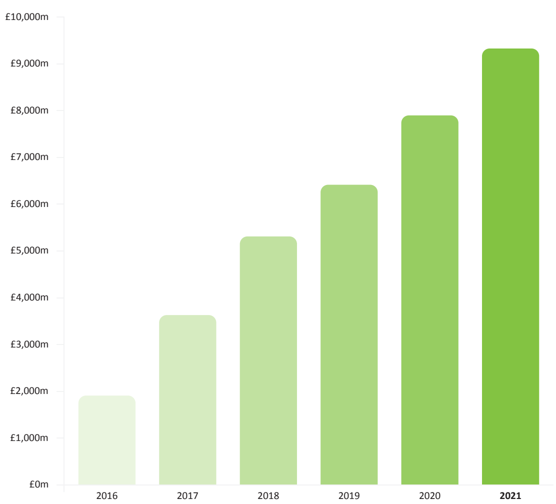
The retail deposit market in the UK is large, deep and well developed. During the year UK household savings balances reported by the Bank of England continued to increase with balances at 30 September 2021 reaching £1,402.5 billion (2020: £1,287.9 billion), an increase of 8.9% in the year. This has resulted from increased saving by consumers during the pandemic and has also depressed market interest rates. Some of this increase may be reversed as the UK economy returns to a more normal footing, but as a small participant the Group is less likely to be affected by this than larger banks and building societies.

The Group's retail deposit franchise has continued to perform strongly in the year with a reduced funding cost, reflecting improvements in the business process, increased channels to market and downward market pressures on rates.

The growth of the retail funding balance over recent years is set out below.

Retail deposits

(At 30 September 2016 - 2021)



Savings accounts at the financial year end are analysed below.

	Average interest rate		Proportion of deposits	
	2021	2020	**2021**	2020
	%	%	**%**	%
Fixed rate deposits	**1.25%**	1.69%	**58.8%**	63.3%
Variable rate deposits	**0.42%**	0.72%	**41.2%**	36.7%
All balances	**0.91%**	1.34%	**100.0%**	100.0%

The average initial term of fixed rate deposits was 26 months (2020: 27 months). Market savings rates in the year have remained at historically low levels, with the Bank of England quoting average interest rates at 30 September 2021 for new 2-year fixed rate deposits at 0.46% (2020: 0.48%) and for instant access balances at 0.10% (2020: 0.07%).

During the year the Group has grown its business both through a focus on its in-house channel and through expanding its offering across other third party platforms. Significant infrastructure investment in the Group's new Mambu platform has enabled the number of external channels where the Group has a presence to be expanded while embedding a strong control environment, providing an effective and efficient service and offering future digital optionality.

Offerings through these channels, which include investment platforms and savings marketplaces operated by digital banks, provide access to a different customer demographic to the Group's mainstream customers. This more diversified sourcing offers enhanced opportunities to manage inflows and costs. The Group has added three new relationships in the period, including one with Aviva Savings, bringing the total to seven. These channels now represent around 12% of the total deposit base and the system investment in the year gives the Group capacity to expand further in this area.

The Group regards the quality of its customer service as a vital component of its savings market strategy and conducts insight surveys throughout the customer journey. In this research 88% of customers opening a savings account with the Group in the year who provided data, stated that they would 'probably' or 'definitely' take a second product (2020: 88%). The NPS in the same survey was +58, similar to that in the previous year (2020: +61).

When customers with maturing savings balances in the year were surveyed, 89% stated that they would 'probably' or 'definitely' consider taking out a replacement product with the Group (2020: 90%) with an NPS at maturity of +52, slightly increased from the 2020 financial year (2020: +50).

These positive responses demonstrate the quality of the Group's customer interaction operations, which support its efforts to retain customers and deposits in the current active and competitive market. This has been enhanced in the year with additional functionality on the Group's website, such as automated password resets, introduced in response to customer feedback.

This level of customer satisfaction is also demonstrated by the Group's continuing success in industry awards. During the year awards won included 'Best Internet Account Provider' at the 2021 Moneyfacts Awards, 'Best Cash ISA Provider' at the 2021 YourMoney awards, 'ISA Provider of the Year' at the 2020 MoneyAge awards, 'Best Notice Savings Provider' at the 2021 Moneynet awards, 'Best Easy Access Savings Provider' and 'Best Easy Access Cash ISA Provider' in the MoneyComms 2021 Top Performers list and 'Best Cash ISA Provider' in the 2021 Savings Champion Awards.

Both aspects of the Group's savings infrastructure, its outsourced deposit administration system and its infrastructure supporting external savings platforms, continue to provide a solid and scalable operating model for the business. Service standards and customer satisfaction have been maintained despite the effects of ongoing Covid restrictions, and servicing resources have continued to develop with the business.

The retail deposit funding stream provides a stable principal funding base for the Group's operations where volumes and rates can be effectively and flexibly managed. The operation will continue to develop on a strategic basis, expanding its offerings, addressing wider demographics and expanding its presence on third party platforms.

This 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.

A4.2.2 Central bank facilities

The Bank of England Term Funding scheme for SMEs ('TFSME') continued to be available throughout the year to support lenders in providing credit to SME customers through the Covid pandemic. The Group has continued to draw on these funds to support its lending, particularly in its SME lending and development finance businesses.

During the year the Group's drawings under TFSME increased to £2,750.0 million (2020: £910.0 million). As TFSME provides funding at or very close to base rate, it is a particularly cost-effective form of borrowing for lenders which, like the Group, wish to support their SME customers through the economic uncertainties of the pandemic. Shortly after the year end the Group repaid and redrew all of its TFSME borrowings, extending the maturities.

Drawings under the Bank of England's original Term Funding Scheme ('TFS') which were due to mature in the current financial year began to be retired early during the period, improving the maturity profile of the Group's borrowings. At 30 September 2021 the remaining TFS borrowings provide £69.0 million of the Group's funding (2020: £944.4 million), but will be repaid in the early part of the new financial year. The Group retains access to other Bank of England funding channels but did not utilise them in the year.

The Group expects to continue to make use of these 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 of up to £1,424.2 million (2020: £684.0 million).

A4.2.3 Wholesale funding

The Group's wholesale funding includes securitisation funding, warehouse bank debt and retail and Tier 2 corporate bonds, which are each accessed from time to time as appropriate. The Group's Long-Term Issuer Default Rating was affirmed at BBB by Fitch in March 2021, with the outlook upgraded from negative to stable, reversing the change which was applied to all the major UK banks during 2020 as a result of the Covid crisis.

During the year capital markets remained active, with activity in most areas of funding. The securitisation markets remained open, but with most volume driven by those lenders without access to central bank facilities.

Wholesale pricing has been attractive for issuers, with strong demand for new issuance. Against this backdrop the Group issued a £150.0 million Tier-2 Green Bond in March 2021. This was the first issuance certified under the Group's Green Bond Framework, approved in March 2021, which sets out how the proceeds of the bond will be applied, and which is available on the Group's website at www.paragonbankinggroup.co.uk.

The new bond carries an interest rate of 4.375%, fixed for five years, and will count in full towards tier 2 capital for a five year period. It was rated BB+ by Fitch on issue. This interest rate represents a considerable saving on the Group's previous Tier 2 bond, issued in 2016, which bore interest at 7.25% per annum.

The majority of the Group's £150.0 million 2016 Tier-2 Bond was acquired by the Group in a tender process during March 2021. The remainder was redeemed at the call date in September 2021.

These bond transactions reduce overall funding costs and place the Group's tier 2 capital position on a longer-term footing, as well as accessing the green bond market.

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 held internally rather than issued in the market.

The Group's four mature legacy securitisation transactions were refinanced during the period. An agreement was also reached in the period to transition the only other LIBOR-linked deal, Paragon Mortgages (No. 25) PLC, from its interest payment date in February 2022. These transactions benefit the Group's overall long-term funding position by releasing cash collateral; removing LIBOR-linked liabilities ahead of transition; crystallising derivative positions, thereby reducing the Group's TRE for capital purposes; and releasing loan assets for use in creating eligible securities which can be used to access TFSME and other forms of funding.

A fully-retained securitisation transaction, Paragon Mortgages (No. 28) PLC was completed in the year. In this transaction £703.1 million of rated notes were issued to group companies, to be used as collateral in other funding transactions, such as TFSME. This repeats the structure of Paragon Mortgages (No. 27) PLC, issued in 2020.

The Group renegotiated its £400.0 million warehouse funding facility during the period reducing the interest margin from 1.05% above LIBOR to 0.60% above LIBOR. This facility is used to provide standby capability, particularly in the event of market disruption elsewhere, where funds need to be deployed rapidly or as an alternative to retail deposit funding for liquidity purposes. After the year end this facility was extended to £450.0 million and the interest rate was transitioned to 0.50% over SONIA. These changes will make this funding more cost effective and practical going forward.

The Group's retail bond issued in 2013 was repaid at maturity in December 2020. The Group also entered into sale and repurchase transactions from time to time, to ensure it retains access to this channel for liquidity purposes.

Overall, these initiatives reduced the Group's dependency on legacy securitisation debt, lowered funding costs, facilitated LIBOR transition, and increased average remaining maturities for its other borrowings. This demonstrates the adaptability of the Group's wholesale funding activities and the Group will continue to access all these funding sources on a strategic and opportunistic basis as appropriate.

A4.2.4 Funding outlook

The year has seen growth in the Group's savings franchise, while the tenor of its wholesale and central bank borrowings has been extended, with the average cost of funding reduced and the green finance market accessed for the first time.

This has been consistent with the Group's funding strategy developing and enhancing its access to 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 notes 26 to 31.

A4.3 Capital

The Group's capital policy is designed to provide appropriate returns to shareholders, preserve the strength of its balance sheet, maintain strong regulatory capital and liquidity positions to safeguard its depositors and to ensure sufficient capital is available to meet strategic objectives and opportunities going forward. The safeguarding of this capital strength has been a fundamental objective of the Group's ongoing Covid response.

This enabled the Group to return to a more normal approach to capital and distributions in the year ended 30 September 2021, with an interim dividend declared and share buy-backs undertaken. The Group's position was also enhanced by a favourable result from the most recent regulatory review of its capital position, which reduced its requirement to hold regulatory capital.

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 2021 Annual General Meeting ('AGM'), which will be proposed for renewal at the 2022 meeting.

A4.3.1 Regulatory capital

The Group continued to maintain strong regulatory capital ratios throughout the year, with capital balances having grown as a result of its prudent approach to capital management through the Covid pandemic. During the period the Prudential Regulation Authority ('PRA') conducted a supervisory review of the Group's capital requirements, based on the Internal Capital Adequacy Assessment Process ('ICAAP') analysis. The results of this review were very positive, with the regulator significantly reducing its capital requirement based on its assessment of the Group's risk exposures and management systems.

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 will issue a Total Capital Requirement ('TCR') setting an amount of regulatory capital, defined under the international Basel III rules, currently implemented through the EU Capital Requirements Regulation and Directive regime ('CRD IV'), which was transposed to the PRA Rulebook as part of the Brexit arrangements.

The TCR includes elements determined based on the Group's total risk exposure together with fixed elements, and is held in order to safeguard depositors in the event of severe losses being incurred by the Group.

As a matter of strategy, the Group maintains strong capital and leverage ratios. It was granted transitional relief on the adoption of IFRS 9, along with most other banks, with additional relief granted in 2020 for the impact on capital of provisions created in response to the Covid pandemic.

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 Group's principal capital measures, CET1 and Total Regulatory Capital ('TRC'), are set out below on both bases.

	Regulatory basis		Fully loaded basis	
	2021	2020	**2021**	2020
	£m	£m	**£m**	£m
Capital				
CET1 capital	**1,055.8**	991.2	**1,026.1**	948.9
Total Regulatory Capital ('TRC')	**1,205.8**	1,141.2	**1,176.1**	1,098.9
Requirement				
TCR	**604.2**	749.6	**601.8**	745.3

As the value of IFRS 9 reliefs will taper over time, the difference between measures on the regulatory and fully loaded bases will narrow and eventually converge.

The Group's CET1 capital comprises its equity shareholders' funds, adjusted as required by the CRD IV rules and can be used for all capital purposes. TRC, in addition, includes tier-2 capital representing the Tier-2 Bonds. This tier-2 capital can be used to meet up to 25% of the Group's TCR. The increase in capital over the year is a result of the positive trading performance, which outweighed the impact of dividend payments and share buy-backs in the period.

The TCR is specific to the Group and is set by the regulator, based on its supervisory reviews. The reduction in TCR on both the regulatory and fully loaded bases shown above has arisen principally as a result of the successful outcome of the most recent review process.

This saw the TCR on both bases reduced to 8.9% of TRE from 10.8% of TRE at 30 September 2020, compared to the minimum TCR allowed under the Basel III framework of 8.0%. This represents a significant benefit to the Group's capital management and reflects the maturity of the Group's systems for the management of capital and risk.

CET1 capital must also cover the CRD IV buffers, the Counter-Cyclical ('CCyB') and Capital Conservation ('CCoB') buffers. These apply to all firms and are based on a percentage of total risk exposure. The CCoB remained at 2.5%, its long-term rate, throughout the year (2020: 2.5%), while the UK CCyB remained at 0.0% (2020: 0.0%), having been reduced from 1.0% during 2020 as a regulatory response to the pandemic. However, it has been stated by the Financial Policy Committee of the Bank of England that the long-term standard rate of the CCyB will be 2.0% and this requirement for additional capital in the future has been factored into the Group's capital planning.

CET1 capital required to cover CRD IV buffers therefore reduced to £170.9 million at the year end on the regulatory basis (2020: £173.7 million).

Further buffers may be set by the PRA on a firm-by-firm basis but cannot be disclosed.

The Group's capital ratios, after allowing for the proposed dividend for the year, are set out below.

	Basic		Fully loaded	
	2021	2020	**2021**	2020
CET1 ratio	**15.4%**	14.3%	**15.1%**	13.7%
Total capital ratio	**17.6%**	16.4%	**17.3%**	15.9%
UK leverage ratio	**7.5%**	7.1%	**7.3%**	6.8%

All of the Group's capital ratios show strong improvement over the period, despite the resumption of distributions to shareholders. This reflects the trading profits, including a reduction in Covid-based impairment provisions, a gain on the pension scheme liability and reductions in risk weighted asset values following the repackaging of legacy securitisations.

The Basel Committee on Banking Supervision ('BCBS') has set the implementation date for its revisions to the Basel III framework as 1 January 2023. This is, however, subject to those revisions being enacted in the relevant jurisdiction. Following the UK's exit from the EU, these rules are expected to be enacted for UK banks through the PRA Rulebook. The PRA has also launched a more extensive consultation on its approach to regulating non-systemically important banks without international activities. The Group is monitoring these developments and will respond through its capital planning as appropriate.

The Group submitted the second stage of its application for the accreditation of its IRB approach to buy-to-let credit risk for capital adequacy purposes to the PRA in March 2021. The project continues to progress to plan, and work continues into the new financial year on both the buy-to-let portfolio and development finance lending, which represents the next step in the Group's IRB roadmap.

A4.3.2 Liquidity

It is Group policy to hold sufficient liquidity in the 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. This policy has a consequent effect on 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 165.6% compared to 173.7% during the 2020 financial year. The reduction is a liquidity policy response to the reduction in Covid-related impacts to the business and in the wider economy.

The NSFR is a longer-term measure of liquidity with a one year horizon, supporting the management of balance sheet maturities. At 30 September 2021 the Bank's NSFR stood at 119.6% (30 September 2020: 114.7%), reflecting the strengthening of the overall funding and capital position over the year.

A4.3.3 Dividends and distribution policy

The Group's distribution policy over recent years has been based on the objective of enhancing shareholder returns on a sustainable basis, while protecting the capital base. In order to achieve this, its stated policy has been to distribute 40% of consolidated 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.

The Group managed its capital cautiously through the pandemic and accumulated a capital and cash surplus over its requirements, including its regulatory requirements, to the level that it was considered appropriate to resume distributions to its shareholders, both in the form of dividends, and in a share buy-back, addressing the needs of different investor groups.

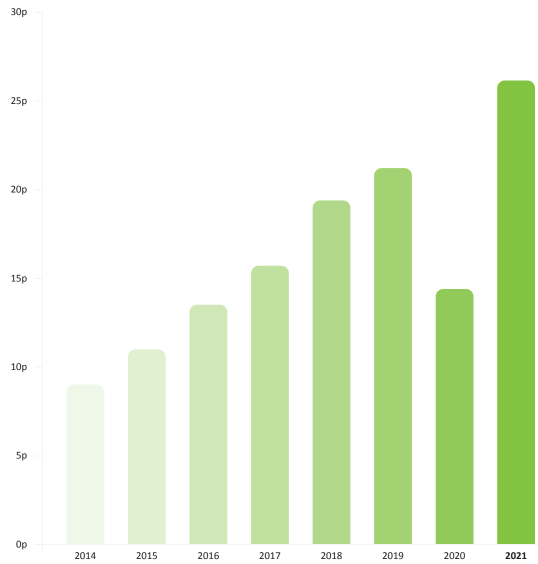
An interim dividend for the year of 7.2 pence per share (2020: nil pence per share) was paid in July 2021 and the Board is proposing, subject to approval at the AGM on 2 March 2022, a final dividend for the year of 18.9 pence per share (2020: 14.4 pence per share). This would give a total dividend of 26.1 pence per share (2020: 14.4 pence per share). This dividend would be in line with the stated policy, giving a dividend cover of 2.50 times (2020: 2.50 times).

The 81.3% increase in total dividend from 2021 reflects the increase in group earnings, including the impact of Covid-related impairment provisions made in 2020 reversing in the current year, which effectively deferred dividend to 2021. The 2021 dividend is also inflated by the high level of fair value gains in the year, which would not necessarily be repeated in a future year. Care must therefore be taken in extrapolating future dividend levels from the current year dividend alone.

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

Dividend for the year

(In respect of the years 2014 - 2021)



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

In addition, the Board authorised a buy-back of up to £40.0 million of shares in the market, initially to be held in treasury. The Group has the authority to make such purchases under a resolution approved by shareholders at the AGM in February 2021. £37.5 million (excluding costs) was expended during the year on the buy-back programme, and it is the Board's intention to complete the programme following the announcement of the annual results.

As part of its review of the Group's capital and dividend policy following the completion of its annual results and the financial forecasts for the coming period, the Board concluded that a further buy-back programme of up to £50.0 million, initially to be held in treasury, was appropriate, and this will commence following the completion of the initial £40.0 million. In this way, the Group seeks to balance the expectations of different investor groups, while maintaining a strong capital position.

Any purchases made under these programme will be announced through the Regulatory News Service ('RNS') of the London Stock Exchange on the day of the transaction.

The Board has affirmed the existing dividend policy going forward, subject to an assessment of prevailing conditions at the time, but noted that, given the unusual factors affecting the 2021 distribution, any interim dividend declared for 2022 would not necessarily bear the normal relation to the preceding final distribution.

A4.3.4 Capital outlook

The Group's current and forecast capital position is kept under regular review, in light of the level and form of capital demanded by current business, regulatory and economic conditions, as well as the Group's strategic objectives.

The capital and liquidity position of the Group had strengthened through the year. The Group's operations increased the capital balance, the Tier-2 issuance has been replaced at a lower cost and the positive result of the regulatory review of the Group's capital management systems has resulted in a lowering of the minimum capital requirement.

The Group ends the year well capitalised, even after the resumption of distributions to shareholders in the form of dividends and buy-backs, and allowing for the return of CCyB requirements and withdrawal of IFRS 9 reliefs in the longer term. This position is both prudent and sustainable and helps ensure the viability of the business for the benefit of all stakeholders.

A4.4 Financial results

The Group's trading performance before impairment charges in the year ended 30 September 2021 highlights the level of progress towards its strategic objectives, in spite of the impact of the Covid pandemic on the UK economy and the necessary steps taken to address this. Income and margins both increased, generally in line with expectations.

As the UK economy began to open up towards the end of the year, and the level of the effectiveness of the UK's vaccination programme became evident, the assumptions underlying the Group's impairment provisioning were revisited, resulting in a release of provision. However the Group remains well provided in the face of what remains an uncertain economic outlook.

These factors leave the Group's results significantly improved, year-on-year, with underlying profit (Appendix A) for the year, at £194.2 million, 61.8% higher than for the preceding twelve months (2020: £120.0 million), with a provision release of £4.7 million (2020: charge of £48.3 million), unwinding some of the previous year's Covid-related impacts. On the statutory basis, which also includes the impact of fair value gains on hedging, profit before tax increased 80.5% to £213.7 million, the largest pre-tax profit the Group has ever recorded (2020: £118.4 million).

Earnings per share increased by 81.1% to 65.2 pence (2020: 36.0 pence) on the statutory basis, and by 62.5% to 59.3 pence excluding the effect of the fair value gains (2020: 36.5 pence) (Appendix A).

A4.4.1 Consolidated results

Consolidated results

For the year ended 30 September 2021

	2021	2020
	£m	£m
Interest receivable	**484.2**	491.7
Interest payable and similar charges	**(173.7)**	(213.6)
Net interest income	**310.5**	278.1
Net leasing income	**3.5**	3.0
Other income	**10.9**	14.0
Total operating income	**324.9**	295.1
Operating expenses	**(135.4)**	(126.8)
Provisions for losses	**4.7**	(48.3)
	194.2	120.0
Fair value net gains / (losses)	**19.5**	(1.6)
Operating profit being profit on ordinary activities before taxation	**213.7**	118.4
Tax charge on profit on ordinary activities	**(49.2)**	(27.1)
Profit on ordinary activities after taxation	**164.5**	91.3

	2021	2020
Dividend – rate per share for the year	**26.1p**	14.4p
Basic earnings per share	**65.2p**	36.0p
Diluted earnings per share	**63.0p**	35.6p

Income

The Group's total operating income in the year increased by 10.1% to £324.9 million (2020: £295.1 million). Net interest income increased in the year by 11.7% to £310.5 million (2020: £278.1 million). Part of this increase was a result of growth in the average loan book in the year, 4.9% higher at £13,017.0 million (2020: £12,408.7 million) (Appendix B), but the business also generated a 15 basis point increase in net interest margin ('NIM') for the year.

NIM in the year ended 30 September 2021 was 239 basis points (2020: 224 basis points) (Appendix B). Each of the Group's segments showed improved NIM in the period as a result of yield management activities in the business areas, coupled with tighter funding costs.

Excluding the impact of the declining Idem Capital business, NIM increased by 19 basis points, from 209 basis points in 2020, to 228 basis points in the current year.

The progression of the Group's NIM, including and excluding the Idem Capital division, over the past five years is set out below.

	Total	Excluding Idem Capital
	Basis points	Basis points
Year ended 30 September		
2021	**239**	**228**
2020	224	209
2019	229	192
2018	219	153
2017	213	141

Other operating income was £14.4 million for the year, with the reduction from the £17.0 million reported in 2020 principally representing a reduction in income from non-core servicing contracts.

Costs

The Group's operating expenses for the year were £135.4 million, increasing by 6.8% year-on-year (2020: £126.8 million). The majority of the increase is attributable to charges for share-based payments (including related National Insurance ('NI') provision) which increased by £8.7 million, following a low charge in 2020 when Covid impacted on vesting expectations and depressed the Group's share price, on which the NI provision calculation is based.

The Group's average number of employees increased to 1,426 for the period, an increase of 2.9% over 2020 (2020: 1,385), generating an increase in non-share-based employment costs of 3.0%.

Costs unrelated to employment reduced in the year. The administration cost of the Group's outsourced savings deposits is determined by reference to the balance outstanding and increased by £0.5 million in the year, as a result of the 18.4% year-on-year growth in the Group's savings balance. These increases were offset by reductions in other areas, including travel and accommodation and office running costs, which reflect the direct impacts of the pandemic and of the associated lockdowns through much of the year.

Despite the impact of Covid, the Group has continued to invest in the development of systems to improve customer service and operational efficiency. Significant improvements were delivered to capabilities in the retail deposit business and new functionality was introduced to the SME lending business.

Much of the Group's IT systems and infrastructure development is carried out by its experienced in-house resource, and the Group has therefore tended to capitalise less software than might be seen elsewhere in the sector, with more costs being taken immediately to profit. During the period £0.7 million of software was capitalised (2020: £1.0 million).

The Group's IRB project made further progress through the period, with the second stage of the application for buy-to-let submitted in March 2021. Costs for the year include expenditure of around £1.3 million on this project, relating to both internal resources and external advice.

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

	Underlying	Idem excluded	Statutory
	%	%	%
Year ended 30 September			
2021	**41.7**	**42.8**	**41.7**
2020	43.0	44.9	43.0
2019	42.1	48.5	40.7
2018	40.6	54.2	37.8
2017	40.5	55.6	40.5

Cost: income reduced in the year as a result of income rising faster than costs, as described above.

The Group considers that the ongoing management of costs is key to the achievement of its operational strategy and seeks to enhance cost-effectiveness from efficiencies and scale, with targeted investment in people and systems. However, the costs of these investments, coupled with new business initiatives and increasing regulatory expectations mean that the achievement of a sustainably lower ratio is a longer-term goal.

Impairment provisions

The Group's Expected Credit Loss ('ECL') evaluation at the year end has resulted in a net release of impairment provision for the year of £4.7 million (2020: charge of £48.3 million). This movement arises from a careful consideration of the factors impacting the Group's loan portfolio, including the progress and impact of the Covid pandemic, both generally and on particular customers, and requires a significant exercise of judgment.

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

	(Release) / charge	Cost of risk
	£m	%
Year ended 30 September		
2021	**(4.7)**	**(0.04)**
2020	48.3	0.39
2019	8.0	0.07

The high level of provisions in 2020 arose as the initial impact of the Covid pandemic was recognised, attempting to represent a weighted average expected loss based on many plausible outcomes of significantly varying severity. This exercise was skewed by the natural asymmetry of provision for secured lending – increased stress will, on average, increase loss more than decreased stress reduces it.

The ongoing development of the pandemic since 30 September 2020 has differed, to a greater or lesser degree, from the scenarios advanced by commentators at the year end, but has generally been more benign, particularly following the rollout of the UK vaccination programme.

To date, little of the provision established at the previous year end has been utilised in writing off defaulted accounts, nor have arrears or enforcement actions generally seen significant increases. However, credit issues, some significant, have been identified with a small number of customers and the Group remains cautious on the future prospects of those loans for which provision is being carried. Support schemes from the UK Government, including furlough support to households and businesses, remain in place and, as at 30 September 2021, levels of CBILS and BBLS loans where customers have so far been required to make repayments have been low. This means that significant uncertainty as to the future behaviour of both directly and indirectly supported customers still exists.

At 30 September 2021, therefore, the Group had to consider whether sufficient hard evidence of both customer performance and a sustainable improvement in UK macro-economic conditions was available to justify a reduction in provision levels, and whether factors existed that suggested that its statistical impairment models might not be able to fully interpret current economic conditions.

Payment holidays and outcomes

The Group offered payment relief to a significant number of its customers during the initial period of the pandemic. Most of these came to an end before the previous year end on 30 September 2020, but some continued into the current financial year. By 30 September 2021, the number of the Group's customers remaining on these arrangements was minimal, with the requirement to make monthly payment arrangements back in place.

The post-relief behaviour in the Group's principal class, buy-to-let mortgages, at 31 October 2021 is summarised in the table below. This highlights, separately for accounts which did not receive payment holidays, those which received a single three month relief and those which had extended relief, the relative change between the October 2021 arrears position and the 29 February 2020, pre-Covid position.

	No relief	**Single relief only**	**Extended relief**	**Total**
	£ billion	**£ billion**	**£ billion**	**£ billion**
Balance	9.24	1.39	0.74	11.37
Proportion	81.2%	12.2%	6.6%	100.0%
% with arrears deterioration	0.3%	0.8%	5.2%	0.7%
% with arrears improvement	0.4%	0.9%	7.1%	0.9%

Whilst the overwhelming majority of accounts which had been granted relief have since returned to a fully paying status, there has been materially more arrears volatility amongst those loans where extensions were granted, both worsening and improving. This generally increased level of volatility for the portfolio has resulted in management identifying such accounts as, on the whole, riskier than average and transferring accounts with extended payment holidays from Stage 1 to Stage 2 for impairment purposes.

Performance across the books has been generally strong, with arrears metrics and loss experience broadly in line with pre-pandemic experience, while external credit measures, such as credit bureau information have also remained positive. However, due to government interventions and lender forbearance across the sector, it is unclear whether these measures are fully representative of underlying credit quality.

From the Group's customer surveys and interactions with its customers it is clear that while many customers may have taken payment reliefs for precautionary reasons, these accounts may have been able to perform due to external support. Examples of this might include tenants of buy-to-let landlords accessing furlough payments to meet rent demands and SME customers using drawings under CBILS and BBLS schemes to meet day-to-day payments. These reliefs would still have an impact at the end of the financial year, but have a limited time scale and the current level of performance may not be fully representative of the true underlying credit position.

As a result, management have maintained the approach of critically assessing the outputs of business as usual provisioning methodologies to ensure all elements of credit quality in the portfolio are adequately addressed. This approach has been taken throughout the Covid crisis and has resulted in substantial overlays to model outputs.

Multiple economic scenarios and impacts

While there is somewhat more consensus on the likely direction than at the previous year end, the setting of economic scenarios for the purposes of IFRS 9 remains complex. The broad thrust of economic data for the UK over the past six months has been positive, but this has been in a period where government interventions have continued and there is continuing uncertainty over the direction the economy will take once these begin to be withdrawn, with potentially radically different medium term outcomes.

The approach to setting economic scenarios for IFRS 9 impairment at 30 September 2021 is broadly aligned to that used at the half year. The Group has adopted a two-part approach:

- The three main scenarios, central, upside and downside, were derived as they would be at a 'normal' year end with the central scenario based on public forecasts and the upside and downside scenarios more benign or severe variants of this. This follows the general sentiment towards the UK economy, assuming a continuation of the easing of Covid restrictions and no significant impact from a new wave of infections.
- The severe scenario has been set to represent a potential negative outturn, either for the economy, for the pandemic, or for both. This is largely based on the Bank of England's stress testing scenarios, but with a less optimistic outlook on house prices, the variable which has the most significant impact on the value of the Group's ECLs. This scenario models a radically different future course for the UK, which is plausible and potentially has a very different impact on the Group's customers.

The weightings applied to each scenario have been held at those used at both 30 September 2020 and 31 March 2021, in the light of the continuing economic uncertainty described above.

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, the impairment provision at 30 September 2021 before post model adjustments ('PMA's) has been recalculated, weighting each of the central scenario and the severe scenario at 100%, with the results shown below.

	Provision before PMAs	Cover ratio
	£m	%
Weighted average	46.0	0.34%
Central scenario	33.3	0.25%
Severe scenario	86.7	0.64%

The level of provisions calculated by the Group's models are lower than might be expected, given the economic conditions. The Group has therefore considered the extent to which this is due to weaknesses in the modelling approach, and should be corrected by PMAs.

Post-model adjustments

It is important to note that the impairment model focusses principally on the impact of future economic changes on the portfolio. Where accounts are currently only being kept from defaulting by external short-term support measures they may still default when these are removed, despite an improved economic climate. The models may also fail to fully allow for longer-term damage caused to particular industries or customers' businesses by the pandemic.

It is also clear that positive movements in economic indicators such as house prices, unemployment and UK Gross Domestic Product ('GDP'), both in actual and forecast terms have had a positive impact on the modelled outputs for cases benefitting from support measures without any broader evidence of improvement in the underlying credit quality of the customer balances being available.

Therefore the Group applies PMAs, based on its experience and its understanding of current customer positions, to allow for the potential for losses in such cases not being identified by the modelling approach.

In order to size the requirement for PMAs across the loan book the Group has considered, on a portfolio-by-portfolio basis the extent to which modelled provisions diverge from long-run experience and the appropriateness of such differences given the underlying economic environment at the period end. All available external information on general customer performance was analysed and the impact of the potential take-up of government support and other reliefs was assessed. The Group also considered whether there were any issues of post-Covid scarring applying to any particular industry.

Notwithstanding this data analysis, the Group considered the potential for apparently well-performing accounts to default, for the reasons set out above, applying the market understanding and credit judgement of its experienced team. The SME lending business was a particular area of focus, given the prevalence of CBILS / BBLS funding in the customer base and the identification of potential credit issues on certain large exposures.

The PMAs generated by this process, analysed by division are set out below.

	2021	2020
	£m	£m
Mortgage Lending	**8.9**	14.0
Commercial Lending	**10.2**	5.8
Idem Capital	**0.3**	-
	19.4	19.8

These broader assessments were then allocated amongst accounts, focussing on higher risk segments, or accounts where sufficient data existed to identify any issues. Any accounts identified as being at significant risk by the PMA process were restaged appropriately.

The PMAs described above align the overall reported provision with current loss expectations, given the inherent uncertainties on a macro and micro level and based on the Group's internal monitoring of credit risk and customer contact metrics. The Group maintains a cautious approach and will require evidence as to customer behaviour once government interventions are scaled back, before moving scenario weightings to more normal levels and revising PMA methodologies so that actual emergent behaviour is reflected.

Ratios and trends

The impact of the economic scenarios adopted, together with PMAs adopted to address uncertainties over the future performance of accounts, particularly those which may have had payment relief or other government-backed support during the pandemic, has resulted in the overall provision amounts and coverage ratios set out below.

	2021	2020	2019
	£m	£m	£m
Calculated provision	**46.0**	62.0	41.9
PMAs	**19.4**	19.8	-
Total	**65.4**	81.8	41.9
Cover ratio			
Mortgage Lending	**0.30%**	0.44%	0.26%
Commercial Lending	**1.74%**	1.85%	0.73%
Idem Capital	**1.27%**	1.62%	1.12%
Total	**0.49%**	0.64%	0.34%

These ratios demonstrate the movement in the Group's overall provisioning back towards more normal levels, without yet reaching the 0.34% coverage ratio seen pre-pandemic at 30 September 2019. The extent to which coverage levels revert to these levels will depend on future performance of the UK economy and on the emergence of reliable evidence on the underlying credit quality of the Group's loan assets.

Fair value movements

The fair value movements reported in the profit and loss account are a consequence of the impact of market movements in spot and forward interest rates on valuations of derivatives held as part of the Group's hedging strategy. While all these instruments are part of economic hedging relationships, their accounting treatment can result in the recognition of substantial gains or losses, especially in periods of market fluctuation. However, the Group remains appropriately hedged.

Movements in rates in 2021 led to a gain of £19.5 million being recognised. While this is of far greater magnitude than the £1.6 million charge recognised in the year ended 30 September 2020, it is comparable in size to the charge of £15.1 million recognised during 2019. These fair value movements reflect non-cash items and revert to zero over the lives of the instruments involved. This, and the volatility of the balance, leads the Group to consistently exclude this item from its measures of underlying results.

Tax

The effective tax rate applied to the Group's profits has increased marginally from 22.9% in 2020 to 23.0% during 2021. While the standard tax rate applying to the Group remained at 19.0%, the proportion of Group profits arising in Paragon Bank and consequently attracting the banking surcharge, increased. This caused the impact of the surcharge on the effective rate to increase from 338 basis points to 454 basis points in the current year, with other timing differences representing the reconciling item to the actual charge.

The effective tax rates for both the current and preceding year have been impacted by legislation for changes in future tax rates enacted in each period, impacting on the carrying value of the Group's deferred tax assets and liabilities.

While the Group's future profitability will be affected by the increase in the basic rate of UK corporation tax to 25.0% legislated for in the year, the proposed reduction in the bank surcharge to 3.0% and the increase in the profit threshold at which it applies to £100.0 million should reduce the divergence of the Group's effective rate of tax from the standard rate.

Results

Profit before tax for the year was 80.5% higher than in 2020 at £213.7 million (2020: £118.4 million), representing the Group's highest ever annual profit. Profit after tax increased 80.2% to £164.5 million (2020: £91.3 million).

Basic earnings per share for 2021 were 65.2 pence (2020: 36.0 pence) and the diluted measure was 63.0 pence per share (2020: 35.6 pence), driven by both the increase in profit and share buy-backs in the year.

This result increased consolidated equity to £1,241.9 million (2020: £1,156.0 million), representing a tangible net asset value of £4.34 per share (2020: £3.90 per share) and a net asset value on the statutory basis of £5.03 per share (2020: £4.57 per share) (Appendix D).

A4.4.2 Assets and liabilities

Summary balance sheet

30 September 2021

	2021	2020	2019
	£m	£m	£m
Investment in customer loans			
Mortgage Lending	**11,608.7**	10,819.5	10,344.1
Commercial Lending	**1,568.8**	1,514.8	1,452.1
Idem Capital	**225.2**	297.1	389.9
	13,402.7	12,631.4	12,186.1
Derivative financial assets	**44.2**	463.3	592.4
Cash	**1,360.1**	1,925.0	1,225.4
Intangible assets	**170.5**	170.1	171.1
Other assets	**159.5**	315.7	220.5
Total assets	**15,137.0**	15,505.5	14,395.5
Equity	**1,241.9**	1,156.0	1,108.6
Retail deposits	**9,300.4**	7,856.6	6,391.9
Other borrowings	**4,451.4**	6,229.7	6,648.4
Derivative financial liabilities	**43.9**	132.4	80.5
Pension deficit	**10.3**	20.4	34.5
Other liabilities	**89.1**	110.4	131.6
Total equity and liabilities	**15,137.0**	15,505.5	14,395.5

The Group's loan portfolio grew by 6.1% during 2021, with growth in both Mortgage Lending and Commercial Lending. Balances in the Idem Capital division continued to pay down. More detail on these movements is given in Section A4.1. This increase, together with the Group's liquidity and capital policy, determines its funding requirements and hence the level of its liabilities.

Funding structure and cash resources

The Group's funding balance reduced by 2.0% during the year, despite the growth in the business, in response to the Group's cautious relaxation of the liquidity strategy put in place in response to the pandemic and the refinancing of its legacy securitisation transactions. The proportion represented by retail deposits increased to 67.6% in accordance with the Group's long-term funding strategy (2020: 55.8%). The Group's cash balance reduced by £564.9 million, partly due to a £100.1 million reduction in cash held in securitisation vehicles, following the collapse of schemes in the year, and partly due to liquidity policy. Movements in funding balances are discussed in more detail in Section A4.2.

Derivatives

The largest part of the movements in the derivative financial asset balance reflects the retirement of the Group's remaining currency denominated floating rate notes during the year and the consequent settlement of their related hedging instruments. The value of these swaps in the 2020 balance sheet was £445.3 million. These movements do not impact the Group's results.

Derivative assets used for interest rate hedging increased by £24.3 million, while derivative liabilities decreased by £88.3 million, mostly as a result of volatility in the year in market interest rate movements. These were largely offset by a £104.2 million decrease in the hedging adjustment on loans to customers, included in sundry assets above, and a £13.4 million reduction in the adjustment on retail deposits, included in sundry liabilities.

Pension obligations

The International Accounting Standard ('IAS') 19 valuation of the Group's defined benefit pension scheme deficit reduced by £10.1 million in the period. The principal factor in this reduction was the better than expected performance of the scheme assets, as world markets began to recover from losses suffered in the early stages of the pandemic. The deficit at 30 September 2021 stood at £10.3 million (2020: £20.4 million).

The Group's pension arrangements were restructured in the year to limit future exposure. However this has no impact on obligations already accrued, or their valuation.

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 deficit at 30 September 2021 was estimated at £1.0 million, a reduction of £8.7 million in the period (2020: £9.7 million), representing a 99.4% funding level (2020: 93.9%).

Other assets and liabilities

Sundry assets have decreased by £156.2 million over the year. This reduction arose principally as a result of hedging transactions where movements in swap rates generated the £104.2 million movement in fair value hedging referred to above and generated a £66.9 million decrease in Credit Support Annex ('CSA') collateral deposits as a result of the increased value of derivative liabilities.

Other movements included the recognition of a current tax liability, rather than last year's asset of £5.7 million, with payments on account in the year, based on the 2020 profit, being less than the calculated tax payable; an increase of £8.6 million in mandatory CRD deposits at the Bank of England, which are calculated based on the size of the Group's deposit base; and a £4.3 million increase in property, plant and equipment, mostly related to the recognition of a right of use ('ROU') asset in respect of the lease on the Group's new London office.

Within sundry liabilities, which reduced by £21.3 million, the reduction in the fair value adjustment of £13.4 million, as referred to above, and an £11.8 million reduction in accrued investment interest payable resulting from reduced interest rates, are offset by the £1.4 million tax creditor.

A4.4.3 Segmental results

The underlying operating profits of the three segments described in the Lending Review in Section A4.1 are detailed fully in note 2 and are summarised below.

	2021	2020
	£m	£m
Segmental profit		
Mortgage Lending	**213.8**	154.3
Commercial Lending	**75.7**	45.9
Idem Capital	**17.1**	19.6
	306.6	219.8
Unallocated central costs and other one-off items	**(112.4)**	(99.8)
	194.2	120.0

The Group's central administration and funding costs, principally the costs of service areas, establishment costs and bond interest have not been allocated.

Mortgage Lending

The Mortgage Lending division continued to perform strongly, with a strong lending performance, a reduction in the proportion of older, lower yielding assets and the Group's tighter overall funding costs combining to deliver a 15 basis point improvement in segmental NIM.

With the average mortgage book increasing by 6.0% in the year, this delivered a 15.4% increase in net interest to £219.2 million (2020: £190.0 million).

The Group's mortgage accounts continued to perform well in the year, generating a provision release of £5.9 million (2020: charge of £25.8 million). Despite this release, coverage levels remain in excess of pre-Covid levels, in response to the uncertainties still prevalent in the UK economy.

Overall these factors drove a 38.6% increase in segment profit for the year, to £213.8 million (2020: £154.3 million).

Commercial Lending

The contribution to profit of the Commercial Lending segment for the year was £75.7 million, rising by 64.9% year-on-year (2020: £45.9 million), with the improvement generated by improved NIM and a reduced provision charge.

The average loan balance increased by 3.9% in the year, but within this there were important mix changes, with the average development finance balance increasing by 9.1% and structured lending by 16.8%. Government-backed loans, where margins are low, had increased to form 5.3% of the portfolio by the year end.

The combination of these changes and tighter funding costs across the Group saw divisional NIM increase from 5.53% to 6.13%, delivering a 15.1% increase in net interest for the year to £94.5 million (2020: £82.1 million).

The impairment charge for the division reduced to £2.9 million (2020: £21.7 million).

While the majority of accounts in the segment have continued to perform satisfactorily, provisions have not yet been returned to pre-Covid levels of cover, particularly in the SME lending business. As discussed under 'Impairment' above, many SME customers will potentially have been in receipt of CBILS and BBLS funds or other government support for their business operations. It is therefore too early to conclude that the current positive performance is sustainable in the long-term as the impact of these interventions fades. At the same time a limited number of SME lending cases with serious credit issues have already been identified and appropriately provided for.

Idem Capital

The acquired Idem Capital loan portfolios continued to run off through the year, with no new transactions completed. As a result the average loan balance fell by 24.0%, following the trend of the previous year. Net interest decreased by 22.6%, to £20.2 million (2020: £26.1 million), as a consequence of this reduction.

While annualised NIM improved in the year to 7.74% (2020: 7.60%), reversing the long-term decline in NIM in this segment, this was principally a result of a Covid-related interest adjustment in 2020 which depressed the margin in that period. On an underlying basis NIM in the segment continues to move down as higher margin portfolios pay off more rapidly than lower margin secured assets.

The performance of the division's portfolios in the year has been satisfactory, with cash flows in line with expectations. As a result of this and the improving economic outlook an impairment provision write back of £1.7 million was recognised (2020: charge of £0.8 million).

Overall, these factors restricted the decline in the segment profit to 12.8%, with a contribution of £17.1 million to the Group result (2020: £19.6 million).

A4.5 Operations

Throughout the pandemic, while the Group's business has inevitably been affected by the impact of the virus on its people, customers and other stakeholders, and by the changing official guidance and levels of restrictions imposed in the UK, its priority has been to maintain business as usual, as far as possible. This has largely been achieved and has played a large part in both delivering the outstanding results for the period and in ensuring the Group is well placed to take advantage of the recovering economy.

It is still too early to say how the experiences of the pandemic will impact both the Group's business model and the way it operates in the longer term, but, with most of the Group's people returning to its offices for at least part of the week by the end of the year, the process of developing working models for the future is well in hand.

A4.5.1 Operations

The Group employs almost 1,450 people, with the majority normally based in its Solihull offices. However, from the onset of the Covid pandemic approximately 90% of employees worked from home.

As a result, the Group was able to continue to provide a full service to customers, intermediaries and other business partners throughout the various lockdowns, while at the same time continuing to develop the business and address issues arising from the pandemic, particularly in dealing with the transition of customers from payment reliefs back to normal payment profiles.

For the vast majority of employees, working from home continued until September 2021 when hybrid working pilots were introduced. New hires during the period predominantly joined the Group working from home, with technology-enabled induction and training plans providing them with the support they needed to start their new roles. All employees are now trialling flexible, hybrid ways of working.

The Group is proud that it has been able to continue to develop the business through new systems, processes and products despite the restrictions on contact, rather than simply mark time until the pandemic is concluded.

Instead, the year has seen the Group complete or progress a significant number of technological, operational and regulatory projects. While long-term projects to provide better technology for the development finance, SME lending and savings operations continued in the period, other important projects included enhancing the Group's cyber-security, developing its operational resilience capabilities, putting in place contingency plans in case of negative interest rates and preparing for the transition of LIBOR-linked customer accounts to alternative reference rates. Overall, the year saw more projects delivered than most recent comparable time periods.

The Group continues to envisage that its office hubs will remain important to ensure that its culture and identity can continue to grow, that collaboration is encouraged and that its peoples' sense of belonging is nurtured. To that end it was pleased to sign a lease during the period on a new, more energy efficient, central London base, bringing together its City-based staff, replacing two existing locations, and providing a venue to interface with stakeholders in the capital.

The Group has demonstrated agility and flexibility in how its resources have been deployed throughout the pandemic, with short-term secondments being introduced to support operational volumes resulting from initiatives such as payment holidays.

Throughout the pandemic the Group's strategy has focussed on customer outcomes, particularly for more vulnerable customers and it was very pleasing that the Group's Financial Ombudsman Service ('FOS') complaints data shows no significant increase in the period. The number of complaint cases reported to FOS in the six months ended 30 June 2021, the most recent reporting period, was 50 with an uphold rate of 34.0% while the number for the six months ended 31 December 2020 was 60, with an uphold rate of 43.3%.

Overall, the Group is very pleased with the way that its people and infrastructure have continued to respond to the challenges posed by the pandemic.

A4.5.2 Governance

Through most of the year the Group continued to operate on a pandemic footing, with board and committee meetings being held remotely. However in June 2021, at its annual offsite strategy conference, the Board was able to meet in person for the first time since March 2020 and resumed physical board meetings in September 2021.

The impact of the pandemic on all the Group's stakeholders has continued to be an area of significant focus for the Board and the Group's ongoing response has been thoroughly reviewed. The Group's 2021 AGM was held in February on a closed basis, in accordance with UK Government guidance and the Board was disappointed that shareholders could not be given the opportunity to attend in person. However, arrangements were made to allow shareholders to view the meeting online and they were encouraged to participate in the meeting by completing and returning their proxy voting forms. The Board is hopeful that the 2022 AGM, due to be held in March, can be conducted on a more normal basis.

Throughout the year ended 30 September 2021, the Group continued to comply with the principles and provisions of the UK Corporate Governance Code ('the Code') and more detail on the application of the Code principles by the Group is set out in section B of this Annual Report and Accounts. The Group adopted the 'comply and explain' approach under Provision 19 of the Code to extend the Chair's tenure past nine years for succession planning purposes and to ensure the appointment of a suitable replacement Chair, as set out below.

Board of Directors

Fiona Clutterbuck's nine year term on the Board, came to an end in September 2021 since she was first appointed in 2012. However, the Board and Nomination Committee considered Fiona's re-appointment beyond nine years and agreed that, in the interests of succession planning purposes and to ensure a smooth transition of duties to Fiona's successor, her appointment be extended to September 2022. Fiona will therefore stand for re-election at the Annual General Meeting in March 2022. A search process, led by Hugo Tudor, the Senior Independent Director is taking place and the results will be communicated to stakeholders once the process is complete.

As announced in the Group's 2020 year end results announcement, Finlay Williamson stepped down from the Board on 31 December 2020. Peter Hill, who was appointed to the Board on 27 October 2020, assumed the role of Risk and Compliance Committee Chair from 31 December 2020.

Peter Hill was appointed to the Board following a robust search and selection process. He was Chief Executive Officer of Leeds Building Society, one of the UK's largest building societies, from 2011 until his retirement in 2019, having previously worked in a number of senior management positions within the society. Peter is currently a non-executive director of Pure Retirement Limited and chair of its risk committee and is also chair of the board at Mortgage Brain. He brings with him a wealth of experience in financial services and a proven track record in risk oversight, gained during his executive and non-executive career.

As at 30 September 2021, the Board has three female directors, including the Chair of the Board, out of a total of eight board members, forming 37.5% of the Board.

A4.5.3 Management and people

The Group employs almost 1,450 people and during the period headcount has grown by 3.6% (2020: 1.4%), largely driven by the creation of new roles in customer facing and risk and compliance functions.

People and development

During the period the Group's priority has continued to be the wellbeing of employees and ensuring that they were provided with adequate support as the pandemic continued. The Group's Wellbeing team has played an important role in helping employees with their mental, physical, financial, and emotional wellbeing over the year through numerous initiatives. Wellbeing pulse surveys ensured that the Group continually monitored and responded to how employees were coping with the pandemic and feedback continued to reflect that employees were pleased with the quality and frequency of communications and how the Group was responding to the ongoing situation.

No employees were placed on furlough or made redundant as a result of Covid, and no use was made of the UK Government Coronavirus Job Retention Scheme in the year.

The Group conducted an employee engagement survey in June 2021, its first since December 2017; this produced a very strong set of positive indicators, including an overall engagement score of 87% (2017: 81%) and an employee net promoter score of +24 (2017: -3, industry norm: +21).

Retention of employees continues to remain high, with the attrition rate of 8.6% (2020: 10.4%) continuing to track below the national average. These high levels of retention are further bolstered by 57% of employees achieving over 5 years' service, 13% achieving over 20 years with the Group and 5% achieving over 30 years' service.

Employees continued to show flexibility during the year with many undertaking secondments to different areas of the business to ensure that the Group continued to meet the needs of its customers. Although the decision was made to close the Second Charge Mortgage business in the year, all 26 affected employees were offered alternative roles, with only a small number deciding to take voluntary redundancy.

The Group maintains its accreditation from the UK Living Wage Foundation and minimum pay continues to meet the levels set by the Foundation, while holiday entitlement for all employees was enhanced during the year.

A new performance management approach was rolled-out, removing the need for a formal annual appraisal and replacing this with more frequent and timely conversations about performance throughout the year. This not only supports individual performance and personal development, but also helps the Group to effectively manage rising talent and fulfil its succession planning objectives.

The third cohort of the Group's senior leadership development programme launched this year with a further nine delegates. The programme is aimed at developing those identified as successors for the executive management team and their direct reports. During this year two members of this programme from previous cohorts secured promotions within the Group. To support the Group's wider training objectives, a new learning management system, Learn Amp was launched in February. This hosts internally designed content alongside relevant subscription material to ensure there is a broad, yet relevant range of learning available for all employees to access.

Equality and diversity

The Group made significant progress on its equality, diversity and inclusion ('EDI') strategy during the year. Richard Rowntree, Managing Director - Mortgages, has taken on the role of Executive Sponsor for EDI and sponsors the Group's EDI Network which was launched in October 2020. The Network has had a tremendous impact in a short space of time and has been involved in the launch of a number of training offerings to all employees, including new EDI eLearning, a new 'Inclusive Workplace' course and an 'Inclusive Leadership' course for all managers.

The Network worked with Human Resources to run a diversity data capture campaign in September 2021. 63% of employees completed a diversity profile on the HR management system and 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.

The Group has made further important commitments to improving the diversity of its workforce by signing up to Business in the Community's Race at Work Charter and becoming accredited as a Disability Confident employer. These commitments complement the pledge the Group previously made to HM Treasury's, Women in Finance Charter in 2016.

The Group is pleased to report that is has now achieved each of its targets set under the Women in Finance Charter in 2017, which focussed on female and ethnic minority representation in the workforce and management. The Group is currently considering the next phase of this initiative.

Details of progress against our targets can be found below.

Measure	Target	Sep 2021	Status
Female representation in senior management *	35%	38.7%	Achieved
Females in workforce	50%	52.5%	Achieved
Females as a percentage of employees receiving management career development and leadership training	50%	52.0%	Achieved
Managers from an ethnic minority background	10%	13.4%	Achieved
Workforce on flexible working	10%	24.0%	Achieved
Flexible working on a part time basis	50%	73.6%	Achieved

*Senior management is defined using the FTSE Women Leaders definition, while the ethnicity measure is based on those employees who self-identified.

To support its efforts to improve gender equality the Group has continued to participate in the 'Women Ahead 30% Club' cross-company mentoring scheme. This programme has proven popular with both mentors and mentees and a similar scheme is being piloted for employees from ethnic minorities 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.

Remuneration policy

The PRA remuneration rules applicable to the Group changed with effect from 1 October 2021, as the Group qualifies as a Proportionality Level 2 ('Level 2') bank from that date, bringing it within the scope of more onerous rules. This is a result both of the reduction in the asset threshold defining a Level 2 bank from £15 billion to £13 billion, announced by the PRA in December 2020, and of the development of the rules themselves in response to Capital Requirements Directive V ('CRD V').

A full gap analysis was performed against the updated rules, with affected employees being identified and remuneration arrangements appropriately adjusted. The majority of the significant changes required to remuneration policies were prospectively approved at the 2020 AGM, with more minor changes approved by the Remuneration Committee in the period. Further information is given in the Directors' Remuneration Report (Section B7) and in the Remuneration Section of the Pillar 3 report for the year as appropriate.

The Group has also taken steps to assess the status of the small number of off-payroll workers in the business and made necessary changes to ensure the Group does not enter into engagements with workers who are paid through personal service companies and similar arrangements and fall within IR35 status for tax purposes, avoiding the complexities of such arrangements.

A4.5.4 Sustainability

Sustainability, including resilience in the face of climate change risks, is core to the Group's strategy: to focus on specialist markets, 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 that the Group has a positive effect on our stakeholders and communities
- Delivering sustainable lending through the design of products offered and the choices of sectors in which to operate

The Group publishes its 2021 Responsible Business Report, its first sustainability report, in December 2021, providing more detailed information on its sustainability initiatives.

Climate change

Climate change is designated as a principal risk within the Group's Risk Management Framework. Information and measures on climate change risks are considered at board level and the Group's responses 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)

The Group has an internal Climate Change Forum, sponsored at executive level and containing representation from across the business, to share information on initiatives within business areas and to help develop the Group's overall response.

During the year the first issuance was made under the Group's Green Bond Framework, which was published in the year and which reflects the Group's commitment to embed sustainability throughout its strategy, operations, and product offerings including funding and capital raising activities. This was the first issue of a green capital instrument by a bank in UK. The Sustainability Committee, established in the year under the oversight of the Executive Committee, is responsible for the Framework.

Developments in sustainable products and climate-related exposures are discussed in the relevant business reviews and within the Sustainability and Citizenship section (A6).

While the Group is not required to report on climate change risk and exposures under the TCFD framework until its 2022 year end, it has signed up as a TCFD supporter, and the disclosures made in respect of the year have been organised using TCFD as a template.

Social engagement

Despite the difficulties for fund-raisers created by the pandemic, the Group's Charity Committee raised over £43,000 for Macmillan Cancer Support, the Group's chosen charity for the 2020 calendar year. For the 2021 calendar year the Group is supporting the Alzheimer's Society with £22,000 raised by September 2021.

The Group has begun to restart its community and volunteering initiatives as pandemic restrictions cease, with employees looking forward to reengaging as soon as possible.

A4.5.5 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.

Inevitably the ongoing impacts of the pandemic have, and continue to be, a priority for the Group and the longer-term implications are still unclear. The Group continues to monitor closely the economic impacts, changes to lending profiles, business volumes and customer credit risk as the immediate restrictions necessitated by the pandemic are released. It is recognised that the wider pandemic is still a global challenge and the possibility of further waves and subsequent lockdowns may pose further issues during the coming months.

However, given the work done over the last 18 months the Group feels it is well-placed to respond to any further Covid-related disruption. The Group's risk management framework has provided a robust mechanism to ensure that new risks are promptly identified, assessed, managed and appropriately overseen from a risk governance perspective.

The Group continues to focus on specific risk issues that have arisen as a direct result of the pandemic. These include:

- Ensuring a Covid-safe return to office-based working and in the longer-term trialling more flexible and hybrid ways of working which are core to the strategy of attracting and retaining highly skilled employees, through a group-wide pilot scheme
- Continuing oversight of the impacts of government schemes and initiatives implemented during the onset of Covid which necessitated rapid deployment of resources and innovation in processes. A small number of remaining payment holidays continue to be managed and where appropriate forbearance solutions necessitated through Covid are tailored to individual customer circumstances and aligned to regulatory guidance and expectation
- Continuing oversight of risks related to the provision of government-backed lending schemes to support businesses through Covid. Given the effective implementation of process changes and underwriting decisions the Group is positioned well to support any further government lending programmes of this nature

Whilst Covid has clearly dominated the risk landscape since early 2020, the Group has successfully continued to evolve and embed its risk management framework. Good progress has been made in further developing its ability to manage all categories of risk through the maturing ERMF.

The evolution of the Group's risk framework remains a core priority and ongoing work is being undertaken to ensure it remains effective and proportionate in line with the Group's strategic aspirations. Significant recruitment has been undertaken during the year to bolster capability, external benchmarking has been undertaken to validate work undertaken and future plans and a detailed roadmap for further development over the next 18 months has been agreed. Good progress has already been made in line with these commitments.

Despite the pervasive impact of the pandemic, the Group has identified and focussed on a number of non-Covid related strategic risk issues including:

- Strategy, operational and conduct-related risk implications of the changes in product design, funding and operations required to transition all LIBOR-linked customers to an alternative rate following the withdrawal of LIBOR in December 2021
- Further embedding operational resilience capabilities which have proven to be critical in handling the Covid situation. Importantly, lessons learned from the handling of the pandemic have been incorporated into the operational resilience framework together with continued refinement of the overarching approach in line with regulatory expectation
- Addressing the impact of climate change on managing financial risks and considering this as part of the wider ESG agenda across the Group
- Continuing to develop advanced models and embed the overarching model risk framework to enhance credit risk management and support the Group's IRB application process
- The impact of issues relating to defective cladding on high-risk buildings where these form the security for mortgage loans. Underwriting guidelines continue to be reviewed to ensure these remain in line with emerging best practice
- Enhancing stress testing procedures to ensure the robustness of capital and liquidity positions
- Ensuring effective cyber-security controls and a robust data protection approach particularly as these evolve in response to changing working practices

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, the end of the transition period on 31 December 2020 caused no immediate impact to the Group. 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 are causing shortages in a number of sectors. Whilst the Group is not directly affected by these issues at present the Board is keeping the situation under ongoing review as supply issues in areas such as building materials and IT equipment could impact the Group's operations.

The principal challenges in the risk environment faced by the Group during the coming year and moving forward into 2023 and beyond include:

- Management of risks arising from changes introduced in response to Covid. With the ending of payment reliefs and the wider economic impacts of the crisis beginning to emerge, there will be a need to ensure 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
- 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 Group is on ensuring that it meets regulatory expectations in respect of its anti-money laundering and wider financial crime control frameworks following the publication of the Dear CEO letter in May 2021
- Risks associated with climate change remain an ever-present challenge. The UK Government has confirmed its goal of net zero carbon by 2050 in November 2020 and the Group, and 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 looking to ensure both its operational impacts, and the impact of its lending activities, explicitly consider climate change risk as a core strategic driver

Further details regarding the governance model, together with the principal risks and uncertainties faced by the Group, the ways in which they are managed and mitigated and the extent to which these have changed in the year are detailed within Section B8 of this annual report.

A4.5.5 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. The impact and pace of change necessitated through the ongoing programme of revisions to the Basel supervisory regime continue to pose a significant risk for the Group. These together with other potential regulatory changes to the business are closely monitored through the comprehensive governance and control structures in place.

Since March 2020, the impact of Covid has largely driven the priorities of both UK and European regulators. The Group has continued to respond effectively to these ongoing challenges despite short consultation and implementation periods. All regulatory publications have been considered by the Group, any implications identified and required changes implemented within an appropriate timeframe. Over the last few months the Group has experienced data requests from the FCA on arrears and forbearance increasing in both scale and frequency. The Group continues to respond to these requests, and to focus controls on the delivery of fair customer outcomes.

In addition to requirements introduced in response to Covid, the following developments currently in progress have the greatest potential impact on the Group:

- The Bank of England published a Consultation Paper ('CP') setting out proposed changes to the Minimum Requirement for Own Funds and Eligible Liabilities ('MREL') on 22 July 2021. The CP builds on the Discussion Paper published in December 2020 and factors in the responses it received from impacted banks and building societies.

On 3 December 2021 the Bank of England published a Statement of Policy based upon this consultation. Although the Group is not currently subject to MREL requirements, given its potential for growth it may be required to issue MREL eligible instruments at some point in the future

- The Bank of England MPC confirmed in February 2021 that negative interest rates still form part of its monetary policy toolkit. In response, the PRA issued a 'Dear CEO' letter requesting firms initiate the implementation of tactical solutions to process zero and negative rates by August 2021. The Group has undertaken this analysis which confirmed that it is well-placed to meet any operational requirements should rates fall to zero or below
- The FCA issued its consultation on "A New Consumer Duty" in May 2021. This seeks to set higher expectations for the standard of care provided to customers and will result in new rules relating to communications, products and services, customer service and price and value. The Group will continue to engage with UKF throughout the consultation period to ensure adequate preparation prior to the new rules coming into force
- The treatment of vulnerable customers continues to be a strong focus for the FCA, with further guidance having been finalised in February 2021. The Group continues to take its responsibilities in this regard seriously. Significant work continues to be undertaken to revise existing procedures, controls and training provisions to meet regulatory and industry expectations

- The FCA, PRA and Bank of England published their final rules and guidance on building operational resilience in financial services on 29 March 2021. As expected, this did not differ significantly from consultation papers and considerable work had already been undertaken by the Group to adhere to the draft proposals. Good progress has been made against the roadmap and the Group is well-positioned to meet the March 2022 policy implementation deadline including setting of impact tolerances, embedding a scenario testing approach and undertaking a self- assessment against the regulatory framework

- The Group continues to work towards embedding its approach to managing climate-related financial risks by the end of 2021 in line with the PRA expectations. A detailed plan of work has been developed which reflects regulatory and wider requirements and will continue to be refined as new thinking emerges. Managing the impacts of climate change is seen as a key strategic priority for the Group and significant effort has been made during 2021 to incorporate climate risk considerations within the Group's ERMF. The improved Governance which now includes the Sustainability Committee alongside the existing executive level risk committees ensures comprehensive consideration across all aspects of the business and ensures the Group is well-positioned to address the emerging challenges

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 Group continues to monitor the impact of Brexit on its operations, but the longer-term regulatory changes are still unclear. With the extension of the temporary transitional powers for the regulators until 31 March 2022 by HM Treasury, regulatory obligations for firms generally remain the same. The Bank of England has commenced the consultation process for the incorporation of the prudential regulation regime previously set out in European legislation into the PRA Rulebook.

However, further clarity has yet to be provided as to how the regulatory landscape may evolve post March 2022. It is expected that the majority of requirements will be directly transcribed although the PRA has indicated it is willing to depart from EU text where this may enhance regulatory oversight in the UK.

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.

A5. Future prospects

The Code requires the directors to consider and report on the future prospects of the Group. In particular, it requires that they:

- Explain how they have assessed the prospects of the Group and whether, on this basis, they have a reasonable expectation that the Group will be able to continue in operation (the 'viability statement')
- State whether they consider it is appropriate for the Group to adopt the going concern basis of accounting in the preparation of the financial statements presented in Section D (the 'going concern statement')

In addition, Listing Rule LR9.8.6 R(3) requires the directors to make these statements and to prepare the viability statement in accordance with the 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting' published by the Financial Reporting Council ('FRC') in September 2014.

The business activities of the Group, its current operations and those factors likely to affect its future results and development, together with a description of its financial position and funding position, are described in the Chairman's Statement in Section A1, Chief Executive's review in Section A3 and review of the business in Section A4. The principal risks and uncertainties affecting the Group, and the steps taken to mitigate these risks are described in Section B8.5.

Section B8 of this annual report describes the Group's risk management system and the three lines of defence model which it is based upon.

Note 53 to the accounts includes an analysis of the Group's working and regulatory capital position and policies, while notes 54 to 57 include a detailed description of its funding structures, its use of financial instruments, its financial risk management objectives and policies and its exposure to credit, interest rate and liquidity risk. Critical accounting judgements and estimates affecting the results and financial position disclosed in this annual report are discussed in notes 62 and 63.

Financial forecasts

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 annual 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 plans for the period commencing on 1 October 2021 have been approved by the Board and have been compiled taking into consideration the Group's cash flow, dividend cover, encumbrance, liquidity and capital requirements as well as other key financial ratios throughout the period.

Current economic and market conditions are reflected at the start of the plan with consideration given to how these will evolve over the plan period and affect the business model. The economic assumptions used are consistent with the economic scenarios considered for determining impairment provisions.

The plan is compiled by consolidating separate income forecasts for each business segment and securitisation vehicle to form the top-level projection for the Group. This allows full visibility of the basis of compilation and enables detailed variance analysis to identify anomalies or unrealistic movements. Cost forecasts and new business volumes are agreed with the heads of the various business areas to ensure that targets are realistic and operationally viable.

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.

The key stresses modelled in detail to evaluate the forecast were:

- Increased business volumes – An increase of 20% in buy-to-let application volumes. This examined the impact of volumes 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 – 25bps higher cost on all new savings deposits throughout. This scenario illustrated the impact of a significant prolonged margin squeeze on profitability and whether this would cause significant impacts on any capital, liquidity or encumbrance ratios
- Lower development finance growth – 50% lower loan book growth across the plan horizon coupled with a 50bp margin reduction. This scenario replicated a significant increase in competition within the sector, illustrating the impact of a lower proportion of the high-yielding development finance product in the Group's long-term asset mix on contribution to costs and other key ratios for the Group
- Higher buy-to-let redemptions – double redemption rates on all cohorts for the first three months post-reversion. With a significant volume of five-year fixes coming to an end in 2022, this scenario highlighted the potential risk that is inherent in the accounting difference between current and amortised cost balances on such loans, and invited discussion as to what mitigating action could be taken to avoid such an impact
- High impairment – a stress that modelled the IFRS 9 year end severe scenario across the plan horizon, simulating a significant short-term capital and profitability shock with prolonged house price deflation, but maintaining the same lending levels as the base case. This scenario is derived from, but more severe than, the stress testing scenario published by the Bank of England in January 2021. Although it is not deemed likely that such a scenario would materialise, since severe stresses almost always result in lower lending volumes, the output from this stress provides a benchmark for a plausible worst-case position that impacts all aspects of business performance and ratios, in particular, capital

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 and viability assessments. 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 outputs from these stresses present the Board with enough information to assess the Group's ability to continue on a going concern basis and ensure that there are enough management actions within their control to mitigate any plausible and foreseeable failure scenario.

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.

Risk assessment

During the year the Board discussed, reviewed and approved the principal risks identified for the Group. This process included debate and challenge regarding the most material areas for focus on an ongoing basis. No material changes were proposed to the principal risks other than the removal of pension obligation risk given the reducing deficit in the pension scheme.

Each of these principal risks is considered on an ongoing basis at each Executive Risk Committee ('ERC') meeting and each meeting of the board-level Risk and Compliance Committee.

The work of the Risk and Compliance Committee, of which all directors are members or attendees included:

- Consideration of new or emerging risks and regulatory developments
- Consideration and challenge of management's rating of the various risk categories to which the Group is exposed
- Consideration of the Group's compliance with the risk appetites set by the Board and the continuing appropriateness of these risk appetites
- Consideration of the root causes and impact of material risk events and the adequacy of actions undertaken by management to address them

The Board has spent considerable time monitoring the impacts of the pandemic including regular analysis and management information illustrating the impacts of Covid on the Group and its risk profile. They have continued to consider specifically regulatory impacts, conduct risks in dealing with customer vulnerabilities caused or exacerbated by Covid, customer credit and the changes in the Group's operational processes. The results of these considerations have fed into the Group's forecasting and risk assessment.

In addition, the directors held 'deep dive' sessions into key areas of risk focus including operational resilience; the ongoing assessment on the impact of cladding; climate change; LIBOR transition: anti-money laundering; and the potential impact of higher interest rates in the UK. The output from these sessions was fed back into the Group's risk management process.

The directors also continued to monitor the potential impact of the UK Brexit process as the economic and regulatory implications of the UK's exit from the EU continue to crystallise.

In addition, the directors specifically considered the impact on risk and viability through review and approval of key risk assessments for the Group, including the Internal Capital Adequacy Assessment Process ('ICAAP'), Internal Liquidity Adequacy Assessment Process ('ILAAP') and its Recovery Plan.

At the year end the directors reviewed their on-going risk management activities and the most recent risk information available to confirm the position of the Group at the balance sheet date.

The directors concluded that those activities, taken together, constituted a robust assessment of all of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity. These principal risks are set out in Section B8.5 of the Risk Management Report.

Availability of funding and liquidity

In considering going concern and viability, the availability of funding and liquidity is a key consideration. For the Group this includes retail deposits, wholesale funding, central bank lending and other contingent liquidity options.

The Group's retail deposits of £9,300.4 million (note 26), raised through Paragon Bank, are repayable within five years, with 77.6% of this balance (£7,212.9 million) payable within twelve months of the balance sheet date. The liquidity exposure represented by these deposits is closely monitored; a process supervised by the Asset and Liability Committee. The Group is required to hold liquid assets in Paragon Bank to mitigate this liquidity risk. At 30 September 2021 Paragon Bank held £942.7 million of balance sheet assets for liquidity purposes, in the form of central bank deposits (note 56). A further £150.0 million of liquidity was provided by an off balance sheet swap arrangement (note 56), bringing the total to £1,092.7 million.

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 £1,424.2 million.

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 2021 the Group had £529.2 million of such notes available for use, of which £287.0 million were rated AAA. The available AAA notes would give access to £149.3 million if used to support drawings on Bank of England facilities.

The Group's securitisation funding structures, described in note 56, 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 in 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 £125.0 million retail bond, due January 2022. £69.0 million of TFS debt was paid down after the year end and all other central bank debt was refinanced and is not payable until 2025.

The Group's access to debt is enhanced by its corporate BBB rating, affirmed by Fitch Ratings in March 2021, and its status as an issuer is evidenced by the BB+ rating of its £150.0 million Tier 2 bond, issued in the year. 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, including during the financial year ended 30 September 2021.

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 53 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 resulted in a reduction of the minimum capital level. Its capital at 30 September 2021 was in excess of regulatory requirements and its forecasts indicate this will continue to be the case.

Viability statement

In considering making the viability statement the directors considered the three-year period commencing on 1 October 2021. This aligns with the horizons used in the Group's analysis of risk and includes the two years covered by the detailed group forecast, together with one year of the less detailed forecasting period.

The directors considered:

- The Group's financial and business position at the year end, described in Sections A3 and A4
- The Group's forecasts, and the assumptions on which they were based
- The Group's prospective access to future funding, both wholesale and retail
- Stress testing carried out as part of the Group's ICAAP, ILAAP and forecasting processes
- The activities of the Group's risk management process throughout the period
- Risk monitoring activities carried out by the Risk and Compliance Committee
- Internal Audit reports in the year

Having considered all the factors described above, the directors believe that the Group is well placed to manage its business risks, including solvency and liquidity risks, successfully.

On this basis, the directors have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the three-year period commencing on 1 October 2021.

While this statement is given in respect of the three-year period specified above, the directors have no reason to believe that the Group will not be viable over the longer term. However, given the inherent uncertainties involved in forecasting over longer periods, the shorter period has been adopted.

Going concern statement

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 FRC in September 2014. The guidance requires that this assessment covers a period of at least twelve months from the date of approval of the financial statements.

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 the potential risks affecting them.

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

A6. Citizenship and sustainability

The Group believes that the long-term interests of shareholders, employees, customers and other stakeholders are best served by acting in a socially responsible manner and aims to ensure that a high standard of corporate governance and corporate responsibility is maintained in all areas of its business and operations.

Sustainability is central to the long-term success of the Group and it is committed to its responsibilities as a good corporate citizen. It aims to reduce the impact that its operations and its customers have on the environment, have a positive effect on all its stakeholders and support the communities in which it operates.

Further information on the Group's sustainability profile can be found in the 'Responsible Business Report: 2021', its first sustainability report, published in December 2021 and available on the Group's website at www.paragonbankinggroup.co.uk.

A6.1 Non-Financial Information Statement

The Group includes information on certain environmental, social and governance matters in its strategic report in accordance with sections 414CA and 414CB of the Companies Act 2006.

In addition to the description of the Group's business model, discussed in section A2, the Group's remaining disclosures are included in this section A6. This includes a discussion of the Group's risk, policies, outcomes and key performance indicators with respect to each of the five areas set out in the Act. The matters specified in the Act are discussed in the following sections.

	Area	Reference
(a)	Environmental matters	Section A6.4
(b)	Employees	Section A6.3
(c)	Social matters	Section A6.5
(d)	Respect for human rights	Section A6.6
(e)	Anti-corruption and anti-bribery matters	Section A6.7

This section also includes the information on the directors' engagement with employees required by Section 11 (1)(b) of Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 ('Schedule 7') (as amended) (in section A6.3) and the information on business relationships with suppliers and customers required by section 11B of that schedule (in section A6.7 and section A6.2).

Sustainability analysts frequently request detail of significant fines or penalties incurred by companies for ESG related incidents, or confirmation that there were no such incidents.

The Group has incurred no such fines greater than US$ 100.0 million in the year (2020: none). Information on penalties and disciplinary incidents is given below in each section, where relevant.

A6.2 Customers

The Group's strategic objective is to be a prudent, risk focussed, specialist bank with a closely controlled, cost efficient operating model which places the delivery of fair customer outcomes at its core.

Putting customers' interests at the heart of the business is therefore integral to the achievement of that objective, and the Group's culture. We want our customers to be confident that we will always consider their needs and act fairly and responsibly in our dealings with them. We strive to ensure that all our customers can be confident that:

- Products and services are designed to meet their needs
- Our employees are appropriately skilled and experienced to provide the services they require
- The information given to them will be clear and jargon free
- Products will perform as they are led to expect
- They will not face unreasonable post-sale barriers to change a product, switch provider, submit a claim or make a complaint
- All complaints will be listened to and claims assessed carefully, fairly and promptly
- Where applicable, they will be made aware of how they can refer their complaint to the FOS
- If they are vulnerable and/or in financial difficulties, we will provide a high level of support and make sure they are signposted to sources of independent advice
- They will be made aware of the FSCS and the protection this provides for them

The desire to achieve positive outcomes for our customers is an important commercial differentiator which has helped the Group build strong relationships over many years. We recognise that customers in vulnerable circumstances are at greater risk of poor outcomes when dealing with their finances and we have focused working groups and employee training to deliver appropriate service and support for vulnerable customers. This pro-active approach accords with the FCA's Principles for Business, particularly with regard to ensuring good customer outcomes, preventing customer harm and ensuring that all communications are clear, fair and not misleading. We ensure that we know how well we are performing in respect of these requirements, regularly adjusting what we do to deliver better customer solutions.

The Board and executive management are committed to maintaining and developing this culture across all the Group's businesses.

Complaints

There will be occasions where the Group does not get things right, and as a consequence this will give customers cause to complain. The effective resolution of complaints is a key focus, with all business areas following the FCA's Dispute Resolution Sourcebook ('DISP') to ensure consistent and fair customer outcomes.

Handling

The Group aims to resolve complaints at the first point of contact, where possible, but acknowledges that some complaints will require further specialist investigation and time to resolve. Where this is the case, regular contact is maintained with the customer to keep them informed of the progress of their complaint. The Group has also established contacts within previous service providers to ensure any relevant complaint is resolved at the earliest possible opportunity.

Where applicable, 'Alternative Dispute Resolution' information is provided to customers to allow them to appeal to independent parties if they are not satisfied with our response. These include the FOS and the FLA. Where customers feel the need to appeal, the Group co-operates fully and promptly with any settlements and awards made by these parties.

Monitoring

The Group has established complaint reporting forums in all business areas, to enable the effective discussion of complaint volumes, trends and root cause analysis. This ensures that all business lines effectively resolve customer complaints and learn from the issues raised to address the causes of those complaints. The effectiveness of this activity is regularly assessed through independent first line outcomes testing to ensure ongoing agent competence in the identification and resolution of complaints ensuring the delivery of fair customer outcomes. The reporting of this activity flows to the Customer and Conduct Committee ('CCC'), ensuring complaint visibility goes right to the top of the organisation.

The Group's complaint case data, reported to FOS, continues to be low compared to the other firms in the sector. Information for the most recent FOS reporting periods is set out below.

	Six months ended			
	30 June 2021	31 December 2020	30 June 2020	31 December 2019
Cases reported	50	60	40	83
Uphold rate	34.0%	43.3%	41.3%	48.2%

This low level of complaints is particularly pleasing given the impact of the Covid pandemic on customers through most of the period shown above.

FOS data across the financial services industry is published on the ombudsman's website at www.financial-ombudsman.org.uk. However, the Group's complaint level has regularly been below the threshold for publication.

Metrics on customer complaints are an important management information measure for the Board and form part of the determination of management bonuses and the vesting conditions for the share-based remuneration described in the Directors' Remuneration Report (Section B7).

A6.3 People

The Group employs almost 1,450 people, with the majority based at its Head Office in Solihull. During the past year, the Group has seen 3.6% growth in its headcount, predominately driven by the creation of new roles in customer facing and risk and compliance functions. This investment in resource has helped the Group to serve its customers and achieve its strategic priorities.

The Group is exceptionally proud of its culture, which is underpinned by a strong set of company values and a commitment to doing the right thing. This was shown in the results of the 2021 employee engagement survey where an 87% engagement score was achieved. High scores were achieved for culture, which was particularly pleasing, and the employee advocacy score, measured by NPS was far higher than international norms. This further supports the Group's Gold Investors in People status, which it will be seeking to retain next year.

Employee survey

The Group conducted a full employee engagement survey in June 2021 and 86% of employees shared their views. The survey produced a very strong set of positive indicators, including an overall engagement score of 87%; 10 percentage points above the industry norm and 6 percentage points greater than the Group's last survey completed in December 2017. Results are analysed into six pillars, with the Group scoring above the industry norm in each one. Results for five of the six pillars also improved since the 2017 survey, with 'employee voice' seeing the biggest increase with a 16 percentage point improvement.

Questions relating to the Group's culture were included, focusing on risk, responsible business actions, customers and inclusion. Overall culture score increased to 95% (2017: 92%). Employee advocacy measured through an employee NPS was at +24 (2017: -3, industry norm +21).

The survey followed a continued focus on monitoring employee wellbeing during the pandemic via short pulse surveys; six surveys were run between April 2020 and April 2021 and results indicated that employees continued to be happy with how the Group was managing the effects of the pandemic. Results have informed targeted actions such as promotion of wellbeing support available to employees, and the trials of hybrid working which are underway across the business.

Employment conditions

All the Group's employees are based in the UK and it is committed to upholding all aspects of employment law. The Group believes that its strategic objectives are best served by building a stable, permanent skill base and therefore minimises its use of short-term and temporary staff.

At 30 September 2021, employees on temporary or short-term contracts accounted for 2.3% of the workforce (2020: 1.5%) and no use was made of zero-hours contracts. The Group's annual employee turnover for the year was 8.7% (2020: 10.4%). XPert HR report average voluntary turnover in the UK financial services industry at 13.1%, demonstrating the strength of the Group's performance.

Flexible working is actively encouraged across all areas, to promote a work-life balance for individuals and to ensure that the Group retains the skills and experience of its people. The Group monitors working practices to ensure that it complies with the Working Time Regulations to ensure no one is forced to work more than a 48 hour week over an average 17 week period. This includes the monitoring of any second jobs.

Formal flexible working arrangements are in place for 24% of our employees (2020: 24.3%), with 73.6% of these working part-time (2020: 82%). The Group has continued to accommodate flexible working arrangements both on a formal and informal basis as the Covid pandemic continues.

No employees were placed on furlough or made redundant as a result of Covid and no use was made of the UK Government Coronavirus Job Retention Scheme in the year.

The Group generally only employs persons over the age of 18, except in connection with apprenticeship or other training arrangements.

During the period the Group took the decision to close its Second Charge Mortgage business; the team of 26 employees were all offered redeployment opportunities, in line with the policy of avoiding redundancy wherever possible, however six employees chose to leave the business.

Remuneration packages across the business are compliant with the UK's national minimum wage rates. In addition, the Group has been accredited as a Living Wage employer since June 2016, by the Living Wage Foundation. The independent Living Wage Foundation sets an hourly rate, the 'real Living Wage', calculated according to the cost of living in the UK which is updated annually. This is a higher rate than the UK Government's National Living Wage. Accredited employers such as the Group must not only pay this rate to their own employees, but also ensure that any contractors used undertake to do so. From 1 November 2021 the Group will pay a minimum of £19,500 to all full-time employees, equivalent to £10 per hour.

The Group runs a Worksave defined contribution pension scheme in line with UK legal requirements. During the year the default investment fund for this pension was changed to a fund closer aligned to the Group's ESG strategy; this change was made in consultation with employees.

During the year the Group's defined benefit pension arrangements were restructured to protect the future of the pension plan, preserve benefits already accrued and rebalance the treatment of the scheme's beneficiaries with those of the wider workforce. A formal consultation with the active scheme members took place and the changes, which are described in more detail in Note 52 to the accounts, came into effect from 1 July 2021.

At 30 September 2021 the Group was making contributions towards the retirement provision of 85% of its employees.

During the year the Group also increased the minimum holiday entitlement for its employees from 22 to 25 days per year for full time employees, in line with its commitment to treating its employees properly.

Equality, diversity and inclusion

The Group is committed to eliminating discrimination and promoting EDI amongst all its employees through its policies, procedures and practices and through its professional dealings with employees, customers and third parties.

Every employee is entitled to a working environment that promotes dignity, equality and respect for all. The Group will not tolerate any acts of unlawful or unfair discrimination (including harassment) committed against an employee, contractor, job applicant or visitor because of a protected characteristic:

- Sex
- Gender reassignment
- Marriage and civil partnership
- Pregnancy and maternity
- Race (including ethnic origin, colour, nationality and national origin)
- Disability
- Sexual orientation
- Religion and or belief
- Age

Discrimination on the basis of work pattern (part-time working, fixed term contract, flexible working) which is unjustifiable will also not be tolerated.

The Board believes the achievement of a balanced workforce at all levels delivers the best culture, behaviours, customer outcomes, profitability and productivity and therefore supports Paragon's success as a business.

During the year the Group has made significant progress on its equlity, diversity and inclusion ('EDI') agenda. In October 2020 it launched its EDI Network; consisting of employees from across the Group who are passionate about shaping the Group's EDI plans. The Network and all the Group's other EDI activities are sponsored at ExCo level by Richard Rowntree, Managing Director – Mortgages, while the Nomination Committee provides board level oversight on all inclusivity matters affecting on the Group's people.

The primary objectives of the EDI Network are:

- Raising awareness and understanding of what EDI in the workplace means
- Providing feedback and advice to the Group's leadership on the issues affecting employees from under-represented groups
- Supporting the delivery of initiatives to improve EDI across the Group
- Promoting Paragon as a diverse and inclusive place to work

Employee satisfaction relating to the equality of opportunity was monitored in the recent employee engagement survey and the Group continues to monitor recruitment data relating to the provision of equal opportunities.

HR policies are reviewed regularly to ensure they are non-discriminatory and promote equality of opportunity. In particular, recruitment, selection, promotion, training and development policies and practices are monitored to ensure that all employees have the opportunity to learn and develop according to their abilities.

The EDI Network has driven several campaigns over its first year and championed signing up to some external schemes. Significant initiatives within the EDI agenda in the year include:

Signing up to the Race at Work Charter

The Race at Work Charter is an initiative run by Business in the Community ('BITC'). Signatories of the charter agree to five commitments to ensure that ethnic minority employees are represented at all levels in an organisation.

1. Appoint an Executive Sponsor for race
2. Capture ethnicity data and publicise progress
3. Commit at Board level to zero tolerance of harassment and bullying
4. Make clear that supporting equality in the workplace is the responsibility of all leaders and managers
5. Take action that supports ethnic minority career progression

The Group has a number of actions in progress to ensure that its commitments under this scheme are being met. Initiatives include involving EDI Network members in the selection process for the Group's development programmes, challenging any unconscious bias observed; piloting a mentoring programme for employees from ethnic minority groups; and running Executive Listening Circles to give employees in under-represented groups the opportunity to share their views with leadership.

Becoming a Disability Confident employer

In April 2021 the Group achieved Level 1 'Disability Confident Committed' status under the UK Government's Disability Confident scheme. As well as continuing to provide paid employment to people with disabilities, as a Disability Confident Committed organisation, the Group has agreed to the five Disability Confident core commitments:

- It will ensure its recruitment process is inclusive and accessible
- It will communicate and promote vacancies
- It will offer an interview to disabled people
- It will anticipate and provide reasonable adjustments as required
- It will support any existing employee who acquires a disability or long-term health condition, enabling them to stay in work

The Group makes every effort to retrain and support employees who suffer from disabilities during their employment, including the provision of flexible working to assist their return to work. Ensuring that opportunities and progression within the Group are available to people with disabilities is an important part of its inclusivity and diversity strategy and will form a strand of the work of the EDI Network.

Collecting diversity monitoring data

In September 2021 the Group launched a diversity profile in its CoreHR system which asks employees to disclose information about their gender identity, sexual orientation, ethnicity and race, religion, socio-economic background, disabilities and responsibilities outside of work. Over 60% of employees completed their profile; this data now gives the Group a better understanding of the composition of the workforce and will help it to monitor whether all employees have the same access to training, development, and job opportunities.

In addition, demographic questions were asked in the employee engagement survey allowing the sentiment of different groups of employees to be assessed. These two data sets will shape the next phase of the Group's EDI strategy.

Pride at Paragon

In June 2021 the Group celebrated 'Pride at Paragon' to recognise its LGBTQ+ employees and in September 50 employees joined the Birmingham Pride Parade event.

Inclusive workplace training

A new 'Inclusive workplace' training course was launched by the Group's learning and development team in 2021, designed and delivered in conjunction with the EDI Network. All employees were invited to attend the course which builds on themes such as unconscious bias, which are already addressed in eLearning courses.

Women in Finance

The Women in Finance Charter, sponsored by HM Treasury, is an initiative amongst financial services companies in the UK, aimed at promoting equality of opportunity in the workplace. The Managing Director - Mortgages is the project sponsor at ExCo level and progress against the Charter requirements is monitored by the executive management and at Board level.

In January 2017 the Group's first set of internal targets under the charter was published on its website. They included a target of 35% female representation in senior management roles by January 2022, increasing from 26% at the time the targets were set. As at 30 September 2021 the Group had achieved 38.7% female representation (2020: 33.9%). The definition of senior management used in the Group's 'Women in Finance' targets is the same as that used by the FTSE Women Leaders initiative (formerly known as the Hampton-Alexander ('HA') Review).

By September 2021, the Group had achieved all its original charter targets, ahead of schedule and it will be reviewing its targets for the next phase of its Women in Finance initiative in the early part of the new financial year.

Gender pay

As required by legislation, the Group has calculated its gender pay gap at April 2021. The results will be published on the UK Government website and on the Group's own website and are summarised below.

	April 2021	April 2020
Median gender pay gap	**36.6%**	36.9%
Mean gender pay gap	**38.4%**	40.7%
Median bonus pay gap	**3.4%**	2.5%
Mean bonus pay gap	**76.5%**	82.6%

This year's gender pay measures are similar to those for 2020, as would be expected given the low staff turnover during Covid, and remain larger than the Group would like. The Group has continued to monitor these differences and found them to be predominately due to the seniority and nature of roles that men and women are undertaking in the organisation.

The results are broadly in line with those for the financial services sector reported by the Office of National Statistics in their 2021 Annual Survey of Hours and Earnings ('ASHE') which showed a median pay gap of 36.5% (2020: 35.9%) and a mean pay gap of 33.2% (2020: 28.8%).

Employees in our lower pay quartiles are predominantly female and typically include operational and processing roles. These roles lend themselves particularly well to part-time working arrangements.

Throughout the organisation females account for the majority of part-time working arrangements and, due to the nature of the gender pay gap calculation taking no account of hours worked by employees in calculating averages, this further increases the size of the gender pay gap.

The Group is proud that the vast majority (85%) of employees are eligible for a bonus under the Group's Profit Related Pay ('PRP') scheme; these awards lead to the small median bonus pay gap. 15% of employees are eligible for the Group's discretionary bonus scheme (31% of the scheme's participants are women), and 5% of employees are also eligible for share based awards of which 27% of recipients are female. This means that discretionary and share based bonus schemes are disproportionately awarded to men, and the large mean bonus gap is further driven by the bonuses awarded to the most senior executives, the majority of whom are men.

The Group analyses gender pay gap data on an ongoing basis as part of the Women in Finance initiative, to identify potential issues and determine what action might be required. However, work carried out during the year, reviewing groups of directly comparable positions, did not suggest evidence of systematic gender bias or unequal pay practices.

Composition of the workforce

During the year the workforce has grown by 3.6% to 1,441 people (2020: 1,391). Information on the composition of the workforce at the year end is summarised below:

	2021 Females	**2021 Males**	2020 Females	2020 Males
Employees				
Number	**757**	**684**	735	656
Percentage	**52.5%**	**47.5%**	52.8%	47.2%
Management grade employees				
Number	**136**	**198**	119	190
Percentage	**40.7%**	**59.3%**	38.5%	61.5%
Senior managers				
Number	**8**	**34**	6	33
Percentage	**19.0%**	**81.0%**	15.4%	84.6%
Directors				
Number	**3**	**5**	3	6
Percentage	**37.5%**	**62.5%**	33.3%	66.7%

The definition of 'senior manager' used in the table above is that required by the Companies Act 2006 (Strategic Report and Directors Report) Regulations 2013 which differs from that used by the FTSE Women Leaders Initiative.

Based on diversity profiles completed by employees during the year, ethnic minority employees comprised:

- 17.2% of employees
- 13.4% of managers
- 4.7% of senior managers

This is based on the 58% of employees who declared their ethnicity. For the purpose of this analysis, ethnic minority employees comprise all those not identifying as 'White British'. As the figures for the current year were prepared on the basis of employees self-identification, in line with best practice, they may not be strictly comparable to those presented in earlier years.

Health and wellbeing

The Group has continued to focus on supporting the wellbeing of employees throughout the year and during the period launched the Wellbeing Hub; a dedicated space on the intranet, which provides employees with support on emotional, physical, financial and social wellbeing issues. Through the Wellbeing Hub employees are able to access services such as free will writing, free exercise classes, support with budgeting and debt management, signposting specialist support services such as those who help with domestic violence or bereavement, as well as numerous resources to help with a wide range of wellbeing issues.

Training and development

Despite the challenges that the continuing pandemic has placed on the business, the Group has continued to focus on providing opportunities to develop all employees and on average employees received 4.6 days training per person in the year (2020: 4.2 days). This continues to significantly exceed the average figure for the private sector of between 2.8 and 3.2 quoted by the CIPD. This number included online training undertaken by all employees on various topics including regulatory requirements.

A new learning management system, Learn Amp, was launched in February this year. Learn Amp hosts relevant subscription content alongside internally designed content to ensure there is a broad, yet relevant range of learning available for employees to access.

During the period a new performance management approach was rolled-out, removing the need for a formal annual appraisal and replacing this with more frequent and timely conversations about performance throughout the year. This not only supports individual performance and personal development, but also helps the Group to effectively manage rising talent and fulfil its succession planning objectives.

The Group's senior leadership development programme launched its third cohort in September, with a further nine individuals undertaking bespoke development plans; two individuals from previous cohorts have been promoted internally. During the period the Group has launched a suite of leadership modules 'Leadership for the future', bringing together all layers of the Group's management structure to spread and share best practice through networking and learning together. Members of the EDI Network have been involved in the selection processes for candidates for some of the Group's talent programmes during the year, with the intention of identifying any unconscious bias and helping to ensure equal opportunities are afforded to all employees.

The Group has continued to focus on developing female talent during the year to support its Women in Finance Charter objectives. 52% of employees receiving management development are female, and the Group continues to support the cross-company Mission Gender Equity mentoring programme.

Apprenticeship Levy funds have been drawn down to support the Group's development objectives. These apprenticeships cover a range of specialist and operational roles including IT, audit, customer services and management. The number of apprenticeships has dropped slightly during the pandemic, with 37 apprentices (2.3% of employees) registered under the levy scheme (2020: 46), although utilisation of levy funding has increased slightly, to 42.6% of new levy funds in the past twelve months (2020: 41%). Usage has increased due to the inclusion of more managerial level apprenticeships which draw down greater funds. The Group also supports employees studying for professional qualifications outside the apprenticeship programme.

Recruitment

Headcount has continued to grow over the period, and in the last quarter of the year recruitment volumes have increased, following the relaxation of lockdown restrictions. Over 156 new hires started during the period with the majority being successfully onboarded remotely.

The Group also runs a successful 'refer a friend' scheme whereby employees receive a referral fee if an individual they refer for a role passes probation. This year 26 individuals were successfully recruited through this scheme (2020: 18).

Employees' involvement

The directors recognise the benefit of keeping employees informed about the progress of the business. The Group operates a People Forum, which meets regularly and is attended by employee representatives from each area of the business. The Forum exists primarily to facilitate communication and dissemination of information throughout the Group and provides a means by which employees can be consulted and provide feedback on matters affecting them.

The Forum has been designated as the primary channel through which the Board receives information on the views of the workforce, either by attendance at the meetings or through the People Director who reports to ExCo and the Nomination Committee on matters raised. This satisfies the 'Employee Voice' provisions of the UK Corporate Governance Code.

During the period non-executive directors have attended several People Forum meetings and discussed topics including executive and wider remuneration and the impact of the Covid pandemic on the workforce and the business.

The Forum has remained a valuable channel of engagement with employees over the year, despite the impact of the pandemic, with both non-executive directors and ExCo members attending meetings to discuss how the Group has addressed the impacts of Covid and the development of its hybrid working trials, amongst other topics.

The Forum also made a recommendation to grant employees additional leave for Christmas Eve and New Year's Eve, and this recommendation was approved by the Board, effective from 2021. Additionally, the Forum was consulted on the decision to increase the minimum annual holiday allowance in the year.

Executive directors also provide biannual updates on business progress to the entire workforce which have been delivered through video messages during the Covid pandemic. ExCo members also use the Group's intranet to deliver updates on important initiatives within the business from time to time.

To involve employees in the Group's performance, the Company operates a Sharesave share option scheme and a profit sharing scheme, both of which enable eligible employees to benefit from the performance of the business. At 30 September 2021, 65% of the Group's employees were members of one or more Sharesave scheme.

In addition, during December 2020 each employee below senior management level received a one off deferred award of £1,000 of shares, valued at the December 2020 market price which vest in December 2023, giving those employees a direct interest in the performance of the Group's shares.

Health and Safety

Throughout the year, the Group has remained compliant with all applicable health and safety legal requirements and implemented best practice management standards across its businesses. This is combined with a commitment to providing a healthy and safe working environment for all employees, contractors and visitors to its premises, and those impacted by its operations in public areas.

Employees are provided with appropriate levels of information, instruction, training and supervision, to empower them to take ownership of their responsibility for a healthy and safe environment and are encouraged to report any concerns in line with the Group's stated health and safety objectives, whether in the office or home based.

While the Group's primary source of health and safety related risk remains with the vehicle maintenance operations of Specialist Fleet Services Limited ('SFS') the focus for the vast majority of this year has been on the continuance of Covid-related control measures in the face of rapidly changing Government guidance.

Throughout the pandemic employee engagement has been a key factor on health, safety and wellbeing. For much of the year most of the Group's people were working from home, with several sites entirely closed. From June, planning began for a phased return to the office in September under a hybrid working model. Employees were engaged to determine if there were any duplicate equipment needs to ensure they have a healthy and safe environment both in the home and at the office with access to appropriate equipment.

In the Group's offices a Covid-secure environment was maintained throughout the year in accordance with the latest Government advice. Risk assessments, procedures and documentation have been kept under review to consider Covid measures and made available to all employees to provide awareness regarding the current control measures as best practice changed through the period.

The offices that remained open continued to comply with all health and safety rules, with the number of fire marshals, first aiders and other qualified personnel continuing to be sufficient, and this continues to be regularly monitored based on the number of occupants.

To ensure the health and safety of home-based employees, a proactive contact programme was put in place to ensure that employees were working in a safe and healthy manner throughout the pandemic.

A programme to automate workstation assessments through the use of software was launched in the year, Which will identify those who need assistance more rapidly. Processes are also being put in place to conduct visual inspections of electrical equipment remotely, ensuring that the Group's equipment in people's homes remains safe to use.

Management and systems

The Group has a dedicated health and safety manager who reports, ultimately, to the Chief Operating Officer, the executive committee member responsible for health and safety. Health and safety incidents are classified as operational risk incidents for the purposes of the Group's risk management system and are monitored through the operational risk management system and the Operational Risk Committee ('ORC').

The Group (excluding SFS) remains certified to ISO45001:2018 and its Occupational Health and Safety Management System ('OHSMS') is audited for compliance bi-annually by a UKAS accredited auditor.

SFS has its own health and safety manager and OHSMS. Incidents are investigated locally with access to Group resources as required. The operation attained certification to ISO45001:2018 in September 2021 and is audited for compliance annually by a UKAS accredited auditor.

Resources within the health and safety function have been kept under review in the year and were sufficient to ensure that health and safety management has been maintained to expected standards throughout the period.

Performance

During the year, the Group reported 8 incidents (2020: 11). All were of a minor nature with no lost time. No incidents were notifiable under the Reporting of Incidents, Disease and Dangerous Occurrences Regulations 2013 ('RIDDOR') (2020: 1).

Health and safety performance continues to be good with the number of incidents remaining at a low level. During the financial year ended 30 September 2021 there were no prosecutions or any enforcement action from visits by the authorities for non-compliance in respect of health and safety matters (2020: None).

A6.4 Environmental impact

Climate change is one of the biggest challenges faced by the world today. The UK Government confirmed its goal of net zero carbon by 2050 in November 2020 and the Group, and the rest of the financial services industry, have a vital role to play in that commitment.

Alongside the widespread societal concerns, financial regulators have also increased their focus on climate change. The PRA has published a Policy Statement, setting out its expectations of the type of strategic approach it expects firms to adopt in managing the financial risks of climate change. The Group is in the process of completing a plan of work which adheres to the requirements set out with the policy statement. This plan also reflects subsequent statements by the PRA and will continue to be updated as the regulators develop their thinking.

The Group's environmental impacts can be considered under two headings, its operational (or internal) impacts and the impact of its lending activities (the external or downstream impacts).

Until recently the focus of the Group's environmental policies has been on its own activities, which are described further below, however, in the last year we have begun to assess the use customers make of the funds loaned to them, with an initial focus across mortgages. This includes developing systems to assess and monitor the environmental impacts associated with the Group's financing activities.

Reporting on climate change

The Taskforce on Climate-related Financial Disclosures ('TCFD') has published a framework setting out the main themes which companies should cover in their reporting on climate change. The use of this framework by UK listed companies will be mandated through new Listing Rules, which will apply to the Group from its year ending 30 September 2022.

These rules will require the Group to state whether it has made disclosures consistent with the TCFD framework, where consistency must be assessed based upon the level of its exposure to climate-related risks and opportunities and the scope and objectives of its climate-related strategy.

The Group has identified its response to climate change as being key to its business strategy and designated it as a principal risk. It therefore presents material relevant to the TCFD objectives throughout its reporting. The table below sets out where material relevant to each TCFD pillar may be found.

Governance		
Disclose the organisation's governance around climate-related risks and opportunities		**Section**
a) Describe the board's oversight of climate-related risks and opportunities	• The Board has designated climate change as a principal risk within the Group's ERMF, following this the focus has been on developing their understanding of the issue through insight sessions and discussions on climate change strategy • The Terms of Reference of the Risk and Compliance Committee have been updated to ensure appropriate oversight of climate-related matters at a board level on a quarterly basis	**Governance** – Board oversight – Sustainability Committee and Climate change working group
b) Describe management's role in assessing and managing climate-related risks and opportunities	• The CFO has been designated as the director responsible for climate change matters • Throughout the year the terms of reference of key executive risk committees have been updated to incorporate climate change. The newly established Sustainability Committee helps to ensure appropriate escalation and awareness of climate related risks across the business as well as escalation up to the Board	**Governance** – Board oversight – Embedding climate change within the organisation's governance structure

Strategy		
Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material		**Section**
a) Describe the climate-related risks and opportunities the organisation has identified over the short, medium, and long term	• The Group has focused its assessment on the most material segment of its balance sheet, buy-to-let mortgages. The initial phase concentrated on the risks posed by flooding, and on energy efficiency • The UK has set a target to increase the proportion of more energy efficient properties in the PRS. In support the Group has released a series of green products aiming to support landlords in improving the energy performance of their properties	**External (downstream) impact** – Impacts of climate change **Risk management** – Quantifying our climate exposure – Climate-related opportunities
b) Describe the impact of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning	• In the year the Group issued an inaugural green capital instrument which outlines its commitment to embed climate change into long-term strategy • During the Group's annual strategy session the Board received an update on climate change and ESG. The session set out the strategic framework for the Group focusing on the Group's own emissions, the climate impact of our financing activity, the delivery of sustainable funding and financing initiatives and the building of partnerships to support change	**Governance** – Board oversight **Risk management** – Climate-related opportunities
c) Describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario	• Work is underway to review the Climate Biennial Exploratory Scenario ('CBES') released in June 2021 and to outline the implications that such scenarios have on the Group's exposure	**Risk management** – Use of scenario analysis

Risk management		
Disclose how the organisation identifies, assesses, and manages climate-related risks		**Section**
a) Describe the organisation's processes for identifying and assessing climate-related risks	• The Group's activity has focused on incorporating climate risk considerations within the ERMF. The Governance framework now includes the Sustainability Committee reporting to Performance ExCo and ensuring comprehensive consideration across all aspects of our business. This governance process allows for climate change updates and monitoring to be escalated up to the Board and the Risk and Compliance Committee as appropriate	**Governance** – Embedding climate change within the organisation's governance structure
b) Describe the organisation's processes for managing climate-related risks	• Underwriting processes consider climate risk factors. For mortgages these include flood, subsidence, coastal erosion and the EPC of the property. Further mitigation against the risk of loss is provided through the requirement to have valid insurance • The Sustainability Committee monitors climate change metrics that are relevant to the business model and the business response to them. The relevant executive level risk committees, such as the credit committee will also monitor relevant risks in their areas of responsibility	**Risk management** – Quantifying our climate exposure
c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organisation's overall risk management	• The governance structure has been updated to include the Sustainability Committee. This governance process allows for climate change updates and monitoring to be escalated as appropriate • The climate change risk policy is under development and will ultimately be approved by the Risk and Compliance Committee. The policy development will support the formalisation of climate change risk governance within the ERMF • The new governance structure and the development of the climate change risk policy are clear stepping stones in the development of risk appetite and further embedding of climate change risk into the Group's ERMF	**Governance** – Sustainability Committee and climate change working group **Risk management** – Future developments

Metrics and Targets		
Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material		**Section**
a) Disclose the metrics used by the organisation to assess climate-related risks and opportunities in line with its strategy and risk management process	• Across the Group's mortgage portfolio energy efficiency, flood risk and ground instability have been qualitatively and quantitatively reviewed during risk driver assessments • Across SME lending SIC codes have been used to identify those operating in high carbon intensive industries • The Group continues to enhance the data, methodology and disclosures in this area to ensure any exposure to physical or transitional climate change risk can be identified and monitored	**Risk management** – Quantifying our climate exposure
b) Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks	• The process for measuring the carbon emissions from the Group's operations continues to be enhanced. Disclosures have been included for the Group's operational emissions (Scope 1, 2 and 3) • The Group has disclosed the financed emissions associated with its mortgage book for the first time. This demonstrates the ongoing work for monitoring the climate-related impact of the Group's lending	**Operational impact** – Performance indicators **Financed emissions** – Scope 3 mortgage emissions
c) Describe the targets used by the organisation to manage climate-related risks and opportunities and performance against targets.	• In March 2021 Paragon Banking Group PLC issued a £150 million Green Tier-2 Bond. The proceeds of the Green Bond are being exclusively allocated to eligible green loans. The focus being green residential real estate with an EPC rating of either A or B. The Green Bond Framework outlines the Group's target for green financing as well as its ambition to support its customers in achieving more sustainable outcomes through the products offered	**Risk management** – Climate related opportunities

External (downstream) impact

The Group's external, or downstream, impacts arise from the use to which its customers put the funds loaned to them. Most directly, for asset-backed lending it relates to the impacts of the asset being financed and its use by the customer.

Impacts of climate change

The uses to which customers put the funds advanced to them by the Group give rise to two related groups of risks:

- Physical risks - Climate change and other environmental factors may, of themselves, increase financial risks. As an example, increased flooding risk might have an adverse impact on security asset valuations
- Transitional risks - Regulatory and governmental pressure might be brought to bear on lenders, amongst other businesses, to reduce the environmental impacts of their product chains. Such regulation might impact on the ability to realise security or to continue business lines

The Group uses these classifications to categorise the financial risks of climate change and is working to further embed the consideration of both forms of risk across all its lending. Risks in each of these categories may impact over the short-term (zero to five years), medium-term (five to ten years) or long-term (over ten years).

The Group already considers these types of issues in its underwriting and credit risk processes to some extent. Examples of how the Group's lending businesses manage their exposure to climate change effects, and seek to promote environmentally positive behaviour by customers, are given in Section A4.1.

Governance

Board oversight

The Board has designated climate change as a principal risk within the ERMF. This means information and measures on climate change risks are considered at board level and the Group's responses considered within the Board's overall strategy. The Chief Financial Officer ('CFO') has been designated as the director responsible for climate change matters.

The Board is engaged on a regular basis on sustainability and climate-related matters receiving frequent sessions to build their understanding on climate change and its associated risks and opportunities.

- An insight session was held for the Board which focused on education and awareness of climate change risk and the session outlined the key considerations from a Paragon perspective
- Further to this as part of a broader ESG presentation, a comprehensive summary of climate change impacts was presented at the Board strategy day. The focus was on strategic alignment and the priorities and implications of our loan portfolio allocation with consideration of net zero pathway commitments

Sustainability Committee and climate change working group

During the year the Group established the Sustainability Committee which reflects the commitment to embed sustainability throughout the organisation. The Sustainability Committee has a broad ESG perspective and reports to Performance ExCo and the Board on a regular basis.

The climate change working group, working under the oversight of the Sustainability Committee and Performance ExCo, has:

- Delivered new green products to encourage our customers to transition to a low carbon economy
- Increased the availability of climate-related data across the business through enhanced data collection at underwriting
- Developed financed emissions estimates across the Group's mortgage book using the Partnership for Carbon Accounting Financials, as set out below
- Performed a climate change risk assessment across the mortgage portfolio focusing on the key risk drivers across both physical and transition risk
- Submitted responses to the CDP climate change questionnaire, for the first time. The CDP is a not-for-profit charity that runs the global disclosure system for investors, companies, cities, states and regions to manage their climate and environmental impacts
- Continued to engage with external climate change initiatives. This includes involvement in industry initiatives, particularly through the Green Finance Institute, the FLA's Green Finance Group and UK Finance's Sustainability Committee and 'COP26 and Beyond' roundtable

Embedding climate change within the organisation's governance structure

Throughout the last year, since designating climate change as a principal risk, climate change continues to be further embedded within the Group's governance structure and culture. During the year the terms of reference of key risk committees have been updated to reflect their responsibilities with respect to climate change.

Consequently, the wider impacts and transmission channels of climate related risks can be identified and managed across the Group. Through improved governance and increased climate related reporting into the Sustainability Committee, and other executive level committees, the process for identifying and managing climate-related risks has been enhanced. This ensures that the broad scope of climate change related risks is escalated and managed by personnel across the business. Examples of the topics discussed at executive level committees throughout the year include:

- An EPC risk paper was presented to the Credit Committee, an outcome of which has been for the Committee and the credit team to review the implications of EPC on loan performance
- An insight session was provided to ORC on the importance of climate considerations with a further session held on incorporating climate change into the RCSA process
- Climate change has been embedded throughout the monthly reporting at Asset and Liability Committee ('ALCO') through the monitoring of our green products and the wider green product market

Risk management

Assessment of current environmental risks and forward-looking climate change risks are factored into the Group's business. When assessing the appropriateness of a property as security on a buy-to-let mortgage, factors such as the EPC rating of the property, flood risk, risk of coastal erosion and ground stability are considered.

As part of the valuation report performed by surveyors, coastal erosion, ground stability and flood risk are assessed based on the surveyor's expertise of the local area, historic events and information from insurers. As part of the conservative approach taken, these risks are assessed on a property-by-property basis. Additionally it is essential for the Group to ensure that a property is and remains insurable providing cover from both subsidence and flood risk across the mortgage book.

Since 2018 all properties accepted as a security must have a minimum EPC rating of E at the time of offer unless valid exemptions are in place. EPC data is likely to be of increasing importance with regulations and government policy tightening with the aim of decarbonising the building stock. The Group's data capture process has been enhanced to improve the current understanding of the exposure but also for use in longer term climate scenario analysis.

Similar activity is planned to ensure any other lending subsets which might be particularly exposed to physical or transitional climate change risk can be identified and monitored. Throughout the year the energy efficiency of completed developments within the Group's development finance business has been assessed using EPC data. This information has been used across the business to assess the quality of the developments and to begin to review the climate change impact that this lending might have.

Climate-related opportunities

Climate change related opportunities have been and continue to be considered as part of the Group's strategy and the Group aims to support its customers in their transition to a low carbon economy.

In March 2021 the Group became the first bank in the UK to issue a green capital instrument. The proceeds of the bond are being allocated exclusively to eligible green loans. This funding structure is an indication of the Group's commitment to place sustainability and climate change at the heart of its long-term strategy.

The Group's lending businesses have released a series of green products during the year and after the year end. These have included

- Buy-to-let mortgage products aimed at supporting landlords to improve the energy performance of their properties and thereby increase the proportion of EPC A to C rated properties in the PRS
- Development finance products promoting the development of properties with high EPC ratings
- Motor finance products for electric vehicles

These are discussed in Section A4.1 in the reviews of the relevant businesses.

Quantifying our climate exposure

During the year the Group has made progress in assessing the potential financial impact of climate change on its buy-to-let mortgage book. The primary focus has been on the potential transitional risk related to the energy efficiency of the properties financed and the physical risk relating to flood risk and ground instability. The assessment included reviewing both the climate change screening during the loan origination process as well as assessing the total current portfolio exposure to such risks.

Throughout the year deep dive sessions and workshops were held with personnel across credit risk, property risk and mortgages on flood risk and ground instability which specifically considered the long-term impacts of climate change. The analysis indicated that the current processes are fit for purpose however they will continue to evolve as data availability improves.

EPC levels and associated regulation have the potential to impact our credit risk and the Credit Committee and our credit team continue to analyse the linkage between EPC and loan performance. Additionally the Sustainability Committee actively monitors the energy performance of properties to ensure that an excessive build up in concentration of less efficient properties is avoided. This EPC risk assessment has led to the launch of new 'green' products and enhancements to the underwriting process in support of climate consideration.

The tables below summarise the principal risk metrics for the Group's mortgage lending exposure in England and Wales. Coverage levels are shown as a percentage of accounts with properties in England or Wales, which represent 97.9% of the portfolio. Work is ongoing to source comparable data for the Group's Scottish and Northern Irish exposures.

Indicator	Measure	2021	Coverage	2020	Coverage
EPC	Grading A to B	8.1%	88.3%	7.8%	87.7%
	Grading A to C	37.6%	88.3%	36.9%	87.7%
	Grading A to E	98.4%	88.3%	98.2%	87.7%
Flood risk	High risk properties	0.7%	100.0%	0.4%	99.0%
	High or medium risk properties	2.5%	100.0%	2.2%	99.0%

Flood risk is based on exposure to flooding from rivers and seas only. In the underwriting process flood risk from other sources is also considered. Work is ongoing to incorporate these additional risks into the Group's risk metrics.

Quantitative analysis for flood risk used localised postcode level data and indicated that only a small proportion of security properties were located within medium or high-risk zones. The Group is yet to experience any loss from flood or ground instability.

Green mortgage lending, for properties with EPC grades of A to C increased by 27.7% in the year to £577.7 million (2020: £452.5 million). For new buy-to-let mortgages in England and Wales advanced during the year ended 30 September 2021, the distribution of EPC grades is shown below.

Indicator	Measure	2021	Coverage	2020	Coverage
EPC	Grading A to B	9.4%	93.0%	10.2%	94.0%
	Grading A to C	40.3%	93.0%	40.8%	94.0%
	Grading A to E	100.0%	93.0%	100.0%	94.0%

The Group's completions continue to have a higher average EPC grade than the total portfolio stock, shifting the overall mix towards more energy efficient properties, a trend which will be accelerated by the launch of green mortgage products in the year. However, a focus by banks on green advances alone will not deliver the desired changes in the housing stock, and initiatives to decarbonise the existing stock will be needed.

In the Group's SME lending business, limited company customers have been broadly analysed by SIC codes to identify those operating in high carbon intensive industries. The results are set out below.

Indicator	Sector	2021	Coverage	2020	Coverage
Sector	Water, sewerage and waste	4.53%	100%	3.54%	100%
	Extractive industries	2.35%	100%	1.75%	100%
	Power generation	0.01%	100%	0.01%	100%
	Total carbon intensive industries	6.89%	100%	5.30%	100%

This demonstrates that the Group's SME lending customer base is not disproportionately exposed to those industries considered to have the highest environmental impacts.

Measures addressing other risk elements including those in other business streams, for example, classifications of business assets and motor vehicles financed by environmental impacts, and classification of development finance projects by environmental rating, are under development and continue to evolve. Further work will also be undertaken to narrow reporting metrics beyond SIC codes, given the breadth of activities that can be included. These will be aligned to the UK's new Green Taxonomy due to be introduced during 2022.

Use of scenario analysis

As our understanding of climate risk develops climate change scenario analysis is becoming of increasing importance. Scenario analysis enables the identification of risks across the short, medium and long term. The complex nature of forward-looking scenarios and long-term scenarios beyond the planning horizon brings about many challenges.

The process to review the implications for the Group of the PRA Climate Biennial Exploratory Scenario ('CBES'), released in June 2021, is currently underway. The CBES is focused on testing the financial resilience of firms across three scenarios for government intervention on climate, referred to as 'Early policy action', 'Late policy action' and 'No additional policy action'. These are aligned with the Network for Greening the Financial System ('NGFS') scenarios which are seen as good practice.

Future developments

In addition to the work currently in progress described above, the Group's climate change programme includes:

- Further embedding climate change risk management across the business
- Enhancement of the understanding of the climate change impact of the Group's lending within the business
- Development of the climate change risk policy which clearly documents the Group's approach to managing climate change risk within the ERMF. The Policy helps document how the understanding and management of climate risk is distributed across the business whilst articulating clear roles and responsibilities for managing and monitoring of climate change risk across the business
- Development of formal climate related risk appetites and a full suite of Key Risk Indicators and Key Performance Indicators. These will then be further developed into short-term and long-term climate related targets or ambitions for the Group
- Continued development of climate change scenario analysis leveraging off the CBES and NGFS scenarios to determine the resilience of the Group's strategy under different climate-related scenarios

Financed emissions

The Group supports the UK's ambition for net zero by 2050 and has a climate ambition of reducing the emissions associated with the mortgage book. This year, for the first time, it has calculated the Scope 3 emissions associated with its buy-to-let mortgage lending activities. With this data being relatively new, the Group is in the process of identifying other ways that it can support its customers whilst reducing the impact that its lending has on the environment.

The Group plans to continue to develop its financed emission disclosures over the next year scoping out methodologies to increase the balance sheet coverage as well as emission reductions. Whilst the Group has not yet set science-based targets across its financed emissions, there are plans to explore this further enabling the Group to track progress and alignment with a net zero pathway.

Scope 3 Mortgage emissions

Financed emissions – considered as scope 3 emissions – are the emissions that the Group's customers produce due to the financing provided. In line with PCAF standard the absolute financed emissions have been calculated across the buy-to-let mortgage portfolio. Under this approach a lender, such as the Group, is considered to be responsible for a proportion of the emissions based on an 'attribution factor'.

For buy-to-let mortgages the annual emissions relating to the finance property are attributed to the mortgage provider on a loan-to-value basis.

PCAF scope 3 financed emissions	
Scope 3 Annual buy-to-let mortgage emissions	**2021**
Balance of mortgage lending (£m)	11,312.7
Balance of mortgage lending with valid EPCs (£m)	9,775.2
Absolute Financed Emissions from properties with valid EPCs (tonnes CO_2)	148,607
Physical Emissions intensity of properties with valid EPCs ($kgCO_2$ per m^2)	47.24
Economics Emissions intensity of properties with valid EPCs ($kgCO_2$ per £ income)	13,419

Notes on calculation methods

1. The financed emission attribution factor uses outstanding balance and original valuation to calculate the (unindexed) loan-to-value factor – this is aligned with the PCAF guidelines.
2. The data contained in the EPC has not been altered or updated.
3. The data score calculated in accordance with the PCAF guidelines was 3 as all the data above relates to properties with available EPCs.
4. The calculation of physical emissions intensity used the sum of attributed floor area using loan-to-values ratios.

Operational Impact

The Group is mainly engaged in mortgage, consumer and commercial finance and therefore the overall environmental impact of its operations is considered to be low.

SFS leases refuse collection vehicles to local authorities throughout the UK. SFS undertakes additional aftersales activities that include servicing, maintenance and breakdown support, hence has the most significant potential environmental impacts.

The main environmental impacts of the Group's other operations are limited to universal environmental issues such as resource use, procurement in offices and business travel.

Policy

The Group complies with all applicable laws and regulations relating to the environment and includes these within its legal compliance framework. The Group's environmental commitment is included within the Health, Safety and Environmental policy that is approved by the CEO and the People Director.

Its environmental commitments are expressed in its Green Charter which is approved by the CEO and kept under regular review.

Group-wide recycling and awareness campaigns are also run with employees to reduce various forms of waste such as food, consumables or energy.

Risk management

The environmental risk inherent in the Group's operations is managed by the Group Property function and is within the remit of the Chief Operating Officer. It is monitored within the Group's operational risk management framework by the second line Operational Risk function and the ORC.

Energy data is collated by Group Property, the division responsible for managing the Group's premises. Consumption figures for all locations occupied, whether directly owned or tenanted, are actively monitored. This is reported upwards to board level.

SFS operates from several workshops around the UK and has exposure to several waste streams (oils, vehicle parts etc) that come from its workshop activities. These are effectively managed under an environmental management system that is certificated to an International Standard – ISO14001:2015. A dedicated health and safety manager has direct responsibility for environmental issues at all SFS sites.

The Group complies with the Energy Savings and Opportunities Scheme ('ESOS'). This is a UK Government initiative, and requires the Group to identify and reduce its energy consumption. The Group submitted its ESOS compliance notification to the Environment Agency in December 2019. The next submission is due in 2023.

Supply chain and procurement

The principal suppliers of the Group comprise its outsourced savings administrator, legal and professional services providers, building lessors and IT service providers. They therefore are exposed to similar operational environmental risks to those of the Group.

The Group remains committed to identifying, targeting and addressing inefficiencies within its supply chain. The procurement function works with key suppliers to identify solutions to reduce the environmental impacts of our business activities, whether direct or indirectly.

All pre-printed stationery items used by the Group are from renewable sources certified by FSC.

84.5% (2020: 84.0%) of the purchased electricity in the year was obtained from sources certified as renewable by the Office of Gas and Electricity Markets ('OFGEM').

Environmental initiatives

All the general waste produced at the Group's principal sites, outside SFS, was disposed through an approved waste contractor using Waste to Energy initiatives, resulting in no waste from these locations being disposed at landfill.

During the year the Group's London operations were centralised at a new location at Fenchurch Street in the City. These new premises both reduce the Group's operational footprint and increase energy efficiency. The new location is a more modern, green building built to the latest BREEAM standards. The Group benefits from clean energy created on site by hydrogen fuel cells, and all waste is segregated on site by the building's facilities management team.

The Group's other environmental initiatives in the period include:

- Installation of a new, more energy efficient heating plant at the main SFS location, reducing the Group's gas consumption
- Continuing the programme of refurbishment work on washroom facilities at the head office building employing touchless energy and resource saving technology. All construction wastes are segregated and disposed of responsibly by the contractor
- Continuing to modernise the key components of the Heating, Ventilation and Air Conditioning ('HVAC') systems at the head office site, reducing the Global Warming Potential ('GWP') of chiller plant used during the summer months

The scope of initiatives in the period has been limited by the impact of lockdowns and other restrictions on access to the Group's buildings for large parts of the period, particularly for external contractors.

An independent assessment of the Group's energy performance, at the head office and its Leeds site, has been commissioned and will take place in the early part of the new financial year. The recommendations from this assessment will form part of the Group's resource planning and be used as the basis for setting short, medium and long term goals for reducing environmental impacts. These objectives will be approved, and progress monitored, at board level.

Key short term objectives are:

- Alignment of the Group's environmental management systems to ISO14001:2015 prior to obtaining external certification
- Set the baseline year to be used for the ongoing measurement of the Group's environmental performance going forward
- For leased buildings managed externally, liason with landlords to encourage the procurement of energy from renewable sources where possible, and generally encourage initiatives to reduce the carbon footprint at such locations
- Roll out training programmes to raise awareness of environmental impacts amongst the Group's people, with focussed training for those with specific responsibilities in the environmental management system

Performance indicators

The environmental key performance indicators for the Group, determined having regard to the Reporting Guidelines published by the Department of Business, Energy and Industrial Strategy ('BEIS') and the Department for Environment, Food and Rural Affairs ('DEFRA') in March 2019, are set out below.

The Group does not consider it has significant environmental impacts under the headings 'Resource Efficiency and Materials', 'Emissions to Land, Air and Water' or 'Biodiversity and Ecosystem Services' set out in the Guidelines, due to the nature of its business activities.

This information is presented for the twelve months ended 30 September in each year and includes all entities consolidated in the Group's financial statements. Normalised data is based on total operating income of £324.9 million (2020: £295.1 million).

Greenhouse gas ('GHG') emissions

	2021 Tonnes CO_2e	2020 Tonnes CO_2e
Scope 1 (Direct emissions)		
Combustion of fuel:		
Operation of gas heating boilers	**450**	452
Petrol and diesel used by company cars	**353**	402
Operation of facilities:		
Air conditioning systems	**33**	33
	836	887
Scope 2 (Energy indirect emissions)		
Directly purchased electricity	**641**	697
Total scope 1 and 2	**1,476**	1,584
Normalised tonnes - scope 1 and 2 CO_2e per £m income	**4.5**	5.4
Scope 3 (Other indirect emissions)		
Fuel and energy related activities not included in scope 1 or 2	**426**	325
Water consumption	**4**	12
Waste generated in operations	**60**	61
Total scope 3	**490**	398
Total scopes 1, 2 and 3	**1,967**	1,982
Normalised tonnes scope 1,2 and 3 CO_2e per £m income	**6.1**	6.7

CO_2 equivalent ('CO_2e') values above are calculated based on the BEIS / DEFRA guidelines published on 1 June 2021.

The amounts shown above for total scope 1 and scope 2 emissions are those required to be reported under the Companies Act (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018. Other scope 3 emissions from operations not reported above are not considered to be significant. All these emissions relate to activities in the UK and its offshore area.

The reduction in emissions in the year is principally driven by the continuing effects of Covid. The majority of emissions included above relate to the provision of heat, light and power to the Group's premises. Several office buildings were closed for long periods, particularly during the winter months when the UK was in lockdown. Social distancing rules continued to mean that the scope for business travel, for meetings and other normal parts of the business process was sharply reduced, particularly in the first half of the year.

Emissions attributable to employees working from home are not included within the scope of the regulations, at present.

It is unlikely that these levels would be maintained in a normal operating environment.

The Group has not been involved in any prosecutions, accidents or similar non-compliances in respect of environmental matters, nor incurred any fines in respect of such matters.

Power usage

The Group uses mains electricity and natural gas from the UK grid to provide heat, light and power to its office buildings. It also uses fuel in company vehicles, which is included in Scope 1 above and through business travel of employees, which is included in Scope 3. The amount of power used in the year ended 30 September 2021 is shown below.

	2021	2020	2019
	MWh	MWh	MWh
Renewable electricity	**2,458.6**	2,509.3	3,123.5
Other electricity	**558.9**	478.2	768.1
Electricity	**3,017.5**	2,987.5	3,891.6
Natural gas	**2,454.9**	2,450.9	2,817.1
Motor fuel	**1,551.7**	1,900.3	3,099.9
	7,024.1	7,338.7	9,808.6
Normalised MWh per £m income	**21.6**	24.9	33.0

Consumption levels have remained low in the year as the pattern of Covid-related lockdowns and working from home, which commenced in March 2020 continued through much of the year. Some of the Group's buildings were closed for long periods, with the utilisation of others reduced.

Gas and electricity usage are based on consumption recorded on purchase invoices. Vehicle fuel usage is based upon expense claims and recorded mileage. Renewable energy is supplied through the grid with OFGEM accreditation received from the suppliers. No separate conversion factor is stated by BEIS / DEFRA for electricity from renewables and therefore the Group receives no benefit for this in the GHG emissions table above.

Water usage

The Group's water usage is limited to the consumption of piped water in the UK and no water is extracted directly. Water usage in the year ended 30 September 2021 was 8,500m^3 (2020: 11,950m^3), based upon consumption recorded on purchase invoices, a normalised amount of 26.1m^3 per £m income (2020: 40.5m^3 per £m income). The reduction in usage is a result of reduced office occupancy through most of the year.

Waste

SFS is the Group's primary waste producers. Their vehicle servicing activities generate a variety of different waste streams – including various grades of oil, and a range of metals and plastics. These wastes are managed responsibly in accordance with an ISO14001:2015 certificated management system. Waste streams generated by SFS are disposed of in accordance with the waste hierarchy before being consigned to approved waste transfer stations under contract and Waste Transfer Notes obtained.

The Group's waste output outside SFS consists of a mixture of general office waste types which includes principally paper and cardboard with some wood, plastic and metals. The Group provides facilities in its offices for recycling paper, cardboard, newspapers, glass, plastics and aluminium and steel cans. Batteries and printer and photocopier cartridges are collected and sent for recycling. The largest part of the Group's recycled outputs relates to waste paper.

All the Group's waste is either recycled, used in waste-to-energy initiatives or sent to landfill. Amounts of waste generated in the year ended 30 September 2021 together with the methods of disposal are shown below.

	2021	2020	2019
	Tonnes	Tonnes	Tonnes
Recycled	**87**	61	122
Waste to Energy Initiatives	**17**	29	-
Landfill	**125**	131	187
	229	221	309
Normalised tonnes per £m income	**0.70**	0.75	1.04

Waste generation data is based upon volumes reported on disposal invoices.

Generation of waste in the Group's buildings continues to be depressed by the low levels of occupancy, coupled with a concerted effort in several areas to reduce paper usage.

The Group's long-term strategy is to increase the proportion of waste which is either recycled or used in Waste to Energy initiatives.

A6.5 Social and community

The Group's activities are based wholly within the United Kingdom. It operates within the legal and regulatory framework of the UK, acknowledging the importance of corporate responsibility and citizenship, striving to go beyond what is required in its relationships with its customers, the wider community and other stakeholders.

The Group operates as a specialist lender and provides funding for business propositions in the development finance and SME lending markets which might struggle to attract larger lenders, helping to support the SMEs which are crucial to the UK economy.

Where possible, the Group uses its lending relationships to promote good practice. The buy-to-let mortgage division demands minimum standards from landlords in the properties it funds, helping to drive up standards in the PRS. Looking forward, the Group is developing products which will help to drive action on climate change.

Industry initiatives

Through its activity within trade organisations in the UK, the Group is helping to formulate public policy and share experience on best practice to drive forward better financial provision. The Group has been particularly active in initiatives to enable the PRS to serve the UK housing market more effectively. The Group also regularly engages directly with Government to help inform departments on how market trends are impacting landlords, their sentiment and behaviours. The Group's CEO is a member of both HM Treasury's Home Finance Forum and the Bank of England Residential Property Forum which provide input to policy at the highest levels.

Membership of bodies such as UK Finance and the FLA enables the Group to be part of shaping the future of financial services provision to the benefit of the whole community. In 2021, this has been enhanced through work by the Mortgage Lending business with the Green Finance Institute on the potential for providing green products to the buy-to-let mortgage market. In particular the business worked with the Coalition for Energy Efficient Buildings formed by the Institute.

The Group contributes to registered charities providing debt advice to support its vulnerable customers. Contributions of £912,000 (2020: £1,110,000) were made by the Group during the year to the work of the Foundation for Credit Counselling which operates the StepChange Debt Charity. This ensures that such customers are able to receive free, independent advice on their finances from qualified counsellors.

Supporting the community

The Group actively supports charity initiatives, focussing on organisations serving the communities in which it operates. Contributions made in the year totalled £39,600. (2020: £157,800).

Charities which benefitted from the Group's charitable donations include local schools, sports clubs, hospitals and hospices, The Down's Syndrome Association, British Heart Foundation, Rethink Mental Illness, Happy Days Children's Charity, Demelza Hospice Care for Children, and many others. During Pride month the Group encouraged fundraising for LGBTQ+ affiliated charities with one of the beneficiaries being St Basil's charity.

Due to the Covid pandemic face-to-face volunteering with SIFA Fireside, local schools and 'Ready to Work' were unfortunately put on hold. Employees continued to make a difference to the local community, focusing on virtual volunteering and providing mentoring for individuals who require careers support. This achieved 49 volunteering days (2020: 23.5 days). The Group is also in the process of resuming its normal volunteering activities with early initiatives including:

- St Basil's charity – Yardley House, a residential housing unit for young vulnerable adults. The unit, specifically for mothers and babies, required support to refurbish its communal garden area
- Stanville Primary School – previously a hospital building which required extensive refurbishment. The school was under pressure to save money, and with reduced staffing due to the pandemic needed volunteers to assist with creating a safe and interesting play area for its Early Years section

At Christmas 2020, the annual donations of food and luxury items by employees for Christians Against Poverty continued. Even though this was impacted by the Covid lockdown with the majority of employees continuing to work remotely, a total of 54 families received a parcel delivery.

The Group also supports Paragon's Charity Committee, consisting of volunteer employees, who organise a variety of fundraising activities throughout the year. Each year all employees are given the opportunity to nominate a charity, and a vote is carried out amongst the employees to select the charity or charities to benefit from the following year's fundraising activities. In the calendar year 2020, £60,000 was raised for Macmillan, while in the first nine months of 2021, £22,000 has been raised for the Alzheimer's Society through online events, monthly raffles and employees taking part in sponsored events including 'Jog on or Step-up for Alzheimer's' and charity football.

Given the restrictions which continued to be imposed on office-based fund-raising activities by working from home, this is an impressive achievement by the Committee and the Group's employees.

Taxation policy and payments

Materially all the Group's taxable income arises in the UK and therefore it has no presence in jurisdictions considered to enable tax base erosion and profit shifting.

The Group's tax strategy is to comply with all relevant tax obligations whilst co-operating fully with the tax authorities. The Group recognises that in generating profits which can be distributed to shareholders it benefits from resources provided by government and the payment of tax is a contribution towards the cost of those resources. The Group will only undertake tax planning that supports commercial activities and, in the UK context, is not contrary to the intention of Parliament.

As a group containing a bank, the Group is subject to The Code of Practice on Taxation for Banks (the 'Bank Tax Code') published by HMRC in March 2013. The Group has previously confirmed to HMRC that it was unconditionally committed to complying with the Bank Tax Code, and formally re-approved the Group's tax governance policies and the tax strategy outlined above.

During each financial year the Group publishes a tax strategy document for that year on its website, in accordance with the Finance Act 2016. This document addresses the following matters:

- The approach of the Group to risk management and governance arrangements in relation to UK taxation
- The attitude of the Group towards tax planning (so far as affecting UK taxation)
- The level of risk in relation to UK taxation that the Group is prepared to accept
- The approach of the Group towards its dealings with HMRC

The fourth such statement was published during the year and can be found in the investor relations section of the Group's website.

The published strategy is owned by the Board collectively in accordance with HMRC's published expectations. The CFO has been designated as the Senior Accounting Officer for tax purposes and, as such, reviews compliance with the Group's policies each year.

The Group has an open and positive relationship with HMRC, meeting with their representatives on a regular basis, and is committed to full disclosure and transparency in all matters.

The Group is resident and operates in the UK and its tax payments to the UK authorities include not only corporation tax but also substantial payroll taxes. The amounts of the Group's cash payments to UK national and local tax authorities in the year, including Pay As You Earn ('PAYE') and National Insurance ('NI') contributions deducted from employee wages and salaries were as follows:

	2021	2020
	£m	£m
Corporation tax	**48.3**	46.1
PAYE and NI	**29.1**	32.8
VAT	**3.8**	2.7
Stamp duty	**0.2**	-
Total national taxation	**81.4**	81.6
Business rates	**1.3**	1.4
	82.7	83.0

In response to the Covid crisis the UK Government permitted companies to defer VAT payments due between 20 March 2020 and 30 June 2020. The Group did not take advantage of this concession and paid its liabilities in accordance with the statutory provisions.

A6.6 Human rights

The Group respects all human rights and in conducting its business regards those rights relating to non-discrimination, fair treatment and respect for privacy to be the most relevant and to have the greatest potential impact on its key stakeholder groups of customers, employees and suppliers.

The Group's commitment to supporting its people's employment rights is described in Section A6.3.

The Group operates exclusively in the UK and, as such, is subject to the UK Human Rights Act 1998 which incorporates the European Convention on Human Rights into UK law. The Group has systems in place to ensure that its policies and procedures are compatible with all legal requirements applicable to it and to identify any new or emerging requirements.

The Board and the CEO have overall responsibility for ensuring that all areas within the Group uphold and promote respect for human rights. The Group seeks to anticipate, prevent and mitigate any potential negative human rights impacts as well as enhance positive impacts through its policies and procedures and, in particular, through its policies regarding employment, equality and diversity, treating customers fairly, and information security.

The Group's policies seek to ensure that employees and business partners comply with the relevant legislation and regulations in place in the UK and to promote good practice. The Group's policies are formulated and kept up-to-date by the relevant business areas, authorised in accordance with the Group's governance procedures and are communicated to all employees.

The Group's compliance with human rights regulation falls within its overall compliance regime, and any breaches or potential breaches would be investigated and addressed through the Group's risk management framework and, if appropriate, its disciplinary procedures.

The Group supports the objective of the Modern Slavery Act 2015, in raising awareness of modern slavery and human trafficking.

It is committed to ensuring that there is no modern slavery or human trafficking in its supply chains or in any part of the business and to acting ethically and with integrity in all business relationships. It actively engages with suppliers to ensure that compliance with Modern Slavery legislation is achieved. This commitment is reflected in the Group's policies and its Supplier Code of Conduct.

The Group publishes an annual Modern Slavery Statement, describing policies for achieving this, which can be found on the Group's website: www.paragonbankinggroup.co.uk.

The Group undertakes extensive monitoring of the implementation of all its policies and has not been made aware of any incident in which the organisation's activities have resulted in an abuse of human rights or a breach of Modern Slavery legislation. No fines or prosecutions in respect of non-compliance with human rights legislation, including Modern Slavery legislation, have been incurred in the financial year (2020: none).

A6.7 Business practices

Business partners

The Group's business model relies on maintaining good relationships with its principal business partners, primarily financial intermediaries, such as mortgage brokers, and purchase ledger suppliers including those for establishment costs and professional services.

The Group is committed to the fair treatment of all suppliers. In return, we expect suppliers to help to deliver a high standard of service to our customers and act responsibly.

The Group has a Supplier Code of Conduct, available on its website, which sets out our overall approach to supplier engagement and corporate responsibility and, importantly, the standards of behaviour expected from suppliers.

The Code of Conduct also includes the Group's conduct commitments and its expectations of business partners in relation to bribery and corruption, data protection and modern slavery. It also contains important information concerning the Group's employment practices, approach to health and safety, community matters and environmental policies.

When outsourcing activities, the Group retains responsibility for those services and the associated risks. Significant work has been focused on the most critical suppliers to meet enhanced regulatory requirements under the European Banking Authority's Guidelines on outsourcing. These changes strengthen the Group's resilience across the supply chain.

The Group aims to pay all of its suppliers within 30 days of receiving a valid invoice, where correct procedures are followed and actively engages with suppliers where issues arise. It is a signatory to the UK's Prompt Payment Code ('PPC'), administered by the Office of the Small Business Commissioner and as such commits to paying invoices within 60 days, unless there is good reason for non-payment. The PPC also aims to ensure all invoices from suppliers it defines as small businesses, are paid within 30 days unless under query.

The Group's central administration company, Paragon Finance PLC, reports its payment performance semi-annually under the 'Reporting on Payment Practices and Performance Regulations 2017'. Following some disruption to process caused by Covid restrictions in the first half of the year, data for the six months ended 30 September 2021 showed invoices paid in an average of 22 days and 95% of invoices paid within 60 days, on the basis set out in the regulations.

Anti-corruption

The Group carries out its business fairly, honestly, and openly. It has a comprehensive anti-bribery and corruption policy, endorsed by the directors, covering all employees, and operated throughout the Group. It will not make or accept bribes, nor will it condone the offering or receiving of bribes on its behalf. The Group will always avoid doing business with those who do not accept its values and who may harm its reputation.

The Group carries out an annual risk assessment as required by the Bribery Act 2010 and continues to conclude that it is not a company with a high risk of bribery. The Group conducts all of its business within the UK and its only significant outsourcing arrangement relates to the administration of its savings operations by the outsourcing arm of a major UK building society. The UK is not considered a jurisdiction with a high incidence of corrupt practices, ranking eleventh safest in the Corruption Perceptions Index for 2020 out of 180 countries.

However, the Group takes its responsibilities seriously and will not tolerate bribery in any form on any scale and as such, its policies and procedures are kept under regular review. The Group will self-report any serious incidence of bribery or corruption that is identified.

The Group's policies cover the conduct of its business, its interactions with suppliers and contractors and the giving or receiving of gifts and corporate hospitality. It prohibits facilitation payments. Before new suppliers are approved, the Group's procedure requires that they must be assessed against the requirements of the anti-bribery and corruption policy which is incorporated in the Supplier Code of Conduct. The policy is updated, and a risk assessment conducted on an annual basis.

All employees are required to read the Group's anti-bribery and corruption policy and undertake annual on-line training to assess their understanding. The anti-bribery culture forms part of the induction course for all new employees and is reinforced at subsequent training sessions. Any employee found to be in breach of these policies will be subject to disciplinary action. No such disciplinary action has taken place in the year ended 30 September 2021.

During the year the CRO, in conjunction with the Head of Financial Crime, who are both part of the 'second line' Risk and Compliance function, were responsible for ensuring the Bribery Act risk assessment is properly completed and that appropriate policies and procedures were in place and reviewed on a regular basis. They were also responsible for ensuring any changes in the law are identified and properly reflected in the Group's policies and procedures, where appropriate. In the last year there have been no material changes in legislation or guidance in the UK. Following the year end a new role of Head of Financial Crime Risk was created, taking on the risk management aspects previously part of the role of the Head of Financial Crime, enabling greater focus on both the first and second line aspects of the role.

The Group has not been involved in any incidents resulting in prosecutions, fines, or penalties or in similar incidents of non-compliance in respect of bribery, corruption, or other illegal business practices (2020: none).

Anti-money laundering

As a financial services entity, the Group also has procedures in place to ensure it cannot be used to facilitate money laundering, sanctions abuse or other forms of financial crime. These procedures are kept under constant review to ensure they remain robust and appropriate, and a further gap analysis was carried out during the year in light of the FCA 'Dear CEO' letter on anti-money laundering frameworks sent to retail banks in May 2021. Additional requirements identified are being addressed as an immediate priority.

Employees receive regular annual training in these areas, with their understanding being tested and levels of completion reported to regulators. At 30 September 2021 the Group's money laundering reporting officer was the CRO, pending the appointment of a new Head of Financial Crime Risk, following the departure of the previous role holder towards the end of the financial year.

Management responsibility

The Group's senior legal officer is the Group Counsel and Company Secretary, who is a member of the Executive Committee and attends meetings of the Board. The CRO has overall responsibility for the risk and compliance functions. He is also a member of the Executive Committee and reports directly to the Risk and Compliance Committee of the Board (see Section B8).

All business heads are responsible for having the appropriate controls in place to ensure that employees adhere to the Group's anti-money laundering, and anti-bribery and corruption policies and procedures, and other policies relating to business practices. This is monitored as part of the Group's risk management process and reviewed, as appropriate, by the Internal Audit function.

Whistleblowing

A whistleblowing hotline, run by an independent third party, Protect, is available to employees who have concerns over any aspects of the Group's business practices. The Group's principal regulators, the PRA and FCA, provide confidential whistleblowing services to customers and external third parties which are communicated to customers and publicised on the Group's and the regulators' websites. Whistleblowing arrangements are described further in Section B4.5.

A7. Approval of Strategic Report

Section A of this Annual Report comprises a Strategic Report for the Group. The information on how the directors have discharged their duties under s172 of the Companies Act 2006 included in Section B4.3 of the corporate governance report is also included in this strategic report by reference.

This Strategic Report has been drawn up and presented in accordance with, and in reliance upon, applicable English company law, in particular Chapter 4A of the Companies Act 2006, and the liabilities of the directors in connection with this report shall be subject to the limitations and restrictions provided by such law.

It should be noted that the Strategic Report has been prepared for the Group as a whole, and therefore gives greater emphasis to those matters which are significant to the Company and its subsidiaries when viewed as a whole.

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

Marius van Niekerk
Company Secretary
7 December 2021