

PARAGON SECOND FUNDING LIMITED

Report and Financial Statements

Year ended 30 September 2020

STRATEGIC REPORT

BUSINESS REVIEW AND PRINCIPAL ACTIVITIES

Paragon Second Funding Limited ('the Company') is a wholly owned subsidiary of Paragon Banking Group PLC ('the Group') and was set up to provide the funding of mortgages loans originated by the Group by using a revolving facility. Subsequently, the mortgage loans were sold to fellow group companies. During the year the Company operated in the United Kingdom, its principal activities are the provision of first mortgage loans. There have been no significant changes in the Company's principal activities in the year under review. The directors are not aware, at the date of this report, of any likely major changes in the Company's activities in the next year.

As shown in the Company's profit and loss account on page 8, the Company's net interest income decreased by 14% compared to the prior year (2019: 6% decrease). This was principally reflecting the reduction in the Company's loan book during the year. Result after tax has decreased from a profit of £5,420,000 to a loss of £568,000. This was mainly due to the charge on provisions on impairment of financial assets being £5,854,000 in the current year compared to just £29,000 in the preceding year.

The balance sheet on page 9 of the financial statements shows the Company's financial position at the year end. Loans to customers have decreased by 7% (2019: decreases of 8%) to £881,892,000 (2019: £948,144,000). As a result, the warehouse facility has decreased by 7% (2019: decrease of 8%) during the year. The outstanding balance as at 30 September 2020 was £799,900,000 (2019: £861,700,000). Details of amounts owed from and to other group companies are shown in notes 14 and 18.

The directors recommend no final dividend (2018: £nil) which, given the interim dividend of £nil per share (2019 £nil per share), means a total dividend for the year of £nil per share (2019: £nil per share).

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

PRINCIPAL RISKS AND UNCERTAINTIES

The assets of the Company are located entirely in the United Kingdom and its results are therefore impacted by the economic environment within the UK. A material downturn in economic performance could increase the numbers of customers who default on loans and / or cause the values of the properties over which the Company enjoys security to fall.

The UK economy in the current year has been impacted significantly by the effects of the Covid-19 virus. This has caused major economic disruption within the UK and global economy but has also driven governments and regulators to offer unprecedented levels of support to businesses and consumers, aimed at mitigating its impact.

The Company has put contingency plans in place to ensure that it can continue to service its customers and to satisfy its obligations under the funding structure. However, should the pandemic have significant long-term impacts on the UK economy then this would significantly impact the Company's future cash flows and performance.

Together with continuing uncertainty arising the potential impact economic impact of the UK's withdrawal from the European Union, the Covid-19 pandemic has made the long-term economic prospects for the UK and their impacts on the Company much difficult to forecast.

The Company is a securitisation company and has been structured so as to avoid, in as far as is possible, all forms of financial risk with its outstanding loan notes match-funded to maturity. An analysis of the Company's exposure to risk, including financial risk, and the steps taken to mitigate these risks are set out in note 6, a discussion of critical accounting judgements is set out in note 4 and a discussion of critical accounting estimates is set out in note 5.

FUTURE PROSPECTS

After considering the above, the directors have a reasonable expectation that the Company will have adequate resources to continue in operational existence for the foreseeable future, this is further discussed in note 3.

STRATEGIC REPORT

BOARD AND STAKEHOLDERS

The Board of the Company is mindful of its duty to act in good faith and to promote the success of the Paragon Banking Group PLC group of companies (the ‘Group’) for the benefit of its shareholders and with regard to the interests of all of its stakeholders and, in particular, the interests of the Company’s noteholders. The Board confirms that, for the year ended 30 September 2020, it has acted to promote the success of the Company for the benefit of its members as a whole and continues to have due regard to the following matters (as per section 172 of the Companies Act 2006):

- a. The likely consequences of any decision in the long-term;
- b. The interests of the Company’s employees;
- c. The need to foster the Company’s business relationships with suppliers, customers and others;
- d. The impact of the Company’s operations on the community and the environment;
- e. The desirability of the Company maintaining a reputation for high standards of business conduct; and
- f. The need to act fairly as between members of the Company.

As part of the Group, stakeholder engagement, for stakeholder groups where there is substantial common identity between the non-shareholder stakeholders of the Company and of the Group, takes place at a group level and the Company looks to group initiatives for guidance and takes them into account in its decision making. The Company follows Group policies and procedures as mentioned above, including those relating to the fair treatment of customers, standards of business conduct, the environment, the community and other stakeholders. More detail may be found in the Group’s 2020 Annual Report and Accounts.

In its decision making the Board of Directors will also have regard to the rights and interests of the holders of the Mortgage Backed Bank Loan in accordance with the transaction documents under which they were issued.

As a securitisation entity the decision-making powers of the Board of Directors are limited so long as the notes remain outstanding. Key policies have been predetermined at the time of issuance and the operational roles have been assigned to third parties with their roles strictly governed by the transaction documents. However, in considering items of business the Board makes autonomous decisions on their own merits, after due consideration of the long-term success of the Company, those factors set out in section 172 of the Companies Act 2006, where relevant, and the stakeholders impacted.

Board meetings are held periodically where the directors consider Company business, including its results and performance. As a special purpose funding vehicle for the Group, the Board also reviews strategy, financial, and operational performance, as well as information covering areas such as key risks and legal and regulatory compliance. This information is presented to the Board through reports sent in advance of each Board meeting and through in person presentations.

More information on the Company’s impact on individual stakeholder groups is set out below.

SHAREHOLDERS

The Company has a single shareholder, Paragon Mortgages Limited, which is itself a wholly owned subsidiary of Paragon Bank PLC, the ultimate parent company is Paragon Banking Group PLC. However, the transaction documents limit this entity to a nominal interest in the risks and rewards of the business of the Company. The interests of the Company’s shareholders thus coincide with those of the shareholders of the Group (s172 (1)(f)).

ENVIRONMENT

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

STRATEGIC REPORT (CONTINUED)

EMPLOYEES

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

Approved by the Board of Directors

and signed on behalf of the Board

A handwritten signature in black ink, appearing to read 'K G Allen', written in a cursive style.

K G Allen

Director

28 January 2021

DIRECTORS' REPORT

The directors present their Annual Report prepared in accordance with Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 and the audited Financial Statements of Paragon Second Funding Limited, a company registered in England and Wales with registration no: 02637506, for the year ended 30 September 2020.

CORPORATE GOVERNANCE

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

DIRECTORS

The directors throughout the year and subsequently were:

R D Shelton

R J Woodman

K G Allen

J P Giles

AUDITOR

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

No notice from members under section 488 of the Companies Act 2006 having been received, the directors intend that the auditor, KPMG LLP, shall be deemed to be reappointed in accordance with section 487(2) of the Act.

INFORMATION PRESENTED IN OTHER SECTIONS

Certain information required to be included in a directors' report by the Companies Act 2006 and regulations made there under can be found in the other sections of the Annual Report, as described below. All of the information presented in these sections is incorporated by reference into this Directors' Report and is deemed to form part of this report.

- Commentary on the likely future developments in the business of the Company is included in the Strategic Report.
- A description of the Company's financial risk management objectives and policies, and its exposure to risks arising from its use of financial instruments are set out in note 6 to the accounts.
- Disclosure on any dividends paid during the year is included in the Strategic Report.

Approved by the Board of Directors

and signed on behalf of the Board



K G Allen

Director

28 January 2021

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

**STATEMENT OF DIRECTORS' RESPONSIBILITIES
in relation to Financial Statements**

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

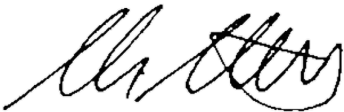
Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law).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

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

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

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets, for the Company's systems of internal control and for taking reasonable steps for the prevention and detection of fraud and other irregularities and for the preparation of a strategic report and directors' report which comply with the applicable requirements of the Companies Act 2006.

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



K G Allen

Director

28 January 2021

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF PARAGON SECOND FUNDING LIMITED

Opinion

We have audited the financial statements of Paragon Second Funding Limited for the year ended 30 September 2020 which comprise the profit and loss account, the balance sheet, the statements of movements in equity and the related notes 1 to 19, including the accounting policies in note 3.

In our opinion the Financial Statements:

- give a true and fair view of the state of the company's affairs as at 30 September 2020 and of its loss for the year then ended;
- have been properly prepared in accordance with UK accounting standards, including Financial Reporting Standard 101 – 'Reduced Disclosure Framework'; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities are described below. We have fulfilled our ethical responsibilities under, and are independent of the company in accordance with, UK ethical requirements including the FRC Ethical Standard. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion.

Going concern

The directors have prepared the financial statements on the going concern basis as they do not intend to liquidate the company or to cease its operations, and as they have concluded that the company's financial position means that this is realistic. They have also concluded that there are no material uncertainties that could have cast significant doubt over its ability to continue as a going concern for at least a year from the date of approval of the financial statements ("the going concern period").

We are required to report to you if we have concluded that the use of the going concern basis of accounting is inappropriate or there is an undisclosed material uncertainty that may cast significant doubt over the use of that basis for a period of at least a year from the date of approval of the financial statements. In our evaluation of the directors' conclusions, we considered the inherent risks to the company's business model and analysed how those risks might affect the company's financial resources or ability to continue operations over the going concern period. We have nothing to report in these respects.

However, as we cannot predict all future events or conditions and as subsequent events may result in outcomes that are inconsistent with judgements that were reasonable at the time they were made, the absence of reference to a material uncertainty in this auditor's report is not a guarantee that the company will continue in operation.

Strategic report and directors' report

The directors are responsible for the strategic report and the directors' report. Our opinion on the financial statements does not cover those reports and we do not express an audit opinion thereon.

Our responsibility is to read the strategic report and the directors' report and, in doing so, consider whether, based on our financial statements audit work, the information therein is materially misstated or inconsistent with the financial statements or our audit knowledge. Based solely on that work:

- we have not identified material misstatements in the strategic report and the directors' report;
- in our opinion the information given in those reports for the financial year is consistent with the financial statements; and
- in our opinion those reports have been prepared in accordance with the Companies Act 2006.

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF PARAGON SECOND FUNDING LIMITED (CONTINUED)

Matters on which we are required to report by exception

Under the Companies Act 2006, we are required to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

We have nothing to report in these respects.

Directors' responsibilities

As explained more fully in their statement set out on page 5, the directors are responsible for: the preparation of the financial statements and for being satisfied that they give a true and fair view; such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; assessing the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and using the going concern basis of accounting unless they either intend to liquidate the company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue our opinion in an auditor's report. Reasonable assurance is a high level of assurance, but does not guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

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

The purpose of our audit work and to whom we owe our responsibilities

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members, as a body, for our audit work, for this report, or for the opinions we have formed.



Michael Davidson (Senior Statutory Auditor)

for and on behalf of KPMG LLP, Statutory Auditor

Chartered Accountants

1 Sovereign Square, Sovereign Street, Leeds, LS1 4DA

28 January 2021

PARAGON SECOND FUNDING LIMITED

PROFIT AND LOSS ACCOUNT

YEAR ENDED 30 SEPTEMBER 2020

	Note	2020 £000	2019 £000
Interest receivable			
Mortgages		21,028	25,556
Other	7	6,353	6,406
		<hr/>	<hr/>
		27,381	31,962
Interest payable and similar charges	8	(19,789)	(23,133)
		<hr/>	<hr/>
Net interest income		7,592	8,829
Other operating income		61	82
		<hr/>	<hr/>
Total operating income		7,653	8,911
Operating expenses		(2,346)	(2,505)
Provisions for losses	13	(5,854)	(29)
		<hr/>	<hr/>
Operating (loss) / profit, being (loss) / profit on ordinary activities before taxation	10	(547)	6,377
Tax on (loss) / profit on ordinary activities	11	(21)	(957)
		<hr/>	<hr/>
(Loss) / profit on ordinary activities after taxation	16	(568)	5,420
		<hr/> <hr/>	<hr/> <hr/>

All activities derive from continuing operations.

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

PARAGON SECOND FUNDING LIMITED

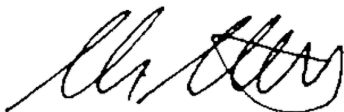
BALANCE SHEET

30 SEPTEMBER 2020

	Note	2020 £000	2020 £000	2019 £000	2019 £000
ASSETS EMPLOYED					
FIXED ASSETS					
Financial assets	12		881,892		948,144
CURRENT ASSETS					
Debtors falling due within one year	14	141,241		140,741	
Cash at bank		3,238		5,217	
			<u>144,479</u>	<u>145,958</u>	
			<u>1,026,371</u>	<u>1,094,102</u>	
FINANCED BY					
EQUITY SHAREHOLDERS' FUNDS					
Called up share capital	15	-		-	
Profit and loss account	16	448		1,016	
			<u>448</u>	<u>1,016</u>	
					1,016
PROVISIONS FOR LIABILITIES	17		298		1,064
CREDITORS					
Amounts falling due within one year	18	1,236		5,886	
Amounts falling due after more than one year	18	1,024,389		1,086,136	
			<u>1,025,625</u>	<u>1,092,022</u>	
			<u>1,026,371</u>	<u>1,094,102</u>	

These financial statements were approved by the Board of Directors on 28 January 2021.

Signed on behalf of the Board of Directors



K G Allen
Director

PARAGON SECOND FUNDING LIMITED

STATEMENT OF MOVEMENTS IN EQUITY

YEAR ENDED 30 SEPTEMBER 2020

	Share capital	Profit and loss	Total
	£000	account	equity
		£000	£000
<i>Total comprehensive income for the year</i>			
Loss for the year	-	(568)	(568)
Other comprehensive income	-	-	-
Total comprehensive income for the year	-	(568)	(568)
<i>Transactions with owners</i>			
Dividends	-	-	-
Net movement in equity in the year	-	(568)	(568)
Opening equity	-	1,016	1,016
Closing equity	-	448	448

YEAR ENDED 30 SEPTEMBER 2019

	Share capital	Profit and loss	Total
	£000	account	equity
		£000	£000
<i>Total comprehensive income for the year</i>			
Profit for the year	-	5,420	5,420
Other comprehensive income	-	-	-
Total comprehensive income for the year	-	5,420	5,420
<i>Transactions with owners</i>			
Dividends	-	-	-
Net movement in equity in the year	-	5,420	5,420
Opening equity	-	983	983
Change in accounting policy on adoption of IFRS9	-	(5,387)	(5,387)
As restated	-	(4,404)	(4,404)
Closing equity	-	1,016	1,016

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

1. GENERAL INFORMATION

Paragon Second Funding Limited ('the Company') is a company domiciled in the United Kingdom and incorporated in England and Wales under the Companies Act 2006 with company number 02637506. The address of the registered office is 51 Homer Road, Solihull, West Midlands, B91 3QJ. The nature of the Company's operations and its principal activities are set out in the Strategic Report.

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

2. BASIS OF PREPARATION

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

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

Adoption of new and reviewed reporting standards

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

- IFRS 16 – 'Leases'

This has had no impact upon the balance sheet or the profit and loss account.

Accounting changes at 1 October 2018

The accounting changes affecting equity at 1 October 2018 relate to the adoption of IFRS 9 – 'Financial Instruments' and are described in detail in note 3 to the accounts for the year ended 30 September 2019.

3. ACCOUNTING POLICIES

The particular accounting policies applied are described below.

Accounting convention

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

Going concern

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

As a result of the transaction documents governing the Company's bank loan borrowings described in note 18 the Company will continue to trade in the same way as it did in the year ended 30 September 2020 until either:

- All of the bank loan is repaid from principal cash flows arising from the Company's mortgage portfolio;
or
- The final repayment date for the bank loan in February 2050 is reached.

The directors have reviewed the balance sheet performance of the company and consider that it is unlikely that any of these events will occur during the year ending 30 September 2021.

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

3. ACCOUNTING POLICIES (CONTINUED)

Going concern (continued)

Before this point, repayments of the principal liabilities of the Company, the bank loan described in note 18, are limited to available principal cash received on the Company's loan portfolio until the final repayment date. Therefore, the directors have a reasonable expectation that the Company has adequate resources to continue in operational existence until this point, satisfying all liabilities as they fall due.

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

Loans to customers

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

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

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

Impairment of loans and receivables

Year ended 30 September 2020 under IFRS 9

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

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

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

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

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

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

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

3. ACCOUNTING POLICIES (CONTINUED)

Impairment of loans and receivables (continued)

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

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

Cash at bank

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

Current tax

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

Deferred taxation

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

Borrowings

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

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

Derivative financial instruments

Derivative instruments utilised by the Company comprise interest rate swaps. All such instruments are used for hedging purposes to alter the risk profile of the existing underlying exposure of the Company in line with the Company’s risk management policies (note 6).

The Company does not enter into speculative derivative contracts.

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

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

3. ACCOUNTING POLICIES (CONTINUED)

Hedging

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

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

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

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

Amounts owed by or to group companies

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

Fee and commission income

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

Revenue

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

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

3. ACCOUNTING POLICIES (CONTINUED)

Disclosures

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

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

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

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

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

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

4. CRITICAL ACCOUNTING JUDGEMENTS

The most significant judgements which the directors have made in the application of the accounting policies set out in note 3 relate to:

Significant Increase in Credit Risk ('SICR')

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

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

In determining whether an account has a SICR in the Covid-19 environment the granting of Covid-19 reliefs, including payment holidays and similar arrangements, may mean that a SICR may exist without this being reflected in either arrears performance or credit bureau data. The Group has accepted the advice of UK regulatory bodies that the grant of Covid-19 relief does not, of itself, indicate an SICR, but has carefully considered internal credit and customer data to determine whether there might be any accounts with SICR not otherwise identified by the process.

More information on the definition of SICR adopted is given in note 13.

Definition of default

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

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

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

More information on the Group's definition of default adopted is given in note 13.

Classification of financial assets

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

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

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

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

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

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

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

5. CRITICAL ACCOUNTING ESTIMATES

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

Impairment losses on loans to customers

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

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

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

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

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

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

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

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

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

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

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

5. CRITICAL ACCOUNTING ESTIMATES (CONTINUED)

Effective interest rates

In order to determine the EIR applicable to loans and borrowings an estimate must be made of the expected life of each loan and hence the cash flows relating thereto. For purchased accounts this will involve estimating the likely future performance of the accounts at the time of acquisition. These estimates are based on historical data and reviewed regularly. For purchased accounts historical data obtained from the vendor will be examined. The accuracy of the EIR applied would therefore be compromised by any differences between actual repayment profiles and that predicted, which in turn would depend directly or indirectly on customer behaviour.

6. FINANCIAL RISK MANAGEMENT

The Company's operations are financed principally by a bank loan and, to a lesser extent, by a mixture of share capital and loans from other group companies. The Company drew down the facility to acquire loans. In addition, various financial instruments, for example debtors and accruals, arise directly from the Company's operations.

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

Credit risk

The Company's credit risk is primarily attributable to its loans to customers. The maximum credit risk at 30 September 2020 approximates to the carrying value of loans to customers (note 13). There are no significant concentrations of credit risk due to the large number of customers included in the portfolios.

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

At 30 September 2020 66.8% (2019: 60.4%) of the Company's mortgage loans by value had a loan-to-value ('LTV') ratio of 70% or less. The weighted average LTV was 68.0% (2019: 70.2%). LTV for each account is calculated by comparing the current balance to the most recent valuation of the mortgaged property, indexed as appropriate.

Paragon Finance PLC and Mortgage Trust Services PLC, fellow group companies, continue to administer the loans on behalf of Paragon Second Funding Limited and the collections process is the same as that utilised for all companies in the Group.

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

Liquidity risk

The Company's assets are principally financed by a bank loan. Details of the Company's borrowings are given in note 18.

The securitisation process and the terms of the warehouse facility effectively limit liquidity risk from the funding of the Group's loan assets. It remains to ensure that sufficient funding is available to fund the Group's participation in the SPVs, provide capital support for new loans and working capital for the Group. This responsibility rests with the Asset and Liability Committee which sets the Group's liquidity policy and uses detailed cash flow projections to ensure that an adequate level of liquidity is available at all times.

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Interest rate risk

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

The rates payable on the term loan are reset monthly on the basis of LIBOR. The Company's assets predominantly bear LIBOR linked interest rates or are hedged fixed rate assets. The interest rates charged on the Company's variable rate loan assets are determined by reference to, inter alia, the Company's funding costs and the rates being charged on similar products in the market. Generally this ensures the matching of changes in interest rates on the Company's loan assets and borrowings and any exposure arising on the interest rate resets is relatively short term.

Currency risk

The company has no material exposure to foreign currency risk.

7. INTEREST RECEIVABLE – OTHER

	2020	2019
	£000	£000
Group interest	6,338	6,374
Other interest	15	32
	<u>6,353</u>	<u>6,406</u>

8. INTEREST PAYABLE AND SIMILAR CHARGES

	2020	2019
	£000	£000
Mortgage backed bank loans	9,097	12,625
Interest payable to group companies	120	-
Subordinated loan interest	10,572	10,508
	<u>19,789</u>	<u>23,133</u>

Included within the interest on mortgage backed bank loans is an amount of £1,402,000 (2019: £734,000) that was paid to a fellow subsidiaries of Paragon Banking Group PLC.

9. DIRECTORS AND EMPLOYEES

Directors received no fees for the services provided to the Company during either the current or the preceding year.

The Company had no employees in the current or preceding year. All administration is performed by employees of the Group. The directors of the Company are all employed by Paragon Finance PLC, a fellow group company, and their remuneration is disclosed within the financial statements of that company, which do not form part of this Report.

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

10. OPERATING (LOSS) / PROFIT, BEING (LOSS) / PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION

	2020	2019
	£000	£000
Operating (loss) / profit is after charging:		
Facility commitment fee	43	46
Auditor remuneration - audit services	11	10
	<u> </u>	<u> </u>

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

11. TAX ON (LOSS) / PROFIT ON ORDINARY ACTIVITIES

a) Tax charge for the year

	2020	2019
	£000	£000
Current tax		
Corporation tax	839	2,452
Adjustment in respect of prior periods	(52)	-
Total current tax	<u>787</u>	<u>2,452</u>
Deferred tax (note 18)		
Origination and reversal of timing differences	(943)	(1,240)
Recognition of previously unrecognised tax losses	47	-
Rate change	130	(255)
Total deferred tax	<u>(766)</u>	<u>(1,495)</u>
Tax charge on (loss) / profit on ordinary activities	<u>21</u>	<u>957</u>

b) Factors affecting the tax charge for the year

	2020	2019
	£000	£000
(Loss) / profit before tax	<u>(547)</u>	<u>6,377</u>
UK corporation tax at 19.0% (2019: 19.0%) based on the (loss) / profit for the year	(104)	1,212
Effects of:		
Prior year credit	(5)	-
Change in rate of taxation on deferred tax balances	130	(255)
Tax charge for the year	<u>21</u>	<u>957</u>

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

11. TAX ON (LOSS) / PROFIT ON ORDINARY ACTIVITIES

The standard rate of corporation tax in the UK applicable to the Company in the period was 19.0% (2019: 19.0%), based on currently enacted legislation. During the period, legislation was substantively enacted, reversing the reduction in the tax rate to 17.0% which had been due to come into effect from April 2020. Consequently, temporary differences which had been expected to reverse at a tax rate of 18% in the current year, or 17% in subsequent years, have either reversed or are expected to reverse at a rate of 19%. The impact of this change has been accounted for in the year.

12. FINANCIAL ASSETS

	2020 £000	2019 £000
Loans to customers (note 13)	881,892	948,144

13. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS

This note sets out information on the Company’s impairment provisioning under IFRS 9 for the loans to customers balances set out in note 12, loans held at amortised cost, accounted for under IFRS 9, subject to the IFRS 9 impairment requirements.

The disclosures are set out under the following headings:

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

Basis of provision

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

Calculation of expected credit loss (‘ECL’)

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

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

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

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

13. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

In certain asset classes a fully modelled approach is not possible. This is generally where there are few assets in the class, where there is insufficient historical data on which to base an analysis or where certain measures, such as days past due are not useful. In these cases, which represent a small proportion of the total portfolio, alternative approaches are adopted. These rely on internal credit monitoring practices and professional credit judgement. Notwithstanding the mechanical procedures discussed above, the Company will always consider whether the process generates sufficient provision for particular loans, especially large exposures, and will provide additional amounts as appropriate.

Significant Increase in Credit Risk ('SICR')

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

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

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

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

Definitions of default

As the IFRS 9 definition of ECL is based on PD, default must be defined for this purpose. The Company's definitions of default for its various portfolios are aligned to its internal operational procedures and the regulatory definitions of default used internally. In particular the Company's receiver of rent cases are defined as defaulted for modelling purposes as the behaviour of the case after that point is significantly influenced by internal management decisions.

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

Credit Impaired loans

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

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

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

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

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

13. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

IFRS 9 Staging

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

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

On initial recognition, and for assets where there has not been an SICR, provisions will be made in respect of losses resulting from the level of credit default events expected in the twelve months following the balance sheet date

Where a loan has experienced an SICR, whether or not the loan is considered to be credit impaired, provisions will be made based on the ECLs over the full life of the loan

For credit impaired assets, provisions will also be made on the basis of ECLs.

Impairments by stage

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

	Stage 1	Stage 2 *	Stage 3 *	Total
	£000	£000	£000	£000
<i>30 September 2020</i>				
Gross loan book	757,078	107,558	31,773	896,409
Impairment provision	(718)	(2,130)	(11,669)	(14,517)
Net loan book	<u>756,360</u>	<u>105,428</u>	<u>20,104</u>	<u>881,892</u>
Coverage ratio	<u>0.09%</u>	<u>1.98%</u>	<u>36.73%</u>	<u>1.62%</u>
	Stage 1	Stage 2 *	Stage 3 *	Total
	£000	£000	£000	£000
<i>1 October 2019</i>				
Gross loan book	844,357	80,993	32,934	958,284
Impairment provision	(38)	(625)	(9,477)	(10,140)
Net loan book	<u>844,319</u>	<u>80,368</u>	<u>23,457</u>	<u>948,144</u>
Coverage ratio	<u>0.00%</u>	<u>0.77%</u>	<u>28.78%</u>	<u>1.06%</u>

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

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

13. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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

Analysis of Stage 2 loans

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

	< 1 month arrears £000	> 1 <= 3 months arrears £000	Total £000
<i>30 September 2020</i>			
Gross loan book	103,982	3,576	107,558
Impairment provision	(719)	(141)	(1,230)
Net loan book	101,993	3,435	105,428
Coverage ratio	1.91%	3.95%	1.98%
<i>1 October 2019</i>			
Gross loan book	74,554	6,439	80,993
Impairment provision	(469)	(156)	(625)
Net loan book	74,085	6,283	80,368
Coverage ratio	0.63%	2.43%	0.77%

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

13. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Analysis of Stage 3 loans

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

	> 3 month arrears £000	RoR managed £000	Realisations £000	Total £000
<i>30 September 2020</i>				
Gross loan book	3,164	22,017	6,592	31,773
Impairment provision	(717)	(7,465)	(3,487)	(11,669)
Net loan book	2,447	14,552	3,105	20,104
Coverage ratio	22.64%	33.91%	52.91%	36.73%
<i>30 September 2019</i>				
Gross loan book	802	27,485	4,647	32,934
Impairment provision	(76)	(7,575)	(1,826)	(9,477)
Net loan book	726	19,910	2,821	23,457
Coverage ratio	9.55%	27.56%	39.30%	28.78%

The exposure at default in the calculation shown above for stage 3 accounts is reduced by £15,528,000 in respect of the value of security given by customers. The estimated value of the security represents, for each account, the lesser of the valuation estimate and the exposure value in the central economic scenario. Security values are based on the most recent valuation of the relevant property held by the Company, indexed as appropriate.

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

13. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Movements in impairment provision by stage

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

	2020	2019
	£000	£000
At 1 October 2019	10,140	12,268
Provided in period	5,240	49
Amounts written off	(863)	(2,177)
At 30 September 2020	<u>14,517</u>	<u>10,140</u>

Accounts are considered to be written off for accounting purposes when standard enforcement processes have been completed, subject to any amount retained in respect of expected salvage receipts. This has no effect on the net carrying value, only on the amounts reported as gross loan balances and accumulated impairment provisions. At 30 September 2020 enforceable contractual balances of £1,434,000 were outstanding on assets written off in the period. This will exclude those accounts where a full and final settlement was agreed and those where the contractual terms do not permit any further action. Enforceable balances will be kept under review for operational purposes but no amounts will be recognised in respect of such accounts unless further cash is received or there is a strong expectation that it will be.

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

13. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

A more detailed analysis of these movements by IFRS 9 stage on a consolidated basis for the year ended 30 September 2020 and 30 September 2019 is set out below.

	Stage 1 £000	Stage 2 * £000	Stage 3 * £000	Total £000
Loss allowance at 1 October 2019	38	625	9,477	10,140
New assets originated or purchased	-	-	-	-
Changes in loss allowance				
Transfer to stage 1	99	(99)	-	-
Transfer to stage 2	(7)	33	(26)	-
Transfer to stage 3	(3)	(69)	72	-
Changes due to credit risk	591	1,640	3,009	5,240
Write offs	-	-	(863)	(863)
Assets recognised	-	-	-	-
Loss allowance at 30 September 2020	<u>718</u>	<u>2,130</u>	<u>11,669</u>	<u>14,517</u>
Loss allowance at 1 October 2018	62	424	11,782	12,268
New assets originated or purchased	-	-	-	-
Changes in loss allowance				
Transfer to stage 1	56	(52)	(4)	-
Transfer to stage 2	(20)	22	(2)	-
Transfer to stage 3	(1)	(22)	23	-
Changes due to credit risk	(59)	253	(145)	49
Write offs	-	-	(2,177)	(2,177)
Assets recognised	-	-	-	-
Loss allowance at 30 September 2019	<u>38</u>	<u>625</u>	<u>9,477</u>	<u>10,140</u>

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

13. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

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

	Stage 1 £000	Stage 2 * £000	Stage 3 * £000	Total £000
Balances at 1 October 2019	844,357	80,993	32,934	958,284
New assets originated or purchased	-	-	-	-
Changes in staging				
Transfer to stage 1	41,244	(41,244)	-	-
Transfer to stage 2	(72,821)	73,032	(211)	-
Transfer to stage 3	(1,256)	(2,377)	3,633	-
Redemptions and repayments	(51,239)	(3,196)	(3,455)	(57,890)
Assets derecognised	-	-	-	-
Write offs	-	-	(863)	(863)
Other changes	(3,207)	350	(265)	(3,122)
Balance at 30 September 2020	<u>757,078</u>	<u>107,558</u>	<u>31,773</u>	<u>896,409</u>
Loss allowance	(718)	(2,130)	(11,669)	(14,517)
Carrying value	<u><u>756,360</u></u>	<u><u>105,428</u></u>	<u><u>20,104</u></u>	<u><u>881,892</u></u>
Balances at 1 October 2018	932,126	70,068	33,850	1,036,044
New assets originated or purchased	-	-	-	-
Changes in staging				
Transfer to stage 1	28,452	(28,322)	(130)	-
Transfer to stage 2	(44,547)	44,748	(201)	-
Transfer to stage 3	(1,879)	(2,833)	4,712	-
Redemptions and repayments	(66,421)	(2,804)	(2,854)	(72,079)
Assets derecognised	-	-	-	-
Write offs	-	-	(2,177)	(2,177)
Other changes	(3,374)	136	(266)	(3,504)
Balance at 30 September 2019	<u>844,357</u>	<u>80,993</u>	<u>32,934</u>	<u>958,284</u>
Loss allowance	(38)	(625)	(9,477)	(10,140)
Carrying value	<u><u>844,319</u></u>	<u><u>80,368</u></u>	<u><u>23,457</u></u>	<u><u>948,144</u></u>

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

13. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

Impairments charged to income

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

	2020	2019
	£000	£000
Provided in period	4,991	20
Written off amounts	863	29
	<u>5,854</u>	<u>49</u>

Economic impacts

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

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

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

The economic variables comprising each scenario, and their projected average rates of increase (or decrease) for the first five years of the forecast period are set out below.

30 September 2020

	Central scenario		Upside scenario		Downside scenario		Severe scenario	
	Max %	Min %	Max %	Min %	Max %	Min %	Max %	Min %
Economic driver								
GDP	18.0	(7.6)	18.8	(5.9)	17.8	(15.1)	20.5	(17.9)
HPI	5.0	(4.0)	4.0	0.0	4.0	(10.0)	4.0	(20.0)
BBR	0.8	0.1	1.0	0.1	1.0	0.1	0.8	(0.4)
CPI	2.4	0.6	2.3	0.7	2.3	0.2	2.3	(0.3)
Unemployment	7.6	4.0	7.0	4.0	9.0	4.5	9.0	5.3
Secured lending	3.9	3.5	4.8	4.0	3.8	1.7	3.7	(1.2)
Consumer credit	6.3	6.0	8.8	6.7	5.7	1.5	4.8	(5.2)

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

13. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS (CONTINUED)

30 September 2019

	Central scenario		Upside scenario		Downside scenario		Severe scenario	
	Max %	Min %	Max %	Min %	Max %	Min %	Max %	Min %
Economic driver								
GDP	1.9	1.2	3.1	1.2	1.6	(1.0)	1.3	(4.7)
HPI	4.3	0.7	9.7	0.9	4.9	(4.7)	5.7	(17.8)
BBR	0.8	0.8	2.5	0.8	0.5	0.5	0.0	0.0
CPI	2.2	2.0	2.2	1.4	3.2	2.0	4.9	2.0
Unemployment	4.1	3.8	3.9	3.5	6.1	4.2	9.2	4.5
Secured lending	3.9	3.2	4.8	3.3	3.8	1.7	3.7	(1.2)
Consumer credit	6.3	6.0	8.8	6.2	6.0	1.5	5.9	(5.2)

14. DEBTORS

	2020 £000	2019 £000
Amounts falling due within one year:		
Amounts due from group companies	141,234	140,732
Prepayments and accrued income	7	9
	141,241	140,741
	141,241	140,741

15. CALLED UP SHARE CAPITAL

	2020 £	2019 £
Allotted:		
2 ordinary shares of £1 each (fully paid)	2	2
	2	2
	2	2

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

16. PROFIT AND LOSS ACCOUNT

	£000
At 1 October 2018	983
Profit for the financial year	5,420
Dividend paid	-
Change in accounting policy on adoption of IFRS9	(5,387)
At 30 September 2019	<u>1,016</u>
Loss for the financial year	(568)
Dividend paid	-
At 30 September 2020	<u><u>448</u></u>

An interim dividend of £nil per share was paid during the year (2019: £nil). No final dividend is proposed (2019: £nil).

17. PROVISIONS FOR LIABILITIES

Deferred tax

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

	2020 £000	2019 £000
Balance at 1 October 2019	1,064	3,663
Profit and loss credit (note 11)	(943)	(1,240)
Profit and loss credit prior period (note 11)	47	-
Rate change (note 11)	130	(255)
Change in accounting policy on adoption of IFRS9	-	(1,104)
Balance at 30 September 2020	<u>298</u>	<u>1,064</u>
The net deferred tax liability for which provision has been made is analysed as follows:		
Other timing differences	<u>298</u>	<u>1,064</u>

NOTES TO THE ACCOUNTS

YEAR ENDED 30 SEPTEMBER 2020

18. CREDITORS

	2020	2019
	£000	£000
Amounts falling due within one year:		
Amounts due to group companies	335	3,351
Corporation tax	839	2,452
Accruals and deferred income	62	83
	<u>1,236</u>	<u>5,886</u>

Included within the accruals and deferred income balance is an amount of £28,000 (2019: £31,000) due to fellow subsidiaries of Paragon Banking Group PLC.

	2020	2019
	£000	£000
Amounts falling due after more than one year:		
Bank loan	799,900	861,700
Intercompany subordinated loan	224,489	224,436
	<u>1,024,389</u>	<u>1,086,136</u>

Included within the bank loan balance is an amount of £133,688,000 (2019: £74,125,000) due to fellow subsidiaries of Paragon Banking Group PLC.

All amounts falling due after more than one year fall due after more than five years.

As at 30 September 2020, the balance outstanding under this bank loan was £799,900,000 (2019: £861,700,000). It is repayable on 29 February 2050. The loan is secured over a portfolio comprising variable rate mortgage loans secured by first charges over residential properties in the United Kingdom. The loan is subject to mandatory redemption in part on each interest payment date in an amount equal to the principal received or recovered in respect of the mortgage. The maturity date of the loan matches the maturity date of the underlying assets.

Interest is payable at a fixed margin, 0.675%, above the London Interbank Offered Rate ('LIBOR') on the loan denominated in sterling.

There is a subordinated loan facility repayable to Paragon Mortgages Limited on the first day on which all the bank loan has been repaid. Interest is charged monthly at a rate of 4% per annum above LIBOR.

19. ULTIMATE PARENT COMPANY

The immediate parent undertaking is Paragon Mortgages Limited.

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

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