

The Paragon Group of Companies PLC

Preliminary Financial Report

For the year ended 30 September 2016

STRONG RESULTS IN A TRANSITIONAL YEAR

The Paragon Group of Companies PLC ('Paragon' or the 'Group') the specialist lender and banking group today announces its full year results for the year ended 30 September 2016.

Financial highlights

- Underlying profit rose 9.1% to £146.9 million (2015: £134.7 million) due to organic growth, diversification of income streams, M&A activity and effective capital management
- Statutory profit before tax increased by 6.7% to £143.2 million (2015: £134.2 million)
- EPS up 14.1% to 40.5p (2015: 35.5p) and underlying RoTE improved to 13.2% (2015: 11.4%) as a result of profit growth and the Group's share buy-back programme
- Dividend up 22.7% to 13.5p (2015: 11.0p) reflecting the strong position of the Group and its confidence in the prospects for the business
- Further £50.0 million share buy-back programme announced
- Strong capital and leverage ratios maintained;
 - CET1 ratio of 15.9% (2015: 19.1%) and a leverage ratio at 6.2% (2015: 7.7%)
 - Total capital ratio 19.0%, enhanced by £150 million Tier-2 issue

Strong lending growth against a challenging backdrop

- Total completions and asset purchases £1,647.9 million (2015: £1,490.1 million)
- Buy-to-let completions at £1,161.0 million (2015: £1,326.6 million)
- Proportion of non-buy-to-let lending increased to 29.5% of total Group lending (2015: 11.0%)

Paragon Bank: becoming Group's core engine for growth and diversification

- Underlying profits of £11.6 million (2015: loss of £8.6 million)
- Retail deposit balances increased by 164.4% over the year, standing at £1,873.9 million (30 September 2015: £708.7 million)
- Idem Capital now working with Paragon Bank to optimise retail deposit funding

FINANCIAL HIGHLIGHTS

Commenting on the results, Nigel Terrington, Chief Executive of Paragon, said:

“I am pleased to report a strong set of results in which we significantly increased revenue, strengthened net interest margins and improved return on equity, whilst maintaining pricing and credit discipline. Whilst the year has been disrupted by fiscal and regulatory changes, as well as political and macro economic factors, our customers’ performance has been exemplary and new business activity has seen encouraging growth recently.

Paragon's operating model is undergoing significant change, as it transitions from a non-bank, securitised, monoline lender into a retail funded banking group. Paragon Bank is increasingly at the heart of the Group’s development, with its deposit book now exceeding £2 billion and its franchise firmly established. This has facilitated further progress in our diversification strategy, notably through the acquisition of Five Arrows Leasing Group and, more recently, Premier Asset Finance, which together have given Paragon a strong platform to build on the significant growth potential in the UK SME finance market.

We have put in place the foundations for strong and sustainable growth. The business is well funded and well capitalised with a robust operating model and an exemplary track record. We continue to believe that over the medium term the banking markets will undergo structural change which will favour specialist lending institutions such as Paragon and we are well positioned to take advantage of the opportunities that will arise.”

FINANCIAL HIGHLIGHTS

KEY PERFORMANCE INDICATORS

	2016	2015	Change	% change
Profit before tax	£143.2m	£134.2m	£9.0m	6.7%
Underlying profit	£146.9m	£134.7m	£12.2m	9.1%
Basic EPS	40.5p	35.5p	5.0p	14.1%
Dividend per share	13.5p	11.0p	2.5p	22.7%
Underlying return on tangible equity	13.2%	11.4%		
Underlying cost:income ratio *	36.7%	33.7%		
Core Tier 1 ratio	15.9%	19.1%		
Total capital ratio	19.0%	19.8%		

* Note 31

New Business	Originations and investments		Pipeline	
	2016	2015	2016	2015
Buy-to-let				
Paragon Mortgages	£599.5m	£976.6m	£123.8m	£404.2m
Paragon Bank	£561.5m	£350.0m	£197.3m	£309.5m
Total buy-to-let	£1,161.0m	£1,326.6m	£321.1m	£713.7m
Asset finance lending	£144.3m			
Other bank lending	£133.8m	£59.1m		
Portfolio acquisitions	£208.8m	£104.4m		
Total new business	£1,647.9m	£1,490.1m		
Of which buy-to-let	70.5%	89.0%		

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Paragon will be holding a results presentation for analysts on 23 November 2016 at 9:30am at UBS, 5 Broadgate, London, EC2M 2QS. The presentation material will be available on the Group's website at www.paragon-group.co.uk/investors from 11:00am.

MANAGEMENT REPORT

A3.1 STRATEGY REVIEW

The Group operates in specialist finance markets with its key objective being to support the funding needs of UK consumers and SMEs whilst growing shareholder returns through operating a robust and sustainable business model. The strategy to deliver this objective combines organic growth, diversification of income streams, M&A activity and capital management utilising a prudently funded and strongly capitalised operating model.

Strong progress has been made in achieving this objective in 2016, with underlying profits (excluding non-repeating acquisition related costs) rising by 9.1% to £146.9 million during the year (2015: £134.7 million) and profits on the statutory basis increasing by 6.7% to £143.2 million (2015: £134.2 million). The combined effects of this growth and the Group's share buy-back programme have resulted in strong earnings per share growth ('EPS') (rising by 14.1% to 40.5p from 35.5p in 2015) and a further improvement in underlying return on tangible equity ('RoTE') to 13.2% (2015: 11.4%) and unadjusted RoTE to 12.9% (2015: 11.4%) (note 3).

The Group's operating model is evolving from its historic, non-bank, securitisation funded position to that of a more broadly based banking group, with a more diversified product set and an increasingly retail deposit focused funding base.

The year has seen strong levels of new organic lending, debt purchase activity and M&A. Group-wide new advances and investments were £1,647.9 million compared to £1,490.1 million last year, taking net loan growth to £657.0 million over the last 12 months.

The Group's banking subsidiary, Paragon Bank PLC, is now at the heart of its development plans and moved into profit in 2016. In addition to accessing the deep and reliable retail deposit market to finance organic balance sheet growth, the Bank's retail deposit funding enables it to work with the wider group to participate in debt purchases and also to refinance previously securitised or externally financed portfolios. The Bank has continued to extend its range of loan products, with the launch of its development finance proposition and, more significantly, the completion of two acquisitions in the asset finance market during the period. The Bank also intends to launch a range of specialist residential lending products in the forthcoming year.

MANAGEMENT REPORT

STRATEGY REVIEW

The scale of retail deposits in Paragon Bank increased by 164.4% over the year, standing at £1,873.9 million at 30 September 2016 (30 September 2015: £708.7 million), and had grown further, to £2,009.6 million, by 21 November 2016. Retail deposits now represent the Group's primary source of funding for new lending, with its traditional securitisation approach taking a more tactical role as and when conditions in that market are attractive. Further evidence of the Bank's growing scale and maturity is provided by its first draw-down under the Funding for Lending Scheme ('FLS'), with £108.8 million of liquidity accessed during the year. The Bank also plans to access the Bank of England's recently announced Term Funding Scheme ('TFS') during the coming year.

The £117.0 million acquisition of Five Arrows Leasing Group (subsequently re-branded Paragon Bank Asset Finance ('PBAF')) marked a scale change in the Group's lending diversification strategy. A well respected business with a long history, PBAF operates in a number of niche sectors in the asset finance market. Following a post-acquisition strategic review, a number of operational and system enhancements have been identified which deliver the opportunity to increase volumes materially and earnings with only modest additional investment. These systems enhancements are expected to be implemented in the first half of 2017, further increasing the capacity of the asset finance business.

The scope of the Group's asset finance operation was further developed at the end of the year with the acquisition of Premier Asset Finance Limited ('Premier') on 30 September 2016. Premier is one of the UK's leading asset finance brokers and its acquisition is expected to provide the Group with access to new markets within the asset finance sector.

The UK private rented sector has seen strong levels of demand from tenants and this strong demand for rented property is expected to continue. Despite this positive backdrop the buy-to-let market has experienced a period of disruption, following a series of fiscal and regulatory changes aimed at both landlords and lenders. These changes disrupted activity during the year and may serve to dampen demand in the sector at an aggregate level. However, the structural changes arising as a consequence are expected to have a positive influence on the Group's ability to take market share, given its twenty-year experience of servicing the complex needs of professional landlords.

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STRATEGY REVIEW

The Group's capital requirements are influenced by the risk weighting of its loan portfolios and other assets. The Group assesses risk weightings by reference to the Standardised Approach to Credit Risk ('SA'), and in its December 2015 consultation paper the Basel Committee on Banking Supervision ('BCBS') proposed a set of higher risk weights for buy-to-let loans. These proposals are still under review. The bulk of UK buy-to-let lending is undertaken by banks using an Internal Ratings Basis ('IRB') for assessing risk weights. The IRB typically results in a lower risk weight for buy-to-let lending. The Group has commenced its move to an IRB application, where its long history and rich data is expected to deliver a further competitive advantage once IRB status is granted. The achievement of IRB status, with its enhanced approach to risk management and consequential commercial benefits is one of the Group's key medium term strategic goals.

Idem Capital and Paragon Bank have formed a strong combination in acquiring loan portfolios, accessing appropriate leverage for high quality assets. This joint approach will be used on an increasing basis going forward. Idem Capital has also refinanced a number of legacy portfolios during the period, improving returns made on the capital it employs and returning surplus funds to the Group.

Enhancing shareholder returns on a sustainable basis is a key objective for the Group. The 14.1% growth in EPS has supported a 22.7% increase in the dividend for the year to 13.5 pence, meeting the Group's target of a three-times dividend cover ratio for the full year in line with the policy announced in 2012. The Group intends to operate a progressive dividend policy going forward, while maintaining its three-times cover ratio target.

The share buy-back programme has also progressed well, with £100.0 million having been invested to date. The programme will be extended by an additional £50.0 million in the coming financial year, further enhancing shareholder returns.

MANAGEMENT REPORT

STRATEGY REVIEW

The share buy-back and goodwill associated with the acquisitions in the year have contributed to the Group's core equity tier 1 ratio ('CET1') reducing to 15.9% in 2016 (2015: 19.1%). The Group issued its first Tier 2 Corporate Bond in September 2016, raising £150.0 million, taking its total capital ratio to 19.0% (2015: 19.8%). Free cash resources totalled £366.5 million at the end of the period, leaving the business well placed to finance further growth, maintain its capital management programme and repay its £110.0 million subordinated bond which matures in April 2017.

The business remains well funded, strongly capitalised and effectively placed to continue to deliver long term, sustainable returns through its robust operating model. The Group is positioned to respond quickly to the challenges and also to take advantage of the opportunities that will arise given changes in the broader operating environment.

A more detailed discussion of the Group's performance is given below covering:

Business review	Funding review	Financial review	Operational review
Lending, performance and markets	Retail deposits, wholesale funding and capital management	Results for the year	People, risk and regulation

MANAGEMENT REPORT

A3.2 LENDING REVIEW

The Group's operations are organised into three divisions, each with responsibility for delivering asset and profit growth. The Paragon Bank segment includes all of the Group's retail deposit funded assets, some of which are of similar types to those in the Paragon Mortgages and Idem Capital segments.

The Group's investments in loans and the amounts invested in the year for each of its division are summarised below:

	Advances and investments in the year		Investments in loans at the year end	
	2016 £m	2015 £m	2016 £m	2015 £m
Paragon Mortgages	599.5	976.6	8,768.0	9,221.7
Idem Capital	24.0	104.4	283.3	451.0
Paragon Bank	1,024.4	409.1	1,686.2	407.8
	<u>1,647.9</u>	<u>1,490.1</u>	<u>10,737.5</u>	<u>10,080.5</u>

Paragon Mortgages

Paragon Mortgages is one of the longest established lending brands in the buy-to-let mortgage market. Alongside its sister brand, Mortgage Trust, Paragon Mortgages maintains a significant presence in this sector of the UK mortgage market. Total loan assets of the Paragon Mortgages segment at 30 September 2016 were £8,768.0 million, 4.9% lower than the £9,221.7 million a year earlier. This reflects the trend to focus an increasing share of the Group's new buy-to-let lending through Paragon Bank and also for the Bank to purchase previously securitised buy-to-let loans, moving the balances between divisions.

Of the total Paragon Mortgages loan balance £8,601.0 million were buy-to-let mortgage assets (30 September 2015: £8,999.1 million), with £167.0 million of other assets (30 September 2015: £222.6 million).

MANAGEMENT REPORT

A3.2 LENDING REVIEW

Buy-to-let

Market Overview

The UK buy-to-let sector has experienced significant levels of disruption since the government signalled the phased reduction of the tax relief available to landlords on mortgage interest to the basic rate of income tax in its budget in the summer of 2015. The phased reduction of the available tax relief to landlords commences in April 2017.

Since that point there have been further regulatory and fiscal interventions in the sector, including increases in the level of Stamp Duty Land Tax ('SDLT') payable by investors in property and a more interventionist approach to the regulation of buy-to-let lending announced by the PRA.

Against this, however, the demand for rental property remains high, with rents remaining strong and expected to rise by many commentators.

The new PRA standards establish minimum levels for lenders' affordability assessments for buy-to-let loans and also set out requirements governing the underwriting process required for lending to portfolio landlords (those with four or more buy-to-let funded properties). Although these standards are similar to those operated by the Group, they are significantly more demanding than those applied to date by lenders in the market. Whilst this increase in regulation may act as a further constraint on market growth, the Group is well placed to benefit from any realignment this may cause among participants in the sector. Early evidence of this is seen in the growth of the proportion of the Group's pipeline relating to complex buy-to-let. This was 61.8% going in to 2017 compared to 45.5% twelve months earlier.

MANAGEMENT REPORT

A3.2 LENDING REVIEW

The monthly flow of UK housing transactions over the year was severely distorted by the changes to SDLT announced in the 2015 Autumn Statement which became effective in April 2016. This caused transactions to spike in March at 171,000 before dropping to just 73,000 in April. Recovery in transaction numbers, driven largely by a resurgent owner-occupied market, was swift with transaction numbers by August 2016 at similar levels to August 2015. Continuing constraints on the supply of properties for sale have helped maintain stable house prices and whilst the Royal Institute of Chartered Surveyors ('RICS') have scaled back their expectations for house price growth in their most recent projections, they still expect house price rises over the next five years of approximately 4.0% per annum.

Regardless of the changes in regulation and housing policy, the primary characteristic of the housing market more generally remains a shortage of supply. As the demand for housing increases due to population growth, inward migration and household formation, the imbalance between supply and demand continues to increase, supporting house price inflation and reducing affordability. This constrains the potential for growth in the owner-occupied sector, whilst limits on public finances limit the ability of the social sector to respond to increasing demand from those in housing need. As a result, demand for private rented property has continued to increase which, in turn, has supported landlord demand for finance for property investment.

Rental demand remains high across the country, which in turn is driving up rents. Research by Savills published in October 2016 suggests that the outlook for rents over the next five years is both stronger and more stable than that for house prices. Savills suggest that whilst rent increases may slow next year due to the ongoing uncertainties around Brexit and tightening affordability, the barriers to home ownership described above will continue to drive demand. As a consequence, they forecast that over the next five years rents will grow by 19% across the UK as a whole, with 25% growth in London.

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A3.2 LENDING REVIEW

The PRS remains the second largest form of tenure according to data in the annual English Housing Survey for 2014-2015 released by Department of Communities and Local Government in February 2016. This showed that 4.3 million households rented privately compared to 3.9 million in the social sector. This represented 19.0% of all households compared to 17.4% renting in the social sector and 63.6% in owner-occupation. A key feature of the sector in recent years has been the increase in the number of families with children that rely on the PRS for a home, which has increased from 30.0% to 37.4% of households over the last ten years. This is also reflected in the increase in the age of first time buyers who were, on average, 32.5 years old according to the latest data, compared with 31.1 years old ten years earlier.

Whilst buy-to-let lending at an overall market level in 2016 is likely to be similar to 2015, the phasing of lending across the year will have been similar to the Group's experience, with activity concentrated in the period between January and March 2016. Lending after that quarter has been below the levels for the same period in 2015 across the market, reflecting both the acceleration of transactions prior to the SDLT deadline and the lower levels of landlord confidence, particularly impacting the purchase market.

Whilst the year ended 30 September 2016 has been a period of disruption in the market, the fiscal and regulatory changes made in the period are expected to restructure supply towards the more complex professional landlords. The overall rate of growth, as a result, is expected to slow, but, with demand from tenants remaining strong, rents are likely to rise and the private rented sector is expected to remain an attractive area for investment. The Group's long established capabilities in this sector are expected to result in it taking an increased share of its target markets as these broader influences play out over the coming years.

MANAGEMENT REPORT

A3.2 LENDING REVIEW*Group performance*

Group buy-to-let completions totalled £1,161.0 million in the year compared to £1,326.6 million in 2015. The credit quality of the new lending business written in the year has remained excellent. With retail deposit funding representing the core of the Group's financing strategy, Paragon Bank has made an increasingly important contribution to funding the Group's buy-to-let lending volumes. Paragon Bank funded buy-to-let originations rose from 26.4% of lending in 2015 to 48.4% of lending in 2016 and the Bank now represents the larger of the two funding streams employed by the Group for new loans.

The Group's buy-to-let completions are set out below.

	Completions in year		Pipeline at year end	
	2016	2015	2016	2015
	£m	£m	£m	£m
Paragon Mortgages	599.5	976.6	123.8	404.2
Paragon Bank	561.5	350.0	197.3	309.5
	<u>1,161.0</u>	<u>1,326.6</u>	<u>321.1</u>	<u>713.7</u>

The flow of new applications has stabilised in the second half of the year, albeit at a lower level than in recent periods, resulting in a pipeline of new business (live cases between application and completion), of £321.1 million at the period end (2015: £713.7 million), of which £197.3 million, representing 61.4% of the total, was in Paragon Bank, exceeding the pipeline in the Paragon Mortgages division.

The level of the pipeline reflects both the market disruption of recent months and the timing of credit tightening by competitors to reflect the impact of changes to interest tax deductibility and in anticipation of PRA mandated minimum underwriting standards. The Group changed its minimum hurdles in January 2016, ahead of some competitors and as these changes are made across the market, the Group's relative competitive position is expected to improve. There has been some early evidence of this, with the buy-to-let pipeline increasing after the year end.

MANAGEMENT REPORT

A3.2 LENDING REVIEW

The Group's approach to underwriting remains robust. The focus on the credit quality and financial capability of our customers is underpinned by a detailed and thorough assessment of the value and suitability of the property as a security. This was enhanced in the period by the adoption of the stricter Interest Cover Ratio ('ICR') requirements.

The average ICR of the Group's pipeline cases, and the average reference rate against which it is measured, at the last four half year ends is shown below.

	30 September 2016	31 March 2016	30 September 2015	31 March 2015
ICR	148.9%	144.6%	142.4%	145.2%
Reference rate	5.46%	5.47%	5.15%	5.21%
Stressed interest rate	8.13%	7.91%	7.33%	7.56%

The stressed rate represents the yield available to the customer on the mortgaged element of their property to cover interest payments and running costs.

The quality of new lending remains high, with a good affordability profile, low average loan-to-value ratios and strong customer credit profiles.

MANAGEMENT REPORT

A3.2 LENDING REVIEW

Over the year the Group has expanded its capacity to deal with the more complex requirements of portfolio landlords. This has included the refocusing of staff resource in this area of our lending, the development of more sophisticated online application processing for complex cases and the introduction of a dedicated service proposition for specialist intermediaries who work with these portfolio landlords. The strategic objective of this approach has been to enhance the Group's capability in this part of the buy-to-let market, both in anticipation of the changes that are expected to result from the PRA's new regulations and to address a rapid increase in demand from incorporated landlords responding to the fiscal changes that come into effect in the next tax year.

Complex cases include incorporated landlords and larger portfolios, but also those involving more specialist property types such as houses in multiple occupation ('HMOs'), multi-unit properties, local authority leases and student lets.

The Group's lending on more complex buy-to-let cases has increased over the year and represents over 60% of the pipeline at 30 September 2016, compared with 44.5% at 30 September 2015. Lending to incorporated landlords has been a significant element of this increase with applications from these customers increasing four-fold over the year, representing over 20% of the total number of pipeline cases at the year end.

The Group's outstanding buy-to-let balances are analysed below:

	Balance outstanding	
	2016	2015
	£m	£m
Paragon Mortgages	8,601.0	8,999.1
Idem Capital	13.7	14.5
Paragon Bank	1,006.5	349.6
	<u>9,621.2</u>	<u>9,363.2</u>

MANAGEMENT REPORT

A3.2 LENDING REVIEW

At 30 September 2016 the Group's buy-to-let portfolio stood at £9,621.2 million, 2.8% higher than the £9,363.2 million reported a year earlier. The redemption rate on the overall buy-to-let book, although higher than the 5.8% reported for 2015, still remains low at 9.1%, despite the increasing numbers of post-credit crisis accounts included in the portfolio, which would be expected to redeem more quickly than the extant book. The annualised redemption rate on these loans, at 16.2% (2015: 12.1%), is, as expected, approaching the levels seen before the credit crisis as the book matures. The annualised redemption rate on pre-crisis lending, at 6.2%, has increased from the 4.4% seen in the year ended 30 September 2015. This included an uplift in March 2016 related to the market disruption from the SDLT changes but remained comparatively low and has since fallen back from the annualised 6.7% reported at the half year.

The Group enjoys the reputation of being a highly prudent lender, with the strong underwriting, customer servicing and collection skills, systems and experience required to advance loans effectively to landlord customers with complex requirements. This is demonstrated by its long-term delivery of market leading buy-to-let credit performance. Despite the regulatory and fiscal changes in the buy-to-let market and, more recently, uncertainties surrounding the Brexit referendum result in the summer, the credit performance of the portfolio over the year continued to be exemplary, maintaining the Group's long-term outperformance of the sector in buy-to-let arrears level. The percentage of loans more than three months in arrears as at 30 September 2016 stood at 0.11% (30 September 2015: 0.19%) and remained considerably better than the CML's comparable market average of 0.55% at that date (30 September 2015: 0.67%).

Security values have also benefitted from increasing house prices. The Nationwide House Price Index showed appreciation in residential property values of 5.3% over the year (2015: 3.8%), while the indexed loan-to-value ratio of the buy-to-let portfolio at 30 September 2016, at 67.2%, had improved from 69.7% a year earlier. The increase in average prices, however, is part of a more volatile picture, with marked variations at the local and regional level.

The average loan to value ratio in the Group's portfolio decreases over time as the book seasons, while loan-to-value at advance remains stable, demonstrating a consistent approach to underwriting.

MANAGEMENT REPORT

A3.2 LENDING REVIEW

The Group maintains a specialist team of in-house surveyors to maximise its understanding of particular markets, both from a valuation and a lettings standpoint. In a potentially less benign economic environment, this capability also enables the Group to closely monitor developments in the residential property market, regionally, nationally and by type of property.

The number of properties with an appointed receiver of rent reduced by 10.9% to 946 at 30 September 2016 (30 September 2015: 1,062), and 97.4% of the properties available for letting in the receiver of rent portfolio were let at that date (30 September 2015: 96.9%).

Yields on the Group's buy-to-let lending balances, based on average monthly balances outstanding are set out below. These are analysed between the post credit crisis lending and the legacy assets, which enjoy the benefit of cheaper dedicated funding through securitisation structures.

	Average balance		Average Yield	
	2016	2015	2016	2015
	£m	£m	%	%
New lending	2,786.0	1,655.5	4.71%	5.17%
Legacy assets	6,814.4	7,211.9	2.23%	2.27%

The distribution of yields on buy-to-let mortgages may vary between Paragon Mortgages and Paragon Bank, dependent on product mix from time to time.

MANAGEMENT REPORT

A3.2 LENDING REVIEW*Other assets*

These include legacy owner-occupied mortgages, car loans, secured consumer loans and unsecured consumer loans originated before 2009. These assets form a very small part of the division's results, when compared to buy-to-let assets and performed in line with our expectations during the year.

	Balance outstanding	
	2016	2015
	£m	£m
Owner-occupied mortgages	19.4	47.6
Secured loans	143.8	170.0
Unsecured loans	3.8	5.0
	<u>167.0</u>	<u>222.6</u>

The monthly average balance of these assets in the year was £188.2m (2015: £244.6m) and the yield was 9.16% (2015: 8.46%). The legacy secured loan book, which forms the largest part of the balance, recorded arrears of 16.1% (2015: 15.9%), consistent with the industry average of 12.5% given the age and seasoning in the portfolio.

The Group has returned to lending in the car finance and secured loan market through Paragon Bank. This activity is reported within that division's results.

MANAGEMENT REPORT

A3.2 LENDING REVIEW**Idem Capital**

Idem Capital is one of the UK's principal consumer debt buyers and is a servicer of loans for third parties and co-investment partners. Activity in the debt purchase market remains high with UK based financial institutions continuing to dispose of both paying and non-paying consumer loans either as business-as-usual sales or through de-leveraging requirements. The market has historically been lumpy in its nature but did suffer a decline in activity at the time of the Brexit referendum. The majority of expected transactions had been put on hold over the summer; however, a number of these have since appeared, with Idem having invested over £65.0 million since the year end. There is also evidence of a strong pipeline of transactions expected to reach the market over the coming months.

UK financial institutions have reduced the size of their purchaser panels in recent years, for operational efficiency and to facilitate compliance with regulatory obligations. Idem Capital has maintained its position as an active panel member for the major UK based debt sellers and has participated in several transactions during the course of the financial year.

Idem Capital, working in partnership with Paragon Bank, invested £208.8 million in loan portfolio acquisitions in the year ended 30 September 2016 (30 September 2015: £104.4 million). This included purchases of loan assets in which Idem Capital had previously had an interest under servicing and co-investment arrangements. The analysis of this balance between the divisions is shown below, together with the outstanding balances at the year end.

	Investment in the year		Balance outstanding at year end	
	2016	2015	2016	2015
	£m	£m	£m	£m
Idem Capital portfolios	24.0	104.4	283.3	432.9
Co-investments	-	-	-	18.1
Idem Capital division assets	24.0	104.4	283.3	451.0
Paragon Bank division assets	184.8	-	250.6	-
	<u>208.8</u>	<u>104.4</u>	<u>533.9</u>	<u>451.0</u>

The outstanding value of the Group's debt purchase investments at 30 September 2016 totalled £533.9 million (30 September 2015: £451.0 million). Of this balance, 64.2% related to loans secured on property (30 September 2015: 51.9%).

MANAGEMENT REPORT

A3.2 LENDING REVIEW

During the period balances to the value of £102.0 million were sold by Idem Capital to Paragon Bank, replacing the division's funding with cheaper retail deposit funded debt.

At 30 September 2016, the 120 month gross (undiscounted) estimated remaining collections ('ERC') for the Group's acquired assets stood at £740.7 million (30 September 2015: £677.7), while those for the division's portfolio stood at £454.3 million (30 September 2015: £677.7 million). This reduction in the division was primarily attributable to the intra-group sale of assets into Paragon Bank, where the 120 month ERC for purchased assets totalled £286.4 million at 30 September 2016 (30 September 2015: £nil). ERC is a common measure of scale in the debt purchase industry reflecting likely future cash flows from the acquired assets over the next ten years, which will reduce over time as balances are collected.

Asset performance continues to be strong. As at 30 September 2016 cumulative cash receipts in the Idem Capital portfolios totalled 109.0% of the values predicted at the point the loans were acquired (30 September 2015: 107.2%).

Yields on the Group's acquired consumer finance balances, based on average monthly balances outstanding are set out below. These are analysed between secured and unsecured balances.

	Average balance		Average Yield	
	2016	2015	2016	2015
	£m	£m	%	%
Secured loans	291.7	235.1	18.22%	17.60%
Unsecured assets	207.7	172.1	15.99%	18.15%

The allocation of yields may vary between Idem Capital and Paragon Bank, dependent on their relative participation in transactions from time to time.

After taking into account portfolio run-off, acquired accounts under Idem Capital management, including those owned by Paragon Bank, increased by 5.1%. Total accounts under Idem Capital management (including third-party serviced assets) decreased by 10.4% in the year, principally due to the reduction in third party administration activity, partly as a result of Idem Capital acquiring previously administered loan portfolios.

MANAGEMENT REPORT

A3.2 LENDING REVIEW

The number of purchased loan assets managed by Idem Capital is shown below.

	2016 Number	2015 Number
Idem Capital owned	279,877	277,063
Paragon Bank owned	13,193	-
	<u>293,070</u>	<u>277,063</u>
Third party	53,742	109,806
Idem Capital managed	<u>346,812</u>	<u>386,869</u>

During the period, Idem Capital successfully raised external finance for both its secured and unsecured portfolios, optimising leverage against these portfolios on more favourable terms. In addition, a partial sale of Idem Capital's secured loan portfolio to Paragon Bank contributed to improving the capital efficiency and funding terms across the Group's acquired portfolios. This is discussed further in the funding review.

Idem Capital utilises the Group's highly developed loan servicing and collection capability which is used for its own purchases and for co-investment and third party assets. The Group has invested heavily in its control and compliance oversight infrastructures and is well placed to continue to deliver robust operational and conduct standards for customers as required by the UK regulatory authorities, portfolio vendors and co-investment partners.

As described under 'Regulation', Paragon Finance PLC, the principal entity within the Group responsible for servicing loan accounts, received the appropriate permissions under the FCA's consumer credit regime ('CONC') and Mortgages: Conduct of Business' ('MCOB') regime during the course of the year.

MANAGEMENT REPORT

A3.2 LENDING REVIEW**Paragon Bank**

Paragon Bank continues to provide the Group with diversification of both income streams and funding sources. It saw strong development in the year with total assets rising to £1,686.2 million (2015: £407.8 million). That growth has been driven by the strategically important acquisition of PBAF, portfolio purchases and ongoing origination activity. It has materially diversified the Group's funding profile, both through raising significant amounts of retail deposit monies and in gaining access to the FLS to support lending to SME customers.

Paragon Bank funds its new lending advances and pipeline through savings deposits. The Bank's funding position at 30 September 2016 is summarised below.

	2016 £m	2015 £m
Loans to customers (note 13)	1,686.2	407.8
Retail deposits (note 22)	1,873.9	708.7
Loan to deposit ratio	<u>90.0%</u>	<u>57.5%</u>

The scale now achieved by Paragon Bank reduces the inefficiencies seen during its start-up phase when deposit levels were dictated by pipeline requirements as well as income generating asset balances. This more efficient liquidity profile enhances profitability and creates a more normal relationship between deposit levels and the size of the loan portfolio.

The Group provided capital of £167.0 million to Paragon Bank during the period (2015: £33.0 million), including amounts required to support acquisitions, and its policy is to provide the Bank with sufficient capital to cover its planned requirements over each twelve-month period.

MANAGEMENT REPORT

A3.2 LENDING REVIEW

In addition to Paragon Bank providing a diversified funding base for the Group, its second strategic objective is to diversify the Group's income flows. An analysis of the Bank's loan portfolio is presented below:

	Current year advances and external investment		Outstanding balance	
	2016 £m	2015 £m	2016 £m	2015 £m
Buy-to-let	561.5	350.0	1,006.5	349.6
Car finance	79.8	43.9	95.2	43.2
Personal finance	229.7	15.2	304.8	15.0
Asset finance	144.3	-	250.4	-
Development finance	9.1	-	9.1	-
Other loans	-	-	20.2	-
	<u>1,024.4</u>	<u>409.1</u>	<u>1,686.2</u>	<u>407.8</u>

As well as entering the asset finance market through acquisitions, Paragon Bank also launched a property development finance offering during the year. It continues to investigate further opportunities to broaden its range of products, both organically and by acquisition, where these match its risk appetite. The next scheduled development is the launch of a specialist residential mortgage operation, serving currently undersupplied areas of that market, expected in the first half of the new financial year.

Yields on the Bank's loan assets, based on average monthly balances outstanding are set out below, analysed between product lines.

	Average balance		Average yield	
	2016 £m	2015 £m	2016 %	2015 %
Buy-to-let mortgages	718.8	114.9	4.49%	3.85%
Acquired balances	234.3	-	4.26%	-
Originated personal finance	36.1	4.8	4.87%	4.23%
Car finance	71.9	21.2	5.40%	5.40%
Development finance	2.2	-	8.99%	-
Asset finance	<u>247.8</u>	<u>-</u>	<u>10.46%</u>	<u>-</u>

MANAGEMENT REPORT

A3.2 LENDING REVIEW

As the Bank's investments in buy-to-let mortgages and acquired assets are part of the wider group position, the yields above will differ from the overall yields for these activities, dependent on the mix of business.

Buy-to-let

Paragon Bank continues to increase its buy-to-let lending, with £561.5 million of advances in the year (2015: £350.0 million), representing 48.4% of the Group's total buy-to-let advances (2015: 26.4%). At the end of the period the Bank's buy-to-let pipeline stood at £197.3 million (2015: £309.5 million). There have been no accounts over three months in arrears on business written by the Bank up to 30 September 2016 (2015: none). The buy-to-let market is discussed in more detail under 'Paragon Mortgages' above. The products originated by the Bank are complementary to those offered by Paragon Mortgages.

In addition to newly originated assets, Paragon Bank acquired the portfolio of buy-to-let loans previously financed in the Group's Paragon Mortgages (No. 17) PLC securitisation. This portfolio, which stood at £99.2 million at 30 September 2016, contained well-seasoned loans which formed part of the Bank's rolling programme of pre-positioning buy-to-let assets with the Bank of England. At the year end £620.3 million of assets had been pre-positioned in this way (2015: £nil).

The Bank is expected to continue to acquire previously securitised assets, where the use of deposit funding can achieve cost and capital optimisation benefits for the Group while conforming to the Bank's risk profile.

MANAGEMENT REPORT

A3.2 LENDING REVIEW

Car finance

The UK car market has continued to grow during the year ended 30 September 2016. During September 2016, 470,000 new cars were registered (2015: 463,000) which was the highest number ever recorded for September. Calendar year-to-date registrations were 2,150,000 which is a 2.6% increase on the comparable period in 2015 (2015: 2,097,000).

The UK car finance market has also experienced considerable growth, with total finance for the year ended September 2016 reported by the Finance and Leasing Association ('FLA') up 11.9% at £40.4 billion (2015: £36.1 billion), with similar percentage increases seen for both new and used car funding at £26.2 billion and £14.2 billion respectively (2015: £23.7 billion and £12.4 billion).

Car finance volumes have continued to build, with total advances increased by 81.8% in the year to £79.8 million (2015: £43.9 million). Paragon Bank's car finance loan book was 120.6% higher than at the start of the period at £95.2 million (2015: £43.2 million). The quality of these loans remains high and the percentage of the Bank's car finance accounts which were more than two months in arrears at 30 September 2016 was 0.09% (2015: none).

The Bank's underwriting standards ensure that car finance loans enjoy significant security from the financed vehicle. At 30 September 2016 external valuations from CAP, the motor vehicle market analysts, were available for vehicles representing £75.0 million of the loan book (excluding light commercial vehicles, motorhomes or vehicles 10 years past the last production date which are not included in the published data). These assets had a total security value of £88.1 million, resulting in headroom of £13.1 million or 16.6%. In the event of a 10% depreciation in vehicle values, the security valuation reduces to £79.3 million, with £4.3 million of headroom still remaining (5.6% of the asset value).

MANAGEMENT REPORT

A3.2 LENDING REVIEW

Personal finance

The second charge mortgage market has continued to experience growth over the year with FLA data for new business volumes in September 2016 showing a year-on-year increase by value of 4.1% to £77 million (September 2015: £74 million). In contrast, the number of new second charge mortgages fell by 1.2% to 1,719 over the same period (September 2015: 1,740). The average second charge mortgage advance in September was therefore £44,700, a year-on-year increase of 5.2% (September 2015: £42,500). The total size of the second charge mortgage market reported by the FLA had increased in the year ended 30 September 2016 by 14.7% to £892 million (2015: £778 million).

The personal finance balances shown below comprise second charge mortgage assets originated by Paragon Bank or purchased by it from third parties or other Group entities:

	Current year advances and external investment		Outstanding balance	
	2016 £m	2015 £m	2016 £m	2015 £m
Originations	44.9	15.2	54.2	15.0
Acquired loans	184.8	-	250.6	-
	<u>229.7</u>	<u>15.2</u>	<u>304.8</u>	<u>15.0</u>

Paragon Bank's advances in the year were £44.9 million (30 September 2015: £15.2 million), increasing its originated loan book by 361.3% in the year, and the pipeline of new business at the period end was £11.5 million (30 September 2015: £4.4 million). The average loan size is just over £57,000 and the average loan to value ratio in the portfolio is 68.8%. None of the Bank's originated second charge mortgage accounts were in arrears at 30 September 2016 (30 September 2015: none).

MANAGEMENT REPORT

A3.2 LENDING REVIEW

Debt purchase opportunities are sourced through the Group's Idem Capital debt purchase operation, when potential asset purchases fit with the Bank's risk appetite and business model. The use of Idem Capital's expertise and resources combined with funding through the Bank broadens the range of potential acquisitions for the Group. During the period the Bank has also purchased certain personal finance balances, formerly disclosed in the Idem Capital segment. The UK debt purchase market is discussed further under 'Idem Capital' above.

Paragon Bank's purchased second charge mortgage assets were of high quality at the acquisition date and at 30 September 2016 only 5.04% of these accounts were two months or more in arrears, compared to an industry average of 12.5% reported by the FLA.

Second charge mortgages became regulated under the FCA's MCOB regime on 21 March 2016. Paragon Personal Finance completed the required systems enhancements, procedural developments and employee training during the year. Whilst these changes disrupted market volumes at the time, they generate further opportunities for product development and broaden the available distribution options for the Group's second charge mortgage products.

Development finance

The development finance balance represents the initial advances from the Bank's new operation to provide funding for small scale property developments. The proposition launched during the year and has developed a strong network of relationships within the market that are expected to drive sustained growth, based on a robust credit assessment and risk proposition.

Paragon Bank's focus in this area is to provide access to finance for smaller builders who are not being supported by the clearing banks, but who have an important part to play in increasing the supply of new properties in the UK. The business delivers attractive returns and operates within the Bank's risk appetite. The operation made loans of £9.1 million in the year (2015: £nil) and had an investment balance of £9.1 million at year end (2015: £nil). The pipeline of the new business at the year end was £63.7 million (30 September 2015: £nil).

MANAGEMENT REPORT

A3.2 LENDING REVIEW

Asset finance

The Group acquired its asset finance business on 3 November 2015. This represents a significant strategic broadening of Paragon Bank's scope into the SME asset finance market and provides an attractive opportunity to deliver growth, addressing a different market to its existing offerings. During the year this business has added £9.4 million to the Bank's profits, before acquisition related costs of £2.8 million (note 6).

PBAF was formed, as Five Arrows Leasing Group, in 1988 and was owned by Rothschild & Co from 1996 until its sale to the Group. It offers a range of asset finance products through its subsidiaries to UK SMEs, including equipment, vehicle and construction equipment finance and is also a provider of lease servicing.

The FLA reports the total market for asset finance for businesses at 30 September 2016 covered £70.3 billion of outstanding balances, an increase of 7.0% over the preceding twelve months (30 September 2015: £65.7 billion). Advances in that market in the year ended 30 September 2016 were £30.2 billion, an increase of 7.9% on the £28.0 billion recorded in the previous year. The market is addressed by a range of companies, many operating within specialist niches.

The finance lease assets acquired with the business were £203.6 million (note 6), which had risen to £250.4 million by the year end, an increase of 23.0%, as a result of new advances in the period since acquisition of £144.3 million. These finance lease assets generated interest income of £19.3 million in the period. The number of loan accounts more than two months in arrears at 30 September 2016 at 0.82% remained very low (0.94% at acquisition), in line with the FLA figure for business finance leasing of 0.7% (2015: 0.8%).

PBAF generates operating lease income from a fleet of vehicles with a book value of £11.4 million at the end of the period (£7.6 million at acquisition), with £6.1 million of new contracts initiated in the period. It also operates a spot hire fleet with a net book value of £4.5 million at the year end (£3.1 million at acquisition). Operating lease activities generated £3.0 million in the year, net of direct costs. The business also has invoice factoring and discounting operations which generated income of £3.0 million in the period.

MANAGEMENT REPORT

A3.2 LENDING REVIEW

The asset finance team is highly regarded in the marketplace, has a strong credit ethos and has a good cultural fit within the Group's wider business. The development of the current team and infrastructure will be guided by Paragon Bank and will provide the building blocks for further SME finance development, organically and, potentially, by further acquisitions. The current product suite delivers a broad asset finance sector coverage, in addition to servicing certain distinct specialist niche segments of the SME market.

The asset finance business was further expanded by the acquisition of Premier Asset Finance on 30 September 2016. Premier is one of the UK's leading asset finance brokerages, sourcing in excess of £100.0 million of lending per annum for a range of SME customers. The business, which is based in Edinburgh, has a national presence, and was voted as Hard Assets Broker of the Year in Leasing World's 2016 awards. The new acquisition will complement the existing asset finance operation and reflects the Group's ongoing commitment to delivering a more material presence in this market to develop its diversification strategy, both by organic growth and, potentially, through further acquisitions.

Other asset finance loan assets

The other loan assets included in the asset finance operation are set out below.

	2016 £m	2015 £m
Commercial mortgages	2.9	-
Factoring and discounting	16.9	-
Other loans	0.4	-
	<u>20.2</u>	<u>-</u>

The factoring business supports the customers of the asset finance business as well as servicing its own customer base and is well positioned to trade successfully and to expand to new customers. The other loan balances above represent legacy portfolios of the acquired business. Factoring balances are agreed on a revolving basis and therefore it is not appropriate to quote an advances figure alongside those for other loan types.

MANAGEMENT REPORT

A3.3 FUNDING REVIEW**Debt Funding**

During the year the Group has continued to pursue its strategy of diversifying its funding base, in particular by making increased use of its retail savings capability through Paragon Bank. The Group's present medium term strategic funding objective is focussed predominantly on retail deposits, with the use of securitisation on a tactical basis if market conditions are favourable.

The Group's funding at 30 September 2016 is summarised as follows:

	2016 £m	2015 £m	2014 £m
Paragon Mortgages (securitised and warehouse funding)	9,812.8	9,597.1	9,367.8
Idem Capital (non-recourse asset backed funding)	136.8	102.9	145.1
Paragon Bank (retail deposit balances)	1,873.9	708.7	60.1
Business specific funding	11,823.5	10,408.7	9,573.0
Corporate borrowings	553.0	404.9	293.2
	<u>12,376.5</u>	<u>10,813.6</u>	<u>9,866.2</u>

During the year Paragon Bank accessed the facilities within the Sterling Monetary Framework and drew £108.8 million to support lending to SMEs. This access has created a platform for future funding under the TFS, which the Bank intends to utilise in the coming year.

Retail funding

The UK savings market continues to grow strongly, with household savings balances reported by the Bank of England increasing by 7.4% in the year to 30 September 2016 to £1,106.1 billion (30 September 2015: £1,030.2 billion). This strong supply has helped to maintain the recent trend for low savings rates with the average annual interest on two year fixed interest bonds, reported by the Bank of England, having declined from 1.54% in September 2015 to 1.00% in September 2016.

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FUNDING REVIEW

The Group initially used retail funding to finance its entry into the car finance market, extending this to secured lending and buy-to-let. Retail deposits are at the core of the Group's funding strategy, being a reliable, cost-effective and scalable source of finance. As a consequence, the volume of retail deposit balances has grown significantly during the year, with retail deposits at 30 September 2016 reaching £1,873.9 million (30 September 2015: £708.7 million).

The Bank's savings proposition provides customers with a range of transparent deposit options, offering value for money. This also provides the Bank with a stable funding platform, with a focus on attracting term funding to manage interest rate risk and often limiting product availability for short periods of time.

The Group's straightforward approach and consistently competitive products have been recognised in the industry and by customers and Paragon Bank was nominated as a finalist for the Best Online Savings Provider award by Moneyfacts for the second consecutive year in October 2015.

During the second half of the year the Bank launched its first ISA product, initially to existing customers. This represents a significant broadening of the Group's offering into a key part of the UK savings market, with ISA accounts representing £271.6 billion, or 24.6%, of the savings balances reported in the Bank of England data at 30 September 2016.

In customer feedback 95% of those opening a savings account with Paragon Bank in the year, who provided data, rated the overall savings process as 'good' or 'very good', while 87% stated that they would 'probably' or 'definitely' take a second product with the Bank.

Savings balances at the year end are analysed below.

	Average interest rate		Average initial balance		Proportion of deposits	
	2016 %	2015 %	2016 £000	2015 £000	2016 %	2015 %
Fixed rate deposits	2.11%	2.33%	28	34	71.0%	71.7%
Variable rate deposits	1.65%	1.62%	15	16	29.0%	28.3%
All balances	1.98%	2.13%	25	28	100.0%	100.0%

The average initial term of fixed rate deposits was 26 months (2015: 29 months).

MANAGEMENT REPORT

FUNDING REVIEW

With the Bank expected to contribute increasingly to the Group's originations, the scale of its deposit-taking activities is expected to expand materially over the next few years.

Securitisation funding

Sentiment within the capital markets was dominated by the build-up to and result of the Brexit Referendum, with significant volatility before and immediately after the event, in addition to a series of other macro-economic concerns troubling investors. The increased volatility produced unattractive conditions for issuance. Given the Group's strategic focus on retail deposit funding, securitisations will only be undertaken on a tactical basis when market conditions support effective execution. With pricing unattractive and demand volatile the Group has not accessed the securitisation market since November 2015.

Buy-to-let mortgage originations outside Paragon Bank are initially funded through three revolving warehouse facilities which totalled £850.0 million at 30 September 2016 (30 September 2015: £950.0 million). Following a review of the available funding one facility, for £100.0 million, was closed in the period, having become redundant through the increased focus on retail deposit funding. Further rationalisation of warehouse capacity is expected as facilities fall due for renewal given the Group's present focus on more cost-effective retail deposit funding opportunities through the Bank.

In the longer term these mortgage loans may be funded through the securitisation markets, subject to favourable market conditions or may be sold to Paragon Bank. The Group's 62nd transaction, Paragon Mortgages (No. 24) PLC ('PM24'), for £350.1 million, was completed during November 2015. It priced in difficult market conditions, reflecting an anticipation of increased issuance resulting from several very large portfolio acquisition transactions expected to be refinanced through the securitisation market. This expectation led to higher margins being demanded by investors on new issues.

MANAGEMENT REPORT

FUNDING REVIEW

The Group's public securitisations issued in the current and previous years are summarised below.

Securitisation	Amount raised £m	Date	Average funding margin over LIBOR (basis points)
Paragon Mortgages (No. 24) PLC	350.1	November 2015	175
Paragon Mortgages (No. 23) PLC	292.5	July 2015	123
Paragon Mortgages (No. 22) PLC	292.5	March 2015	95
Paragon Mortgages (No. 21) PLC	243.7	November 2014	88

During the period the mortgage assets held by Paragon Mortgages (No. 17) PLC were sold to Paragon Bank and are now financed with retail deposits.

Following the issue of PM24, conditions in the securitisation markets deteriorated further through the early part of the financial year and then recovered somewhat towards the year end, resulting in issuance being at its lowest level in recent years. Conditions remain volatile and with the availability of the alternative retail deposit funding route, the Group has not returned to the securitisation market. The Group continues to keep developments in the securitisation market under review and will continue to use it as a funding source on a tactical basis.

Due to the lack of securitisation issues, the amounts drawn on the warehouse facilities at 30 September 2016 had increased to £489.0 million (2015: £254.0 million). The warehouse balances will either be securitised during 2017 or will be acquired by Paragon Bank to be pre-positioned with the Bank of England, for use in the TFS or other such arrangements. This funding scheme, announced on 4 August 2016, gives Paragon Bank access to cost effective funding, in the form of central bank reserves, against eligible collateral during a four-year period. The availability of the TFS is likely to reduce further the Group's reliance on the securitisation market during 2017.

Funding for purchased assets

Idem Capital has continued its funding strategy of financing smaller scale acquisitions from the Group's equity while keeping under review the opportunities to introduce external funding when asset volumes make that economically appropriate.

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FUNDING REVIEW

In October 2015, an Idem Capital special purpose vehicle company ('SPV') entered into an agreement to issue £117.3 million of sterling floating rate notes to Citibank NA. These notes bear interest at a rate of one month LIBOR plus 3.5% and the funds raised were used to re-finance existing Idem Capital unsecured loan assets, previously funded intra-group and through an existing SPV, and are secured on those assets. The transaction raised net new funding of £65.5 million. This agreement was extended by £74.9 million in the year.

During the year other Idem Capital borrowings were repaid following the sale of the underlying assets to Paragon Bank, reducing funding costs, and the Bank joined with Idem Capital in a portfolio purchase transaction. As a result of these transactions, at 30 September 2016 the funding of certain of the Group's debt purchase assets was distributed as shown below.

	2016 £m	2015 £m	2014 £m
<i>Purchased assets by funding source</i>			
Externally funded	269.1	275.6	324.4
Retail deposit funded	250.6	-	-
Funded through Group resources	14.1	157.3	82.8
	<u>533.8</u>	<u>432.9</u>	<u>407.2</u>

This demonstrates the increased flexibility in the Group's funding for its debt purchase activities, broadening its sources of finance and demonstrating its ability to access third party funding on a more regular basis. The participation of Paragon Bank in debt purchase transactions offers greater flexibility in terms of deal size and asset class, where increasingly the focus will move to more strongly performing portfolios.

Corporate funding

While the Group's working capital has primarily been provided by equity since 2008, in recent years it has expanded its use of corporate debt funding, allowing it to diversify its funding base and extend the tenor of its borrowings.

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FUNDING REVIEW

During September 2016, the tone of capital markets improved for a short period, as UK economic activity experienced less of an immediate downturn than expected following the outcome of the Brexit referendum. The improved conditions allowed the Company to issue £150.0 million of Subordinated Tier 2 Notes due September 2026, the proceeds of which will be used, in part, to repay the £110.0 million Subordinated Notes due April 2017 as well as for general corporate purposes. The transaction was rated BB+ by Fitch and subscribed for by over 70 investors. This is the first issue of its kind by the Group and demonstrates the continuing broadening of its corporate funding.

The Group is rated by Fitch Ratings, and maintains its BBB- senior debt rating, with Fitch confirming this rating with a stable outlook on 5 May 2016. With a strategy to increase holding company leverage levels over time, the rating will support long dated corporate debt issuance in both scale and pricing terms.

The Group's £1.0 billion Euro Medium Term Note Programme announced in January 2013 remains in place and while no issuance was made in the period the programme was renewed in January 2016 to allow further issuance and continues to form part of the Group's long-term funding strategy.

Further information on all of the above borrowings is given in note 23.

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FUNDING REVIEW

Capital Management

The Group has continued to enjoy strong cash generation during the year. Free cash balances were £366.5 million at the year-end (30 September 2015: £199.9 million) (note 17) after investments to support the asset finance acquisitions and other organic growth within Paragon Bank, new buy-to-let originations and acquisitions by Idem Capital. The free cash balance also includes the proceeds of the £150.0 million Tier 2 Bond issue, £110.0 million of which will be required to repay existing corporate debt maturing in April 2017. The Company sees opportunities to deploy capital to support organic growth and invest in portfolio purchases and potentially in further M&A opportunities.

Dividend and dividend policy

In view of the strong position of the Group and its confidence in the prospects for the business, the Board is proposing, subject to approval at the Annual General Meeting on 9 February 2017, a final dividend of 9.2 pence per share which, when added to the interim dividend of 4.3 pence, gives a total dividend of 13.5 pence per share for the year. This represents an increase of 22.7% from 2015, bringing the dividend cover to 3.0 times (2015: 3.2 times) (note 3).

This level of dividend cover is in line with the Company's stated policy, established in 2012, to target a cover ratio of 3.0 to 3.5 times by the financial year ended 30 September 2016. Annual dividend per share has grown at a compound rate of 27.5% from the 4.0 pence per share for the year ended 30 September 2011, the last year before the policy was adopted, to the 13.5 pence per share proposed for the current year.

The Company intends to pursue a progressive dividend policy, maintaining its dividend cover ratio at three times.

MANAGEMENT REPORT

FUNDING REVIEW

Regulatory capital

The Group is subject to supervision by the PRA on a consolidated basis, as a group containing an authorised bank. As part of this supervision, the regulator will issue individual capital guidance setting an amount of regulatory capital, defined under the international Basel III rules, implemented through the Capital Requirements Regulation and Directive ('CRD IV'), which the Group is required to hold relative to its risk weighted assets in order to safeguard depositors against the risk of losses being incurred by the Group.

The Group maintains extremely strong capital and leverage ratios, with a CET1 ratio of 15.9% at 30 September 2016 (2015: 19.1%) and a leverage ratio at 6.2% (2015: 7.7%) (note 3) leaving the Group's capital at 30 September 2016 comfortably in excess of the regulatory requirement. The reduction in the CET1 ratio in the year results principally from the effect of the PBAF acquisition on risk weighted assets and the impact of the asset finance acquisitions, the share buy-back programme and the deficit on the Group's pension plan on regulatory capital.

The Group notes the consultation paper issued by the BCBS on 15 December 2015 regarding the proposed amendments to the Standardised Approach ('SA') for assessing the capital adequacy of institutions. The most material proposal for the Group relates to a potential increase in the risk weightings applicable to buy-to-let lending assets. The Group considers that the proposed risk weightings do not properly reflect the strong credit performance of the asset class in the UK and has engaged with both the PRA and the BCBS as part of the consultation process. The BCBS has also issued a consultation paper in March 2016, proposing revisions to the Internal Ratings Basis ('IRB') for assessing capital, which is based on firms' own internal calculations and subject to supervisory approval. The proposals may serve to limit the comparative advantage available to IRB users over SA users through the use of floors.

Notwithstanding the outcome of these consultations, the Group has substantial performance data and excellent credit metrics to support the adoption of an IRB approach for determining appropriate risk weightings for its buy-to-let mortgage assets. Other UK institutions that currently use the IRB approach for their buy-to-let portfolios achieve materially lower risk weightings than the 35% required by the present SA, with figures reported by the PRA in July 2015 as being typically in the low to mid-teen percentages.

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FUNDING REVIEW

In addition to the potential capital advantages from adopting the IRB approach, the Group sees broader business benefits from adopting the disciplines required by IRB as a core part of its risk management structure. Additional resources have been dedicated to this project.

The Group will be closely monitoring developments in both of these consultations as they progress and has commenced a project to prepare an application to the PRA to adopt the IRB in future, which will build on the Group's existing core competencies in credit risk and data handling and should lead to further enhancements in the internal risk governance framework.

Gearing and share buy-backs

Given the strong capital base and low leverage in the Company's balance sheet, the Board has determined that the Group should seek to utilise greater levels of debt to support growth and reduce its over-reliance on equity capital, improving returns for shareholders. In pursuit of this strategy the Group issued £150.0 million of Tier 2 Corporate Bonds in the period and will continue to review the opportunities available to it to access the sterling senior unsecured debt market and the UK retail bond market to add further incremental long-dated debt to the Group balance sheet.

In November 2014 the Group announced a share buy-back programme, initially for up to £50.0 million and extended to £100.0 million in November 2015, to be reviewed periodically to take account of anticipated investment opportunities and the balance of the Group's debt and equity capital resources. During the year the Group bought back 16.6 million of its ordinary shares at a cost of £51.0 million. These shares being initially held in treasury. The Board intends to extend the programme by up to £50.0 million in the financial year ending 30 September 2017. These shares will also be initially held in treasury, but may be cancelled subsequently.

The Company currently has the necessary shareholder approval to undertake such share buy-backs and will propose the appropriate renewal of the relevant authority at its 2017 Annual General Meeting, when a special resolution seeking authority for the Company to purchase up to 28.0 million of its own shares (10% of the issued share capital excluding treasury shares) will be put to shareholders.

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FUNDING REVIEW

The Board keeps under review the appropriate level of capital for the business to meet its operational requirements and strategic development objectives. The strength of the Paragon Mortgages and Idem Capital businesses, the diversification which has been achieved in the funding base in recent years and the further opportunities for growth and sustainability provided by Paragon Bank, have now created the foundations upon which to develop the Group's next phase of growth.

MANAGEMENT REPORT

FINANCIAL REVIEW

The financial year ended 30 September 2016 saw the Group's underlying profit (note 32) increase by 9.1% to £146.9 million (30 September 2015: £134.7 million) while on the statutory basis profit before tax increased by 6.7% to £143.2 million (30 September 2015: £134.2 million). Earnings per share increased by 14.1% to 40.5p (30 September 2015: 35.5p).

Results for the year

CONSOLIDATED RESULTS

For the year ended 30 September 2016

	2016 Acquisition £m	2016 Extant £m	2016 Total £m	2015 £m
Interest receivable	22.4	389.0	411.4	341.0
Interest payable and similar charges	(5.3)	(182.9)	(188.2)	(143.6)
Net interest income	<u>17.1</u>	<u>206.1</u>	<u>223.2</u>	<u>197.4</u>
Other leasing income	13.0	-	13.0	-
Related costs	(10.0)	-	(10.0)	-
Net leasing income	<u>3.0</u>	<u>-</u>	<u>3.0</u>	<u>-</u>
Other income	4.8	13.0	17.8	-
Other operating income	<u>7.8</u>	<u>13.0</u>	<u>20.8</u>	<u>14.1</u>
Total operating income	24.9	219.1	244.0	211.5
Operating expenses	(18.2)	(74.3)	(92.5)	(71.2)
Provisions for losses	(0.4)	(7.3)	(7.7)	(5.6)
	<u>6.3</u>	<u>137.5</u>	<u>143.8</u>	<u>134.7</u>
Fair value net (losses)	-	(0.6)	(0.6)	(0.5)
Operating profit being profit on ordinary activities before taxation	<u>6.3</u>	<u>136.9</u>	143.2	134.2
Tax charge on profit on ordinary activities			(27.2)	(27.1)
Profit on ordinary activities after taxation			<u>116.0</u>	<u>107.1</u>

MANAGEMENT REPORT

FINANCIAL REVIEW

	2016	2015
Dividend – rate per share for the year	13.5p	11.0p
Basic earnings per share	40.5p	35.5p
Diluted earnings per share	39.7p	34.8p

The acquisition of PBAF took place on 3 November 2015. To aid comparison the Group's results for the year are analysed above between the acquisition and extant business. The acquisition results include transaction costs of £1.7 million and other consequential costs of £1.1 million.

The acquisition of Premier took place on 30 September 2016 and hence no trading results from this business are included in the Group's results for the year. However, transaction costs of £0.3 million are included in the acquisition result above.

Total operating income increased by 15.4% to £244.0 million (2015: £211.5 million). This represents a 3.6% organic increase combined with the £24.9 million of net income arising from the acquisition.

Within this, net interest income increased to £223.2 million from the £197.4 million recorded in the year ended 30 September 2015. The increase reflects improving margins and growth in the size of the average loan book, which rose by 7.7% to £10,400.0 million (2015: £9,659.2 million) (note 30).

Net interest margins in the year ended 30 September 2016 increased to 2.15% compared to the 2.04% in the previous year (note 30), driven by new originations and portfolio purchases having higher margins than those assets redeeming in the period.

Other operating income was £20.8 million for the year, compared with £14.1 million in 2015. The increase principally results from the acquisition which contributed £3.0 million of net leasing income and £3.4 million of third party servicing fees. The decrease in the extant business reflects a lower level of third party fee income earned in Idem Capital with formerly administered third party assets being purchased by the Group.

MANAGEMENT REPORT

FINANCIAL REVIEW

Operating expenses excluding the acquired business increased by 4.4% to £74.3 million from £71.2 million reported in the previous year, partly reflecting the increase in the average number of employees outside the acquired businesses to 1,040, a 2.0% rise (2015: 1,020).

Costs in the acquired business were £18.2 million, including those relating to the acquisition. The asset finance business naturally operates with a higher cost:income ratio than the rest of the Group, in particular with respect to maintenance and specialist servicing options offered alongside the provision of asset finance, resulting in it accounting for 19.0% of the Group's headcount at the year end. This resulted in the overall underlying cost:income ratio (excluding acquisition related costs) increasing to 36.7% from 33.7% for the corresponding period last year (note 31), although it remains significantly below the industry average. The unadjusted cost:income ratio for the year was 37.9% (2015: 33.7%) (note 31).

The cost:income ratio excluding the acquired business was broadly similar to that in the preceding year at 33.9%. The Board remains focused on controlling operating costs through the application of rigorous budgeting and monitoring procedures, and expects the overall cost:income ratio for the asset finance business to improve as it is integrated into the Group and starts to see the benefits of income growth from its expanded operations.

The charge of £7.7 million for loan impairment has increased from that for 2015 (2015: £5.6 million), partly as a result of provisions arising in the acquired business. As a percentage of average loans to customers (note 30) the impairment charge remains broadly stable at 0.07% compared to 0.06% in 2015. The Group has seen favourable trends in arrears performance over the period, both in terms of new cases reducing and customers correcting past arrears, whilst increasing property values have served to reduce overall exposure to losses on enforcement of security. The loan books continue to be carefully managed and the credit performance of the buy-to-let book remains exemplary.

Yield curve movements during the period resulted in hedging instrument fair value net losses of £0.6 million (2015: £0.5 million net losses), which do not affect cash flow. The fair value movements of hedged assets or liabilities are expected to trend to zero over time, as such this item represents a timing difference. The Group remains economically and appropriately hedged.

MANAGEMENT REPORT

FINANCIAL REVIEW

Corporation tax has been charged at the rate of 19.0%, compared with 20.2% for the last year; the decrease principally resulting from the impact of reductions in the UK Corporation Tax rate on both current year results and deferred tax liabilities.

Profits after taxation of £116.0 million (2015: £107.1 million) have been transferred to shareholders' funds, which totalled £969.5 million at the year end (2015: £969.5 million), representing a tangible net asset value of £3.12 per share (2015: £3.26) and an unadjusted net asset value of £3.50 per share (2015: £3.28).

Segmental Results

The Group analyses its results between three segments, which are the principal divisions for which performance is monitored:

- Paragon Mortgages includes revenue, in the form of interest and ancillary income, from the Group's first mortgage operations, other than the buy-to-let lending of Paragon Bank, and from other assets remaining in legacy consumer portfolios;
- Idem Capital includes revenue generated from assets purchased by the Group's debt investment business, Idem Capital Holdings Limited, other than those financed by Paragon Bank and from third party consumer loan administration activity; and
- Paragon Bank includes revenue generated from the Group's regulated banking business, Paragon Bank PLC and its subsidiaries including the acquired asset finance companies.

The underlying operating profits of these business segments are detailed fully in note 32 and are summarised below.

MANAGEMENT REPORT

FINANCIAL REVIEW

	2016 £m	2015 £m
Underlying operating profit / (loss)		
Paragon Mortgages	89.9	94.0
Idem Capital	45.4	49.3
Paragon Bank	11.6	(8.6)
	<u>146.9</u>	<u>134.7</u>

Paragon Mortgages

Trading activity during the year in the Paragon Mortgages division was very strong, with the segment contributing £89.9 million to underlying Group profit (2015: £94.0 million). The division's reduced profit level resulted from its underlying growth from net new lending being broadly counterbalanced by the sale of seasoned assets to Paragon Bank in the year, together with the higher funding costs allocated to the segment following the Group's retail bond issue in August 2015.

Idem Capital

The Idem Capital division's portfolios performed strongly in the year to 30 September 2016 and, while the division benefitted from new investments made during the year and a firm control of costs, the transfer of previously acquired assets to the Paragon Bank division reduced Idem Capital's underlying profit contribution to £45.4 million (30 September 2015: £49.3 million).

MANAGEMENT REPORT

FINANCIAL REVIEW

Paragon Bank

The increasing maturity of Paragon Bank and the acquisition of the PBAF asset finance business towards the start of the year have resulted in this segment achieving an underlying profit of £11.6 million (2015: loss of £8.6 million), excluding acquisition costs of £3.1 million. This includes £9.4 million of profit arising in the acquired business. Paragon Bank has invested heavily both in the development of the risk and compliance structure required for regulatory purposes and to provide the foundations for organic growth across its product lines. As these product lines grow the Bank will naturally increase the utilisation of the present fixed cost base improving its overall cost effectiveness.

Assets and Liabilities

SUMMARY BALANCE SHEET

30 September 2016

	2016 £m	2015 £m
Intangible assets	105.4	7.7
Investment in customer loans	10,737.5	10,062.4
Derivative financial assets	1,366.4	660.1
Free cash	366.5	199.9
Other cash	871.1	856.1
Other assets	71.5	92.7
Total assets	13,518.4	11,878.9
Equity	969.5	969.5
Retail deposits	1,873.9	708.7
Borrowings	10,502.6	10,105.6
Pension deficit	58.4	21.5
Other liabilities	114.0	73.6
Total equity and liabilities	13,518.4	11,878.9

MANAGEMENT REPORT

FINANCIAL REVIEW

The increase in intangible assets reflects the goodwill and intangible assets recognised on the acquisitions of PBAF (£80.1 million) and Premier (£17.8 million) which are carried on the balance sheet in accordance with the requirements of International Financial Reporting Standards ('IFRS') 3. The carrying amount was reviewed at the year end and was not found to be impaired.

The Group's loan assets include:

- First mortgage assets, with new originations and legacy assets in Paragon Mortgages, new originations in Paragon Bank and purchased assets in Idem Capital;
- Second mortgages, with new originations in Paragon Bank, legacy assets in Paragon Mortgages and purchased assets in Idem Capital;
- Car finance loans, with new originations in Paragon Bank and legacy assets in Paragon Mortgages;
- Asset finance loans, originated by the acquired PBAF business and included in the Paragon Bank segment; and
- Other unsecured consumer lending with purchased assets in Idem Capital and legacy assets in Paragon Mortgages.

An analysis of the Group's financial assets by type is shown in note 13. Movements in these balances are discussed in the business review section.

Movements in the Group's loan asset balances are discussed in the lending review section.

Movements in derivative financial assets arise principally as a result of the effect of changes in exchange rates on instruments forming cash flow hedges for the Group's floating rate notes. These movements do not impact on the Group's results.

MANAGEMENT REPORT

FINANCIAL REVIEW

Cash flows from the Group's securitisation vehicle companies and the acquired portfolios remain strong. These, together with debt raisings, financed further investments in loan portfolios, the capital requirements of Paragon Bank and credit enhancement for mortgage originations. Cash was also utilised in the share buy-back programme, which commenced during December 2014 and where £100.7 million (including costs) had been deployed by 30 September 2016. Free cash balances were £366.5 million at 30 September 2016 (2015: £199.9 million) following the receipt of cash from the Group's £150.0 million Tier 2 Corporate Bond issue in September (note 23).

Movements in the Group's funding are discussed in the funding review section.

Decreasing gilt yields have increased the accounting value placed on the liabilities of the Group's defined benefit pension plan over the year ended 30 September 2016, leading to the deficit under International Accounting Standard ('IAS') 19 increasing to £58.4 million (2015: £21.5 million). This resulted in an actuarial loss in other comprehensive income of £37.2 million before tax (2015: £4.3 million).

MANAGEMENT REPORT**OPERATIONAL REVIEW****Management and People**

The Group has always recognised that its people are its most important asset and are key to its future growth and development. The learning and development of its employees, together with a rigorous recruitment process are a key part of the Group's organic growth strategy and underpin the strong progress it has made. It retains its Gold Investor in People status, reflecting the quality of its internal processes and during the year has continued to act, by invitation, as an Investor in People Champion, sharing its experience with other businesses. This places it in the top 1% of companies in the UK for people development.

The Group is proud to have signed the Women in Finance Charter, sponsored by HM Treasury, during the year. The Charter's objectives reflect the Group's own aspirations in the field of gender diversity and the Group will be responding to its requirements in the future periods.

The Group prides itself on the fact that its people remain with it for a long time. Its annual employee attrition rate of 6.5% is below the national average and 28.7% of its people have been with Paragon for more than ten years, with 8.3% having achieved over 20 years with the Group. We believe this is due to providing quality development opportunities and creating a place where people want to work, which has meant that knowledge and experience have been retained in each of our specialist areas. We have continued to add to the team over the past year with excellent people at all levels of the organisation, increasing numbers by 23.4% over the year, which includes the acquisition of Five Arrows Leasing Group. We believe our people are well positioned to support the Group's future growth strategy.

During 2017 the Board, initially through the Nomination Committee, will give in depth consideration to the appointment of an additional non-executive director, particularly who has retail and SME banking experience.

The Group's succession planning strategy has been an important area of focus during the year, with key roles in the Group identified from a leadership and specialist perspective. Immediate successors are in place for these roles for the short term to provide business continuity and longer term succession plans are being developed for those with career aspirations and strong potential. This area will remain a priority for the Board, with the assistance of the Nomination Committee, during the forthcoming year.

MANAGEMENT REPORT

OPERATIONAL REPORT

Risk

The Group's risk governance framework is based upon a formal three lines of defence model. Within this framework the Credit, Asset and Liability and Operational Risk and Compliance Committees, formed of senior management, report to the board level Risk and Compliance Committee. This committee comprises the Chairman and the independent non-executive directors of the Company.

In the last year the Group has strengthened its risk resource in areas such as operational risk and credit risk. These appointments have been made to ensure that subject matter experts are in place ahead of planned future growth to help shape policy and process. They will also ensure that the Risk and Compliance function has sufficient capability and capacity to provide effective oversight of the Group's expanding activities, including the acquired asset finance business.

The Group's governance structure therefore provides an effective basis for the management of risk within which:

- The ***first line of defence***, comprising executive directors, managers and employees, holds primary responsibility for designing, operating and monitoring risk management and control processes
- The ***second line of defence*** is provided by the Risk and Compliance division, the board Risk and Compliance Committee and its supporting sub-committees
- The ***third line of defence*** is provided by the Group Internal Audit function and the board Audit Committee which are responsible for reviewing the effectiveness of the first and second lines of defence

The principal changes in the risk environment faced by the Group during the year include:

- Impact of the Brexit referendum result on the UK economy and capital markets
- Transitional risk on the asset finance transaction as the business is integrated into the Group
- New operational risks arising from the acquired operations

MANAGEMENT REPORT

OPERATIONAL REPORT

- Increasing cyber-security risks, through the increased scope of the retail deposit operation and the increasing sophistication of cyber-attacks on the financial sector
- Potential impact of changes in the regulatory and fiscal environment for buy-to-let mortgages in the UK, in particular for the Group's future advances and redemption levels
- Impact of new proposals on capital regulation from the BCBS

The Group is carefully monitoring these risks as they develop and considers itself well placed to mitigate their impact.

MANAGEMENT REPORT

OPERATIONAL REPORT

Regulation

The Mortgage Credit Directive Order took effect on 21 March 2016 and was arguably the largest change to the structure of consumer credit since the introduction of the Consumer Credit Act in 1974. The Directive's implementation in the UK resulted in second charge residential mortgages moving from the FCA's CONC to its residential mortgage regime ('MCOB'). It also resulted in the introduction of regulation to a limited area of the buy-to-let segment through specific consumer buy-to-let requirements ('CBTL').

In anticipation of these changes, the Group commenced a formal programme of work in 2015 to ensure that any necessary operational changes were made and regulatory permissions obtained by March 2016. Whilst the programme of work was extensive, it is pleasing to note that it was delivered on time, with no adverse impact for our customers nor any material impact on the operation of our businesses.

All relevant Group companies now hold the required permissions from the FCA under the CONC, MCOB for second mortgage and CBTL regimes as appropriate. As part of a wider strategy to enter the first charge residential mortgage market, the Group's principal servicing business, Paragon Finance PLC, now holds the requisite permission from the FCA to administer both second and first charge residential mortgages. Following the year end, Paragon Bank has received the FCA / PRA permissions required to undertake first charge residential lending.

The Financial Policy Committee of the Bank of England ('FPC') has powers to regulate owner-occupied mortgage lending and these powers were extended to buy-to-let lending by HM Treasury on 16 November 2016. This will mean that from early 2017, the FPC will be able to direct the PRA and FCA to require regulated lenders to place limits on buy-to-let mortgage lending in relation to LTV and ICR ratios.

MANAGEMENT REPORT

OPERATIONAL REPORT

In March 2016, the PRA issued a Consultation Paper setting out proposals to enhance underwriting standards in the buy-to-let segment to support the FPC's ability to act from a macro-prudential perspective. In September 2016, the PRA published its resulting Policy Statement which was broadly in line with the proposals within the original Consultation Paper. The Group's historically conservative approach to the underwriting of buy-to-let lending is entirely consistent with the PRA's objective of ensuring that lenders conduct their buy-to-let business in a prudent manner, avoiding inappropriate lending and the potential for excessive credit losses. As a result, whilst a formal programme of work is already in place to ensure the Group meets the detailed PRA requirements, these changes are not expected to have a material impact on the operation of our business.

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, the current and projected rate of regulatory change, driven by domestic and European policy, is significant, particularly as additional aspects of the Basel III supervisory regime are rolled out and the BCBS consults on further changes. The governance and control structure within Paragon Bank and the wider Group has therefore been established and developed to ensure that the impacts of all new regulatory requirements on the business are clearly understood and planned for. Regular reports on key regulatory developments are received at both executive and board risk committees. Current BCBS consultations on regulatory capital requirements and their potential impact on the Group are discussed under 'Capital Management' above.

Paragon Bank provided the required submissions to the PRA and FCA in relation to the Senior Managers Regime and Certification Regime during the year. Steps are well advanced within the Bank to ensure it complies with all the requirements of the regimes by the relevant dates. In addition, the Group is conscious of the extension of the regimes to other Financial Services and Markets Acts firms with effect from 2018 and is taking appropriate steps to ensure it is able to comply with the requirements.

MANAGEMENT REPORT

CONCLUSION

I am pleased to report a strong set of results in which we significantly increased revenue, strengthened net interest margins and improved return on equity, whilst maintaining pricing and credit discipline. Whilst the year has been disrupted by fiscal and regulatory changes, as well as political and macro economic factors, our customers' performance has been exemplary and new business activity has seen encouraging growth recently.

The Group's operating model is undergoing significant change, as it transitions from a non-bank, securitised, monoline lender into a retail funded banking group. Paragon Bank is increasingly at the heart of the Group's development, with its deposit book now exceeding £2 billion and its franchise firmly established. This has facilitated further progress in our diversification strategy, notably through the acquisition of Five Arrows Leasing Group and, more recently, Premier Asset Finance, which together have given Paragon a strong platform to build on the significant growth potential in the UK SME finance market.

We have put in place the foundations for strong and sustainable growth. The business is well funded and well capitalised with a robust operating model and an exemplary track record. We continue to believe that over the medium term the banking markets will undergo structural change which will favour specialist lending institutions such as Paragon and we are well positioned to take advantage of the opportunities that will arise.

The Paragon Group of Companies PLC

CONSOLIDATED INCOME STATEMENT
For the year ended 30 September 2016

	Note	2016 £m	2016 £m	2015 £m	2015 £m
Interest receivable			411.4		341.0
Interest payable and similar charges			(188.2)		(143.6)
Net interest income			<u>223.2</u>		<u>197.4</u>
Other leasing income		13.0		-	
Related costs		(10.0)		-	
Net leasing income		<u>3.0</u>		<u>-</u>	
Other income	9	17.8		14.1	
Other operating income			<u>20.8</u>		<u>14.1</u>
Total operating income			<u>244.0</u>		<u>211.5</u>
Operating expenses			(92.5)		(71.2)
Provisions for losses			(7.7)		(5.6)
Operating profit before fair value items			<u>143.8</u>		<u>134.7</u>
Fair value net (losses)	10		(0.6)		(0.5)
Operating profit being profit on ordinary activities before taxation			<u>143.2</u>		<u>134.2</u>
Tax charge on profit on ordinary activities			(27.2)		(27.1)
Profit on ordinary activities after taxation for the financial year			<u><u>116.0</u></u>		<u><u>107.1</u></u>
			2016		2015
Earnings per share					
- basic			40.5p		35.5p
- diluted			<u>39.7p</u>		<u>34.8p</u>

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

The Paragon Group of Companies PLC

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
For the year ended 30 September 2016

	2016		2015
	£m	£m	£m
Profit for the year		116.0	107.1
Other comprehensive income			
<i>Items that will not be reclassified subsequently to profit or loss</i>			
Actuarial (loss) on pension scheme	(37.2)		(4.3)
Tax thereon	6.8		0.9
		(30.4)	(3.4)
<i>Items that may be reclassified subsequently to profit or loss</i>			
Cash flow hedge gains /(losses) taken to equity	5.0		(3.1)
Tax thereon	(1.0)		0.6
		4.0	(2.5)
Other comprehensive income for the year net of tax		(26.4)	(5.9)
Total comprehensive income for the year		89.6	101.2

The Paragon Group of Companies PLC

CONSOLIDATED BALANCE SHEET
30 September 2016

	Note	2016 £m	2015 £m	2014 £m
Assets employed				
Non-current assets				
Intangible assets	12	105.4	7.7	7.9
Property, plant and equipment		39.2	22.1	22.9
Financial assets	13	12,116.4	10,745.8	9,969.6
		<u>12,261.0</u>	<u>10,775.6</u>	<u>10,000.4</u>
Current assets				
Other receivables		12.7	6.2	6.5
Short term investments	16	7.1	41.1	39.4
Cash and cash equivalents	17	1,237.6	1,056.0	848.8
		<u>1,257.4</u>	<u>1,103.3</u>	<u>894.7</u>
Total assets		<u>13,518.4</u>	<u>11,878.9</u>	<u>10,895.1</u>
Financed by				
Equity shareholders' funds				
Called-up share capital	18	295.9	309.3	307.3
Reserves	19	736.1	760.2	688.0
		<u>1,032.0</u>	<u>1,069.5</u>	<u>995.3</u>
Share capital and reserves		(62.5)	(100.0)	(48.2)
Total equity		<u>969.5</u>	<u>969.5</u>	<u>947.1</u>
Current liabilities				
Financial liabilities	21	1,128.3	339.6	54.4
Current tax liabilities		16.7	12.5	11.9
Other liabilities		56.3	43.0	40.1
		<u>1,201.3</u>	<u>395.1</u>	<u>106.4</u>
Non-current liabilities				
Financial liabilities	21	11,264.8	10,481.4	9,814.0
Retirement benefit obligations	24	58.4	21.5	17.3
Deferred tax		2.0	11.3	10.1
Other liabilities		22.4	0.1	0.2
		<u>11,347.6</u>	<u>10,514.3</u>	<u>9,841.6</u>
Total liabilities		<u>12,548.9</u>	<u>10,909.4</u>	<u>9,948.0</u>
		<u>13,518.4</u>	<u>11,878.9</u>	<u>10,895.1</u>

Approved by the Board of Directors on 23 November 2016.

Signed on behalf of the Board of Directors

N S Terrington
Chief Executive

R J Woodman
Group Finance Director

The Paragon Group of Companies PLC

CONSOLIDATED CASH FLOW STATEMENT
For the year ended 30 September 2016

	Note	2016 £m	2015 £m
Net cash generated / (utilised) by operating activities	26	865.2	(25.9)
Net cash (utilised) by investing activities	27	(278.6)	(3.6)
Net cash (utilised) / generated by financing activities	28	(405.5)	237.1
Net increase in cash and cash equivalents		181.1	207.6
Opening cash and cash equivalents		1,055.3	847.7
Closing cash and cash equivalents		<u>1,236.4</u>	<u>1,055.3</u>
Represented by balances within:			
Cash and cash equivalents		1,237.6	1,056.0
Financial liabilities		(1.2)	(0.7)
		<u>1,236.4</u>	<u>1,055.3</u>

The Paragon Group of Companies PLC

CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY
For the year ended 30 September 2016

		2016	2015
	Note	£m	£m
Total comprehensive income for the year		89.6	101.2
Dividends paid	20	(33.9)	(29.1)
Shares cancelled		(94.0)	-
Net movement in own shares		37.5	(51.8)
(Deficit) on transactions in own shares		(3.4)	(3.6)
Charge for share based remuneration		4.4	4.5
Tax on share based remuneration		(0.2)	1.2
Net movement in equity in the year		-	22.4
Opening equity		969.5	947.1
Closing equity		969.5	969.5

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

1. GENERAL INFORMATION

The financial information set out in the announcement does not constitute the Company's statutory accounts for the years ended 30 September 2014, 30 September 2015 or 30 September 2016, but is derived from those statutory accounts, which have been reported on by the Company's auditors. Statutory accounts for the years ended 30 September 2014 and 30 September 2015 have been delivered to the Registrar of Companies and those for the year ended 30 September 2016 will be delivered to the Registrar following the Company's Annual General Meeting. The reports of the auditors in each case were unqualified, did not draw attention to any matters by way of emphasis and did not contain an adverse statement under sections 498(2) or 498(3) of the Companies Act 2006.

Sections of this preliminary announcement, including but not limited to the Management Report, may contain forward-looking statements with respect to certain of the plans and current goals and expectations relating to the future financial condition, business performance and results of the Group. These have been made by the directors in good faith using information available up to the date on which they approved this report. By their nature, all forward-looking statements involve risk and uncertainty because they relate to future events and circumstances that are beyond the control of the Group and depend upon circumstances that may or may not occur in the future. There are a number of factors that could cause actual future financial conditions, business performance, results or developments to differ materially from the plans, goals and expectations expressed or implied by these forward-looking statements and forecasts. Nothing in this document should be construed as a profit forecast.

A copy of the Annual Report and Accounts for the year ended 30 September 2016 will be posted to shareholders in due course. Copies of this announcement can be obtained from the Group Company Secretary, The Paragon Group of Companies PLC at 51 Homer Road, Solihull, West Midlands, B91 3QJ and on the Group's website at www.paragon-group.co.uk.

2. ACCOUNTING POLICIES

The annual financial statements of the Group for the year ended 30 September 2016 have been prepared in accordance with International Financial Reporting Standards ('IFRS') as adopted for use in the European Union. Accordingly, the preliminary financial information has been prepared in accordance with the recognition and measurement criteria of IFRS. Except as noted below, the particular accounting policies adopted are those described in the Annual Report and Accounts of the Group for the year ended 30 September 2015.

Going concern

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 Management Report. The principal risks and uncertainties affecting the Group are described on page 100.

Note 6 to the accounts for the year ended 30 September 2015 includes an analysis of the Group's working and regulatory capital position and policies, while note 7 includes 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 estimates affecting the results and financial position disclosed in that annual report are discussed in note 5. The position and policies described in these notes remain materially unchanged to the date of this preliminary announcement.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

2. ACCOUNTING POLICIES (Continued)

The Group has a formalised process of budgeting, reporting and review. The Group's planning procedures forecast its profitability, capital position, funding requirement and cash flows. Detailed plans are produced for a rolling 24 month period with longer term forecasts covering a 5 year period. 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 Group's securitisation funding structures described in note 7 to the accounts for the year ended 30 September 2015 ensure that both a substantial proportion of its originated loan portfolio and a significant amount of its acquired Idem Capital assets are match-funded. 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 utilising the Group's available warehouse facilities are refinanced through securitisation or retail deposits from time to time.

The Group's retail deposits of £1,873.9m (note 22), accepted through Paragon Bank are repayable within five years, with 54.3% of this balance (£1,017.1m) payable within twelve months of the balance sheet date. The liquidity exposure represented by these deposits is monitored; a process supervised by the Asset and Liability Committees of the Group and Paragon Bank. The Group is required to hold liquid assets in Paragon Bank to mitigate this liquidity risk. At 30 September 2016 Paragon Bank held £322.1m in liquid assets, £7.1m of short term investments (note 16) and £315.0m of cash (note 17). A further £108.8m of liquidity was provided by the Bank of England FLS, bringing the total to £430.9m.

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 Individual Liquidity Adequacy Assessment Process ('ILAAP'). 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 an additional £428.1m has been prepositioned.

The earliest maturity of any of the Group's working capital debt is in April 2017, when the £110.0m corporate bond is repayable. The issue of the £150.0m tier 2 bond in September 2016 is intended to replace this borrowing in the Group's capital structure and has raised the necessary cash to make the repayment on the due date.

The Group also raised external debt finance for its acquired assets in the past year and after the period end. The Group has therefore significantly enhanced its access to funding for its business during the year and at 30 September 2016 the Group had free cash balances of £199.9m immediately available for use.

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.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

3. CAPITAL MANAGEMENT

(a) Dividend cover

The Group's dividend policy, announced in 2012 has been to target a dividend cover ratio of between 3.0 and 3.5 times by the end of this financial year. The dividend cover ratio had reached 3.2 times in respect of the year ended 30 September 2015 and the target of 3.0 times was achieved in respect of the financial year ended 30 September 2016. The Group has stated its intention to operate a progressive dividend policy, maintaining the three times cover ratio going forward. The Group considers that it has sufficient cash resources available to pay dividends at this level, and that the parent company has abundant distributable reserves for this purpose.

The most common measure of dividend cover used by financial analysts is based on earnings and dividend per share. The Group has confirmed that its dividend cover target will be based on this calculation. The expected level of dividend cover on this basis in respect of the year, subject to the approval of the final dividend at the Annual General Meeting, is shown below.

	Note	2016	2015
Earnings per share (p)		40.5	35.5
Proposed dividend per share in respect of the year (p)	20	13.5	11.0
Dividend cover (times)		<u>3.0</u>	<u>3.2</u>

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

3. CAPITAL MANAGEMENT (Continued)

(b) Return on tangible equity

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

The Group's consolidated RoTE for the year ended 30 September 2016 is derived as follows

	Note	2016 £m	2015 £m
Profit for the year		116.0	107.1
Amortisation of intangible assets		1.6	1.4
Adjusted profit		<u>117.6</u>	<u>108.5</u>
Divided by			
Opening equity		969.5	947.1
Opening intangible assets	12	(7.7)	(7.9)
Opening tangible equity		<u>961.8</u>	<u>939.2</u>
Closing equity		969.5	969.5
Closing intangible assets	12	(105.4)	(7.7)
Closing tangible equity		<u>864.1</u>	<u>961.8</u>
Average tangible equity		<u>913.0</u>	<u>950.5</u>
Return on Tangible Equity		<u>12.9%</u>	<u>11.4%</u>

This table is not subject to audit

(c) Regulatory capital

The Group is subject to supervision by the PRA on a consolidated basis, as a group containing an authorised bank. As part of this supervision the regulator will issue individual capital guidance setting an amount of regulatory capital, defined under the international Basel III rules, implemented through the Capital Requirements Regulation and Directive ('CRD IV'), which the Group is required to hold relative to its risk weighted assets in order to safeguard depositors against the risk of losses being incurred by the Group.

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

At 30 September 2016 the Group's regulatory capital of £1,005.6m (2015: £976.3m) was comfortably in excess of that required by the regulator.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

3. CAPITAL MANAGEMENT (Continued)

The Group's regulatory capital differs from its equity as certain adjustments are required by the regulator. A reconciliation of the Group's equity to its regulatory capital determined in accordance with CRD IV at 30 September 2016 is set out below.

	Note	2016 £m	2015 £m
Total equity		969.5	969.5
Deductions			
Proposed final dividend	20	(25.5)	(21.8)
Intangible assets	12	(105.4)	(7.7)
Deferred tax adjustment	*	-	(0.3)
Common Equity Tier 1 ('CET1') capital		838.6	939.7
Other tier 1 capital		-	-
Total Tier 1 capital		838.6	939.7
Corporate bond	23	260.0	110.0
Less: amortisation adjustment	†	(97.8)	(75.8)
		162.2	34.2
Collectively assessed credit impairment allowances		4.8	2.4
Total Tier 2 capital		167.0	36.6
Total regulatory capital		1,005.6	976.3

* Deferred tax assets in subsidiary companies are required to be deducted from regulatory capital. This balance is offset against the deferred tax liability in the consolidated accounts.

† When tier 2 capital instruments have less than five years to maturity the amount eligible as regulatory capital reduces by 20% per annum. As the Group's £110.0m Corporate Bond matures in 2017, this adjustment is required in respect of this instrument. No such adjustment is required in respect of the Corporate Bond issued in the year, which matures in 2026.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

3. CAPITAL MANAGEMENT (Continued)

The total exposure amount calculated under the CRD IV framework against which this capital is held, and the proportion of these assets it represents, are calculated as shown below.

	2016	2015
	£m	£m
Credit risk		
Balance sheet assets	4,728.4	4,426.8
Off balance sheet	51.5	88.7
Total credit risk	4,779.9	4,515.5
Operational risk	445.7	363.6
Market risk	-	-
Other	61.9	50.2
Total exposure amount	5,287.5	4,929.3
	%	%
Solvency ratios		
CET1	15.9	19.1
Total regulatory capital	19.0	19.8

This table is not subject to audit

The CRD IV risk weightings for credit risk exposures are calculated using the Standardised Approach, while the Basic Indicator Approach for operational risk is used.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

3. CAPITAL MANAGEMENT (Continued)

The table below shows the calculation of the leverage ratio, based on the consolidated balance sheet assets adjusted as shown below. The PRA has set a minimum leverage ratio of 3.0% for UK firms.

	Note	2016 £m	2015 £m
Total balance sheet assets		13,518.4	11,878.9
Less: Derivative assets	15	(1,366.4)	(660.1)
On-balance sheet items		12,152.0	11,218.8
Less: Intangible assets	12	(105.4)	(7.7)
Total on balance sheet exposures		12,046.6	11,211.1
Derivative assets	15	1,366.4	660.1
Potential future exposure on derivatives		68.6	69.1
Total derivative exposures		1,435.0	729.2
Post offer pipeline at gross notional amount		273.8	482.3
Adjustment to convert to credit equivalent amounts		(136.9)	(241.1)
Off balance sheet items		136.9	241.2
Tier 1 capital		838.6	939.7
Total leverage exposure		13,618.5	12,181.5
Basel III leverage ratio		6.2%	7.7%

This table is not subject to audit

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

4. CREDIT RISK

The Group's business objectives rely on maintaining a high-quality customer base and place strong emphasis on good credit management, both at the time of acquiring or underwriting a new loan, where strict lending criteria are applied, and throughout the loan's life.

The Group's credit risk is primarily attributable to its loans to customers. There are no significant concentrations of credit risk to individual counterparties due to the large number of customers included in the portfolios.

The Group's loan assets at 30 September 2016 are analysed as follows:

	2016 £m	2016 %	2015 £m	2015 %
Buy-to-let mortgages	9,621.2	89.6%	9,363.2	93.0%
Owner occupied mortgages	19.4	0.2%	47.6	0.5%
Total first residential mortgages	9,640.6	89.8%	9,410.8	93.5%
Secured loans	526.8	4.9%	387.1	3.9%
Loans secured on residential property	10,167.4	94.7%	9,797.9	97.4%
Development Finance	9.1	0.1%	-	-
Commercial Mortgages	2.9	-	-	-
Loans secured on property	10,179.4	94.8%	9,797.9	97.4%
Car loans	95.3	0.9%	43.4	0.4%
Retail finance loans	0.2	-	0.2	-
Other consumer loans	194.9	1.8%	220.9	2.2%
Asset finance loans	250.4	2.3%	-	-
Factoring and discounting balances	16.9	0.2%	-	-
Other loans	0.4	-	-	-
Total loans to customers	10,737.5	100.0%	10,062.4	100.0%

Other loans include unsecured loans either advanced by Group companies or acquired from their originators at a discount.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

4. CREDIT RISK (Continued)

An analysis of the indexed loan to value ratio ('LTV') for those loan accounts secured on property by value at 30 September 2016 is set out below. For acquired accounts the effect of any discount on purchase is allowed for.

	2016 First Mortgages %	2016 Secured Loans %	2015 First Mortgages %	2015 Secured Loans %
Loan to value ratio				
Less than 70%	60.7	50.9	51.9	33.7
70% to 80%	23.4	17.8	27.6	16.3
80% to 90%	11.3	13.0	12.8	16.7
90% to 100%	2.2	8.9	4.9	13.5
Over 100%	2.4	9.4	2.8	19.8
	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
 Average loan to value ratio	 <u>67.1</u>	 <u>72.7</u>	 <u>69.5</u>	 <u>80.9</u>
 Buy-to-let	 67.2		 69.7	
Owner-occupied	<u>27.5</u>		<u>28.8</u>	

The regionally indexed LTVs shown above are affected by changes in house prices, with the Nationwide house price index, for the UK as a whole, registering an annual increase of 5.3% in the year ended 30 September 2016 (2015: 3.8%).

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

4. CREDIT RISK (Continued)

The number of accounts in arrears by asset class, based on the most commonly quoted definition of arrears for the type of asset, at 30 September 2016 and 30 September 2015, compared to the industry averages at those dates published by the Council of Mortgage Lenders ('CML') and the Finance and Leasing Association ('FLA'), was:

	2016	2015
	%	%
First mortgages		
Accounts more than three months in arrears		
Buy-to-Let accounts including receiver of rent cases	0.11	0.19
Buy-to-Let accounts excluding receiver of rent cases	0.02	0.04
Owner Occupied accounts	3.23	3.55
CML data for mortgage accounts more than three months in arrears		
Buy-to-Let accounts including receiver of rent cases	0.55	0.66
Buy-to-Let accounts excluding receiver of rent cases	0.50	0.60
Owner Occupied accounts	1.11	1.27
All mortgages	1.01	1.17
Secured loans		
Accounts more than 2 months in arrears	17.15	19.56
FLA data for secured loans	12.50	15.40
Car loans		
Accounts more than 2 months in arrears	0.30	0.67
FLA data for point of sale hire purchase	1.50	1.20
Asset finance loans		
Accounts more than 2 months in arrears	0.82	-
FLA data for business lease / hire purchase loans	0.70	0.80
Other loans		
Accounts more than 2 months in arrears	96.35	94.66

No published industry data for asset classes comparable to the Group's other books has been identified. Where revised data at 30 September 2015 has been published by the FLA or CML, the comparative industry figures above have been amended.

The Group calculates its headline arrears measure for buy-to-let mortgages, shown above, based on the numbers of accounts three months or more in arrears, including purchased Idem Capital assets, but excluding those cases in possession and receiver of rent cases designated for sale. This is consistent with the methodology used by the CML in compiling its statistics for the buy-to-let mortgage market as a whole.

The number of accounts in arrears will be higher for closed books such as the owner-occupied mortgage book and the retail finance and unsecured loan books than for comparable active ones, as performing accounts pay off their balances, leaving arrears accounts representing a greater proportion of the total.

The improvement in the arrears position for car loans shown above is due to the recommencement of lending in this market, through Paragon Bank, with the new performing cases reducing the overall average.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

4. CREDIT RISK (Continued)

The figures shown above for secured loans and other loans include purchased portfolios which generally include a high proportion of cases in arrears at the time of purchase and where this level of performance is allowed for in the discount to current balance represented by the purchase price.

The payment status of the carrying balances of the Group's live loan assets, before provision for impairment, at 30 September 2016 and at 30 September 2015 split between those accounts considered as performing and those included in the population for impairment testing, is shown below. Balances for immaterial asset classes are not shown. Asset finance loans below includes other related loan balances. Fully provided non-live accounts are excluded from the tables below.

Days past due is not a relevant measure for the development finance or invoice discounting businesses, due to their particular contractual arrangements.

First Mortgages

	2016	2015
	£m	£m
Not past due	9,528.1	9,274.0
Arrears less than 3 months	82.1	100.8
Performing accounts	9,610.2	9,374.8
Arrears 3 to 6 months	2.4	4.6
Arrears 6 to 12 months	2.8	4.1
Arrears over 12 months	11.0	15.8
Possessions and similar cases	31.1	28.8
Impairment population	47.3	53.3
Total gross balances	9,657.5	9,428.1
Impairment provision on live cases	(16.4)	(15.3)
Timing adjustments	(0.5)	(2.0)
Carrying balance	9,640.6	9,410.8

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

4. CREDIT RISK (Continued)

Consumer and Asset Finance

	Secured loans	Car loans	Asset finance loans	Total
	£m	£m	£m	£m
30 September 2016				
Not past due	415.0	92.7	251.6	759.3
Arrears less than 2 months	33.3	3.0	1.5	37.8
Performing accounts	448.3	95.7	253.1	797.1
Arrears 2 to 6 months	20.3	0.2	1.0	21.5
Arrears 6 to 9 months	8.3	-	0.3	8.6
Arrears 9 to 12 months	7.4	-	-	7.4
Arrears over 12 months	51.0	0.2	0.4	51.6
Specifically impaired asset finance cases	-	-	3.3	3.3
Impairment population	87.0	0.4	5.0	92.4
Total gross balances	535.3	96.1	258.1	889.5
Impairment provision on live cases	(3.4)	(0.6)	(0.5)	(4.5)
Timing adjustments	(5.1)	(0.2)	(3.9)	(9.2)
Carrying balance	526.8	95.3	253.7	875.8
30 September 2015				
Not past due	265.2	43.3	-	308.5
Arrears less than 2 months	25.7	0.2	-	25.9
Performing accounts	290.9	43.5	-	334.4
Arrears 2 to 6 months	20.2	-	-	20.2
Arrears 6 to 9 months	8.9	-	-	8.9
Arrears 9 to 12 months	7.4	-	-	7.4
Arrears over 12 months	63.5	0.4	-	63.9
Specifically impaired asset finance cases	-	-	-	-
Impairment population	100.0	0.4	-	100.4
Total gross balances	390.9	43.9	-	434.8
Impairment provision on live cases	(5.4)	(0.5)	-	(5.9)
Timing adjustments	1.6	-	-	1.6
Carrying balance	387.1	43.4	-	430.5

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

4. CREDIT RISK (Continued)

Other Loans

	2016 £m	2015 £m
Not past due	4.1	6.7
Arrears less than 1 month	0.3	0.5
Performing accounts	4.4	7.2
Arrears 1 to 3 months	0.4	0.5
Arrears 3 to 6 months	0.7	0.9
Arrears 6 to 12 months	2.3	2.7
Arrears over 12 months	203.5	226.5
Impairment population	206.9	230.6
Total gross balances	211.3	237.8
Impairment provision	(16.4)	(16.9)
Timing adjustments	-	-
Carrying balance	194.9	220.9

Arrears in the tables above are based on the contractual payment status of the customers concerned. Where assets have been purchased by the Idem Capital loan investment business, customers may already have been in arrears at the time of acquisition and an appropriate adjustment made to the consideration paid.

In the debt purchase industry, Estimated Remaining Collections ('ERC') is commonly used as a measure of the value of a portfolio. This is defined as the sum of the undiscounted cash flows expected to be received over a specified future period. In the Group's view, this measure may be suitable for heavily discounted, unsecured, distressed portfolios, but is less applicable for the types of portfolio in which the Group has invested, where cash flows are higher on acquisition, loans may be secured on property and customers may not be in default. In such cases, the IAS 39 amortised cost balance, at which these assets are carried in the Group balance sheet, provides a better indication of value.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

4. CREDIT RISK (Continued)

However, to aid comparability the 84 and 120 month ERC values for the Group's purchased assets included in the Idem Capital division, are set out below, analysed by the balance sheet line on which they appear. These are derived using the same models and assumptions used in the EIR calculations, but the differing bases of calculation lead to different outcomes.

	2016 Carrying value £m	2016 84 month ERC £m	2016 120 month ERC £m	2015 Carrying value £m	2015 84 month ERC £m	2015 120 month ERC £m
<i>Loans to customers</i>						
Idem Capital	283.3	398.4	454.3	432.9	555.1	647.3
Paragon Bank	250.6	252.9	286.4	-	-	-
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Loans to customers	533.9	651.3	740.7	432.9	555.1	647.3
Investments in structured entities	-	-	-	18.1	25.7	30.4
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
	533.9	651.3	740.7	451.0	580.8	677.7
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>

Amounts shown as loans to customers above include loans disclosed as first mortgages and other loans (note 13).

5. ACQUISITIONS

The Group acquired two businesses in the year ended 30 September 2016. Paragon Bank Asset Finance Limited ('PBAF') was acquired on 3 November 2015 and Premier Asset Finance Limited ('Premier') was acquired on 30 September 2016. The disclosures required by IFRS 3 – 'Business Combinations' in respect of these acquisitions are given in notes 6 and 7.

Amounts shown in other notes in respect of these acquisitions are analysed as shown below.

	Note	PBAF Note 6 £m	Premier Note 7 £m	Total £m
Goodwill arising on acquisition	12	79.1	17.7	96.8
Intangible assets acquired	12	1.0	0.1	1.1
Property, plant and machinery acquired		12.4	-	12.4
Loans to customers acquired		221.7	-	221.7
Deferred tax balances at acquisition		3.5	-	3.5
		<hr/>	<hr/>	<hr/>
Cash flows on acquisition		305.3	4.8	310.1
		<hr/>	<hr/>	<hr/>
Acquisition related costs		2.8	0.3	3.1
		<hr/>	<hr/>	<hr/>

Had both acquisitions taken place on 1 October 2015, the consolidated revenue of the Group for the year ended 30 September 2016 would have been £448.8m and its consolidated profit before tax for the period would have been £145.2m.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

6. ACQUISITION OF PARAGON BANK ASSET FINANCE

On 3 November 2015 the Group acquired the entire share capital of Paragon Bank Asset Finance Limited (formerly Five Arrows Leasing Group Limited) from Rothschild & Co. PBAF is the parent company of a group of companies ('PBAF Group') providing a range of asset finance products to UK SMEs, including equipment, vehicle and construction equipment finance and is also a provider of lease servicing. The acquisition allows the Group to diversify its range of both products and the markets it serves within the financial services sector.

The Group acquired 100% of the voting equity interests in PBAF and the consideration was satisfied entirely in cash. Cash transferred on completion was £308.2m, £117.0m in respect of equity and £191.2m to settle existing debt owed by PBAF Group to the vendor. There are no contingent consideration arrangements. Transaction costs of £1.7m have been included in operating expenses for the year ended 30 September 2016.

The principal operating companies of the PBAF Group are listed below.

Company	Principal Activity
Paragon Bank Asset Finance Limited (Five Arrows Leasing Group Limited at acquisition)	Holding company and portfolio administration
Dash Commercial Finance Limited	Asset finance
Paragon Bank Business Finance PLC (Five Arrows Business Finance PLC at acquisition)	Asset finance
Paragon Bank Technology Finance (Five Arrows Media Finance Limited at acquisition)	Asset finance
Specialist Fleet Services Limited	Asset finance and contract hire

The contribution of PBAF Group to consolidated revenue for the year ended 30 September 2016 was £40.2m and its contribution to consolidated profit before tax for the period is set out below.

	£m	£m
Contribution to consolidated profit excluding costs of acquisition		9.4
Transaction costs	(1.7)	
Other acquisition related expenses	(1.1)	
		<hr/> (2.8)
Contribution to consolidated profit after costs of acquisition		<hr/> 6.6 <hr/>

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

6. ACQUISITION OF PARAGON BANK ASSET FINANCE (Continued)

The amounts recognised in the consolidated accounts on acquisition in respect of the identifiable assets acquired and liabilities assumed are set out below. The amounts presented are considered to be materially consistent with the existing accounting policies of the Group.

	Note	£m	£m
Non-current assets			
Operating lease assets		10.6	
Other property, plant and equipment		1.8	
		<hr/>	
Property, plant and equipment		12.4	
Intangible assets	a	1.0	
Loans to customers	b	221.7	
Deferred tax		3.5	
		<hr/>	238.6
Current assets			
Other receivables		5.2	
Cash	c	3.4	
		<hr/>	8.6
			<hr/>
			247.2
			<hr/>
Current liabilities			
Financial liabilities- bank overdraft	c	0.5	
Current tax liabilities		0.2	
Other liabilities		14.3	
		<hr/>	15.0
Non-current liabilities			
Other liabilities		3.1	
		<hr/>	3.1
			<hr/>
Total liabilities			18.1
			<hr/>
Total net identifiable assets			229.1
Goodwill	d		79.1
			<hr/>
Consideration	c		308.2
			<hr/>

a) Intangible assets

Identifiable intangible assets acquired represent broker networks and trading arrangements. They will be amortised over a ten year period.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

6. ACQUISITION OF PARAGON BANK ASSET FINANCE (Continued)

b) Loans to customers

The financial assets acquired at 3 November 2015 comprised:

	Fair value	Gross Contractual Value	Contractual flows not to be collected
	£m	£m	£m
Asset finance leases	203.6	207.7	2.2
Commercial mortgages	3.6	4.2	0.5
Factoring and discounting	14.1	14.1	-
Other loans	0.4	0.4	-
Loans to customers	<u>221.7</u>	<u>226.4</u>	<u>2.7</u>

c) Cash flows on acquisition

Net cashflows on acquisition were:

	Total
	£m
Payment for shares	117.0
Settlement of existing vendor balances	191.2
Consideration paid on completion	<u>308.2</u>
Cash	(3.4)
Bank overdraft	0.5
Net cash outflow (note 5)	<u>305.3</u>

The fair value and the gross contractual value of the cash balances acquired was equal to their book value, there are no contractual flows which are expected not to be collectable.

d) Goodwill

The goodwill of £79.1m arising from the acquisition consists of the values of the business relationships, market positions and knowledge base inherent in the business which do not qualify for recognition as intangible assets. These will be utilised in the future development of the acquired business and in expanding the Group's asset finance activities. None of the goodwill is expected to be deductible for tax purposes.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

7. ACQUISITION OF PREMIER ASSET FINANCE

The Group acquired 100% of the voting equity interests in Premier and the consideration will be satisfied entirely in cash. Cash transferred on completion was £7.0m, with a further payment to be made, following the agreement of completion accounts, estimated at £1.9m.

Further contingent consideration is payable in cash, up to a maximum of £12.0m based on the future performance of the acquired business. £10.6m has been provided in the accounts in respect of this contingent consideration, based on the net present value of the maximum amount. This is considered to be the fair value of the consideration at the transaction date, based on initial forecasts for the business. Transaction costs of £0.3m have been included in operating expenses for the year ended 30 September 2016.

As the acquisition occurred on 30 September 2016 the contribution of Premier to consolidated revenue for the year ended 30 September 2016 was £nil and its contribution to consolidated profit before tax for the period comprised only the transaction costs set out above.

The amounts recognised in the consolidated accounts on acquisition in respect of the identifiable assets acquired and liabilities assumed are set out below. The amounts presented are considered to be materially consistent with the existing accounting policies of the Group. Due to the proximity of the acquisition date to the year end, the Group has yet to finalise its exercise to determine these balances and therefore the amounts presented in this note should be considered as provisional. Final amounts will be presented with the Group's annual results for the year ending 30 September 2017.

	Note	£m	£m
Non-current assets			
Property, plant and equipment		-	
Intangible assets	a	0.1	
			0.1
Current assets			
Other receivables		0.2	
Cash	b	2.2	
			2.4
			2.5
Current liabilities			
Corporation tax payable		(0.2)	
Other liabilities		(0.5)	
			(0.7)
Total liabilities			(0.7)
Total net identifiable assets			1.8
Goodwill	c		17.7
Consideration	d		19.5

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

7. ACQUISITION OF PREMIER ASSET FINANCE (Continued)

a) Intangible assets

Identifiable intangible assets acquired represent broker networks and trading arrangements. They will be amortised over a ten year period.

b) Cash flows on acquisition

Net cashflows on acquisition were:

	Total £m
Consideration paid on completion	7.0
Cash	(2.2)
Net cash outflow (note 5)	<u>4.8</u>

The fair value and the gross contractual value of the cash balances acquired was equal to their book value, there are no contractual flows which are expected not to be collectable.

c) Goodwill

The goodwill of £17.7m arising from the acquisition consists of the values of the business relationships, market positions and knowledge base inherent in the business which do not qualify for recognition as intangible assets. These will be utilised in the future development of the acquired business and in expanding the Group's asset finance activities. None of the goodwill is expected to be deductible for tax purposes.

d) Consideration

The total consideration accounted for on acquisition was:

	Total £m
Consideration paid on completion (note (c))	7.0
Accrual for payment due on agreement of completion accounts	1.9
Contingent consideration	10.6
Total consideration	<u>19.5</u>

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

8. SEGMENTAL INFORMATION

The Group analyses its operations, both for internal management reporting and external financial reporting, on the basis of the entities within the Group generating its assets. The segments used are described below.

- Paragon Mortgages includes revenue, in the form of interest and ancillary income, from the Group's first mortgage operations, other than the buy-to-let lending of Paragon Bank, and from other assets remaining in legacy portfolios.
- Idem Capital includes revenue generated from assets purchased by the Group's debt investment business, Idem Capital Holdings Limited, other than those financed by Paragon Bank and from third party loan administration activity.
- Paragon Bank includes revenue, in the form of interest and ancillary income, generated from the Group's regulated banking business, Paragon Bank PLC and its subsidiary companies including the PBAF group.

Each of these businesses invests in consumer finance assets or SME finance, and an analysis of the Group's financial assets by type and segment is shown in note 13.

Dedicated financing and administration costs of each of these businesses are allocated to the segment. Shared costs, and the financing costs of the Group's working capital invested, are allocated based on the segment's use of those resources.

No profit has been recognised in the segmental disclosures below in respect of transfers of loan assets between segments.

The costs arising from the PBAF and Premier acquisitions in the period of £3.1m are included in the Paragon Bank segmental profit and loss account for the year.

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

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

8. SEGMENTAL INFORMATION (Continued)

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

Year ended 30 September 2016

	Paragon Mortgages £m	Idem Capital £m	Paragon Bank £m	Total £m
Interest receivable	264.2	76.4	70.8	411.4
Interest payable	(144.5)	(11.9)	(31.8)	(188.2)
Net interest income	119.7	64.5	39.0	223.2
Other operating income	8.1	4.0	8.7	20.8
Total operating income	127.8	68.5	47.7	244.0
Operating expenses	(31.8)	(23.1)	(37.6)	(92.5)
Provisions for (losses)	(6.1)	-	(1.6)	(7.7)
	89.9	45.4	8.5	143.8
Fair value net (losses)	(0.4)	-	(0.2)	(0.6)
Operating profit / (loss)	89.5	45.4	8.3	143.2
Tax charge				(27.2)
Profit after tax				116.0

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

8. SEGMENTAL INFORMATION (Continued)

Year ended 30 September 2015

	Paragon Mortgages £m	Idem Capital £m	Paragon Bank £m	Total £m
Interest receivable	263.2	71.6	6.2	341.0
Interest payable	(128.1)	(9.9)	(5.6)	(143.6)
Net interest income	135.1	61.7	0.6	197.4
Other operating income	8.5	5.3	0.3	14.1
Total operating income	143.6	67.0	0.9	211.5
Operating expenses	(44.0)	(17.7)	(9.5)	(71.2)
Provisions for (losses)	(5.6)	-	-	(5.6)
	94.0	49.3	(8.6)	134.7
Fair value net (losses)	(0.4)	-	(0.1)	(0.5)
Operating profit / (loss)	93.6	49.3	(8.7)	134.2
Tax charge				(27.1)
Profit after tax				107.1

The assets and liabilities attributable to each of the segments at 30 September 2016, 30 September 2015 and 30 September 2014 were:

	Paragon Mortgages £m	Idem Capital £m	Paragon Bank £m	Total £m
30 September 2016				
Segment assets	11,044.9	314.2	2,159.3	13,518.4
Segment liabilities	(10,560.9)	(71.6)	(1,916.4)	(12,548.9)
	484.0	242.6	242.9	969.5
30 September 2015				
Segment assets	10,622.9	481.2	774.8	11,878.9
Segment liabilities	(9,927.7)	(276.5)	(705.2)	(10,909.4)
	695.2	204.7	69.6	969.5
30 September 2014				
Segment assets	10,343.3	445.8	106.0	10,895.1
Segment liabilities	(9,658.8)	(226.6)	(62.6)	(9,948.0)
	684.5	219.2	43.4	947.1

All of the assets shown above were located in the United Kingdom.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

9. OTHER INCOME

	2016 £m	2015 £m
Loan account fee income	7.7	6.7
Insurance income	1.2	1.2
Third party servicing	7.4	4.9
Other income	1.5	1.3
	<u>17.8</u>	<u>14.1</u>

10. FAIR VALUE NET (LOSSES)

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

11. EARNINGS PER SHARE

Earnings per ordinary share is calculated as follows:

	2016	2015
Profit for the year (£m)	<u>116.0</u>	<u>107.1</u>
Basic weighted average number of ordinary shares ranking for dividend during the year (million)	286.5	301.9
Dilutive effect of the weighted average number of share options and incentive plans in issue during the year (million)	<u>5.5</u>	<u>5.9</u>
Diluted weighted average number of ordinary shares ranking for dividend during the year (million)	<u>292.0</u>	<u>307.8</u>
Earnings per ordinary share - basic	40.5p	35.5p
- diluted	<u>39.7p</u>	<u>34.8p</u>

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

12. INTANGIBLE ASSETS

	2016 £m	2015 £m	2014 £m
Goodwill	98.4	1.6	1.6
Computer software	2.1	1.6	1.3
Other intangible assets	4.9	4.5	5.0
	<u>105.4</u>	<u>7.7</u>	<u>7.9</u>
At 30 September 2016	<u>105.4</u>	<u>7.7</u>	<u>7.9</u>

The increase in goodwill relates primarily to goodwill and intangible assets arising on acquisition (note 5).

Other intangible assets comprise brands and the benefit of business networks recognised on the acquisition of subsidiary companies.

13. FINANCIAL ASSETS

	Note	2016 £m	2015 £m	2014 £m
Loans and receivables		10,391.8	10,019.0	9,250.2
Finance lease receivables		345.7	43.4	5.7
		<u>10,737.5</u>	<u>10,062.4</u>	<u>9,255.9</u>
Loans to customers		10,737.5	10,062.4	9,255.9
Fair value adjustments from portfolio hedging		12.5	5.2	0.5
Investments in structured entities		-	18.1	19.3
Derivative financial assets	15	1,366.4	660.1	693.9
		<u>12,116.4</u>	<u>10,745.8</u>	<u>9,969.6</u>

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

13. FINANCIAL ASSETS (Continued)

The Group's loan assets and investments in structured entities at 30 September 2016, analysed between the segments described in note 4 are as follows:

	Paragon Mortgages £m	Idem Capital £m	Paragon Bank £m	Total £m
<i>At 30 September 2016</i>				
First mortgages	8,620.4	13.7	1,015.6	9,649.7
Consumer loans	147.6	269.6	400.0	817.2
Asset finance	-	-	250.4	250.4
Other loans	-	-	20.2	20.2
Loans to customers	8,768.0	283.3	1,686.2	10,737.5
Investments in structured entities	-	-	-	-
Total investments in loans	8,768.0	283.3	1,686.2	10,737.5
<i>At 30 September 2015</i>				
First mortgages	9,046.7	14.5	349.6	9,410.8
Consumer loans	175.0	418.4	58.2	651.6
Asset finance	-	-	-	-
Other loans	-	-	-	-
Loans to customers	9,221.7	432.9	407.8	10,062.4
Investments in structured entities	-	18.1	-	18.1
Total investments in loans	9,221.7	451.0	407.8	10,080.5

The Group calculates its headline arrears measure for buy-to-let mortgages based on the numbers of accounts three months or more in arrears, including purchased Idem Capital assets, but excluding those cases in possession and receiver of rent cases designated for sale. Other receivership cases are included. This is consistent with the methodology used by the CML in compiling statistics for the buy-to-let mortgage market as a whole.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

14. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS

The following amounts in respect of impairment provisions, net of allowances for recoveries of written off assets, have been deducted from the appropriate assets in the balance sheet.

	First Mortgages	Other loans and receivables	Finance leases	Total
	£m	£m	£m	£m
At 1 October 2014	87.0	27.0	0.8	114.8
Charge for the year	3.6	2.4	(0.4)	5.6
Amounts written off	(4.5)	(3.5)	0.2	(7.8)
Amounts recovered	(0.1)	(1.5)	-	(1.6)
At 30 September 2015	86.0	24.4	0.6	111.0
Charge for the year	4.8	2.6	0.3	7.7
Amounts written off	(2.1)	(2.0)	(1.3)	(5.4)
Amounts recovered	0.1	(2.4)	1.6	(0.7)
At 30 September 2016	88.8	22.6	1.2	112.6

Of the above balances, the following provisions were held in respect of realised losses not charged off, which remain on the balance sheet and provided for in full.

	First mortgages	Other loans and receivables	Finance leases	Total
	£m	£m	£m	£m
At 30 September 2016	72.4	0.1	0.1	72.6
At 30 September 2015	70.7	0.3	0.1	71.1

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

15. DERIVATIVE FINANCIAL ASSETS AND LIABILITIES

	Note	2016 £m	2015 £m	2014 £m
Derivative financial assets	13	1,366.4	660.1	693.9
Derivative financial liabilities	21	(15.8)	(6.7)	(1.1)
		<u>1,350.6</u>	<u>653.4</u>	<u>692.8</u>
Of which:				
Foreign exchange basis swaps		1,364.8	659.8	693.5
Other derivatives		(14.2)	(6.4)	(0.7)
		<u>1,350.6</u>	<u>653.4</u>	<u>692.8</u>

The Group's securitisation borrowings are denominated in sterling, euros and US dollars. All currency borrowings are swapped at inception so that they have the effect of sterling borrowings. These swaps provide an effective hedge against exchange rate movements, but the requirement to carry them at fair value leads, when exchange rates have moved significantly since the issue of the notes, to large balances for the swaps being carried in the balance sheet. This is currently the case with both euro and US dollar swaps, although the debit balance is compensated for by retranslating the borrowings at the current exchange rate.

16. SHORT TERM INVESTMENTS

This amount represents fixed rate securities issued by the UK Government for which a liquid market exists and are held as part of the liquidity requirement of Paragon Bank PLC. As such they are designated as 'Available for Sale', as defined by IAS 39 - 'Financial Instruments: Recognition and Measurement' and are consequently shown at fair value which corresponds to their market value.

The total nominal value of the securities at 30 September 2016 was £7.0m (2015: £40.0m), the weighted average coupon was 1.75% (2015: 4.41%) and their carrying value was £7.1m (2015: £41.1m).

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

17. CASH AND CASH EQUIVALENTS

	2016 £m	2015 £m	2014 £m
Balances with central banks	315.0	286.0	-
Balances with other banks	922.6	770.0	848.8
	<u>1,237.6</u>	<u>1,056.0</u>	<u>848.8</u>

Only 'Free Cash' is unrestrictedly available for the Group's general purposes. Cash received in respect of loan assets is not immediately available, due to the terms of the warehouse facilities and the securitisations. Cash held in the Group's banking subsidiary is subject to regulatory rules covering liquidity and capital adequacy and is shown as 'Bank Cash' below.

'Cash and Cash Equivalents' also includes balances held by the Trustees of the Paragon Employee Share Ownership Plans which may only be used to invest in the shares of the Company, pursuant to the aims of those plans.

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

	2016 £m	2015 £m	2014 £m
Free cash	366.5	199.9	177.3
Securitisation cash	537.1	530.9	609.0
Bank cash	331.6	323.3	60.6
ESOP cash	2.4	1.9	1.9
	<u>1,237.6</u>	<u>1,056.0</u>	<u>848.8</u>

'Cash and Cash Equivalents' includes current bank balances, money market placements and fixed rate sterling term deposits with London banks, and balances with the Bank of England.

18. CALLED-UP SHARE CAPITAL

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

Movements in the issued share capital in the year were:

	2016 Number	2015 Number
Ordinary shares		
At 1 October 2015	309,349,316	307,308,283
Shares issued	218,872	2,041,033
Shares cancelled	(13,716,094)	-
At 30 September 2016	<u>295,852,094</u>	<u>309,349,316</u>

During the year the Company issued 163,045 shares at par (2015: 1,050,000) to the trustees of its ESOP Trusts in order that they could fulfil their obligations under the Group's share based award arrangements. It also issued 55,827 shares (2015: 991,033) to satisfy options granted under sharesave schemes for a consideration of £68,070 (2015: £1,365,944).

On 18 August 2016 13,716,094 shares held in treasury were cancelled by the Company.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

19. RESERVES

(a) The Group

	2016 £m	2015 £m	2014 £m
Share premium account	64.6	64.6	64.1
Capital redemption reserve	13.7	-	-
Merger reserve	(70.2)	(70.2)	(70.2)
Cash flow hedging reserve	2.1	(1.9)	0.6
Profit and loss account	725.9	767.7	693.5
	<u>736.1</u>	<u>760.2</u>	<u>688.0</u>

20. EQUITY DIVIDEND

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

	2016 Per share	2015 Per share	2016 £m	2015 £m
<i>Equity dividends on ordinary shares</i>				
Final dividend for the year ended 30 September 2015	7.4p	6.0p	21.7	18.3
Interim dividend for the year ended 30 September 2016	4.3p	3.6p	12.2	10.8
	<u>11.7p</u>	<u>9.6p</u>	<u>33.9</u>	<u>29.1</u>

Amounts paid and proposed in respect of the year:

	2016 Per share	2015 Per share	2016 £m	2015 £m
Interim dividend for the year ended 30 September 2016	4.3	3.6p	12.2	10.8
Proposed final dividend for the year ended 30 September 2016	9.2p	7.4p	25.5	21.8
	<u>13.5p</u>	<u>11.0p</u>	<u>37.7</u>	<u>32.6</u>

Dividends of £0.0m (2015: £0.0m) were paid by the Company in respect of shares held by ESOP trusts on which dividends had not been waived.

The proposed final dividend for the year ended 30 September 2016 will be paid on 13 February 2017, subject to approval at the Annual General Meeting, with a record date of 6 January 2017. The dividend will be recognised in the accounts when it is paid.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

21. FINANCIAL LIABILITIES

	Note	2016 £m	2015 £m	2014 £m
Current liabilities				
Corporate bonds		110.0	-	-
Retail deposits	22	1,017.1	338.9	53.3
Bank loans and overdrafts		1.2	0.7	1.1
		<u>1,128.3</u>	<u>339.6</u>	<u>54.4</u>
Non-current liabilities				
Asset backed loan notes		8,374.1	8,274.6	8,115.0
Corporate bond		149.0	110.0	110.0
Retail bonds		295.3	294.9	183.2
Retail deposits	22	856.8	369.8	6.8
Fair value adjustments from portfolio hedging		0.8	-	-
Bank loans and overdrafts		1,573.0	1,425.4	1,397.9
Derivative financial instruments	15	15.8	6.7	1.1
		<u>11,264.8</u>	<u>10,481.4</u>	<u>9,814.0</u>

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

22. RETAIL DEPOSITS

The Group's retail deposits, held by Paragon Bank PLC, were received from customers in the United Kingdom and are denominated in sterling. The deposits comprise principally term deposits and 120 day notice accounts. The method of interest calculation on these deposits is analysed as follows:

	2016 £m	2015 £m	2014 £m
Fixed rate	1,332.5	508.3	39.8
Variable rates	541.4	200.4	20.3
	<u>1,873.9</u>	<u>708.7</u>	<u>60.1</u>

The weighted average interest rate on retail deposits at 30 September 2015, analysed by charging method, was:

	2016 %	2015 %	2014 %
Fixed rate	2.11	2.33	1.90
Variable rates	1.65	1.62	1.85

The contractual maturity of these deposits is analysed below.

	2016 £m	2015 £m	2014 £m
Amounts repayable			
In less than three months	55.7	9.1	-
In more than three months but not more than one year	690.3	242.6	52.8
In more than one year, but not more than two years	572.9	181.7	6.8
In more than two years, but not more than five years	283.9	188.1	-
Total term deposits	<u>1,602.8</u>	<u>621.5</u>	<u>59.6</u>
Repayable on demand	<u>271.1</u>	<u>87.2</u>	<u>0.5</u>
	<u>1,873.9</u>	<u>708.7</u>	<u>60.1</u>
 Total falling due in less than one year (note 21)	 1,017.1	 338.9	 53.3
Total falling due in more than one year (note 21)	856.8	369.8	6.8
	<u>1,873.9</u>	<u>708.7</u>	<u>60.1</u>

The fair value of the deposits is not considered to be significantly different from their carrying value.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

23. BORROWINGS

All borrowings described in the Group Accounts for the year ended 30 September 2015 remained in place throughout the period, except as described below.

On 20 October 2015, a Group company, Idem Luxembourg (No. 8) entered into an agreement under which £117.3m of sterling floating rate notes have been issued to Citibank NA on a limited recourse basis. These notes bear interest at a rate of one month LIBOR plus 3.50%. The Group investment in this company to support these notes was £84.9m. The facility was used to refinance existing Idem Capital borrowings and to refinance further existing Idem Capital unsecured loan assets and is secured on those assets. During the period two further tranches of £4.1m and £70.8m of notes were issued under the facility. Both of these issues were used to fund the purchase of loan balances from third parties.

On 19 November 2015, a Group company, Paragon Mortgages (No. 24) PLC, issued €125.0m of euro mortgage backed floating rate notes and £253.0m of sterling mortgage backed floating rate notes to external investors at par. The euro notes were class A1 notes, rated AAA by Fitch and Aaa by Moody's and bearing interest at 1.10% above EURIBOR. £208.3m of the sterling notes were class A2 notes, rated AAA by Fitch and Aaa by Moody's, £19.3m were class B notes, rated AA by Fitch and Aa2 by Moody's and £25.4m were class C notes rated A by Fitch and A1 by Moody's. The interest margins above LIBOR on the sterling notes were 1.50% on the A2 notes, 2.45% on the B notes and 3.20% on the C notes. Cross-currency basis swaps were entered into at the time of the transaction, effectively translating the euro notes into a LIBOR linked sterling liability. The average interest margin on the transaction, taking swap costs into account was 1.75% and the proceeds were used to pay down existing warehouse debt. The Group retained £8.8m of class Z notes and also invested £8.7m in the first loss fund, bringing its total investment to £17.5m, or 5.0% of the issued notes.

As with the Group's existing securitisation borrowings, these financings are structured so that payments of interest and principal are limited to cash generated from the funded assets and there is no recourse to other Group funds. Therefore the issue of these new borrowings do not impact on the liquidity risk of the Group.

During the year the £100.0m Paragon Sixth Funding Limited committed sterling warehouse facility was terminated.

On 9 September 2016 the Company issued £150.0m of 7.25% Fixed Rate Reset Callable Subordinated Tier 2 Notes at par to provide long term capital for the Group. These bonds bear interest at a fixed rate of 7.25% per annum until 9 September 2021, after which interest will be payable at a fixed rate which is 6.731% over the sterling 5-year mid-market swap rate at that time. These bonds are unsecured and subordinated to any other creditors of the Company. At issue the Notes were rated BB+ by Fitch. At 30 September 2016 £149.0m (2015: £nil 2014: £nil) was included within the financial liabilities of the Company and the Group in respect of these bonds.

On 11 February 2013 the Company inaugurated a £1,000.0m Euro Medium Term Note Programme under which it may issue retail bonds, or other notes, within a twelve month period. The prospectus was updated, renewing the programme for a further twelve month period on 22 January 2016.

Repayments made in respect of the Group's borrowings are shown in note 28.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

24. RETIREMENT BENEFIT OBLIGATIONS

The defined benefit obligation at 30 September 2016 has been calculated using the latest actuarial valuation. There have been movements in financial market conditions since 30 September 2015 requiring an adjustment to the actuarial assumptions underlying the calculation of the defined benefit obligation. In particular, over the period since the 30 September 2015 actuarial valuation, the discount rate has decreased by 1.5% per annum, whereas expectations of long term inflation have decreased by 0.05% per annum. The net effect of these changes has resulted in an increase in the value of the defined benefit obligation at 30 September 2016. The impact of the change in actuarial assumptions has been recognised as an actuarial loss in other comprehensive income.

The defined benefit plan assets have been updated to reflect their market value at 30 September 2016. In particular, over the period since 30 September 2015 the Plan assets have achieved returns in excess of the assumptions made at 30 September 2015. The difference between the expected and actual return on assets has been recognised as an actuarial gain in other comprehensive income.

The movements in the deficit on the defined benefit plan during the year ended 30 September 2016 are summarised below.

	Year to 30 September 2016 £m	Year to 30 September 2015 £m
Opening pension deficit	21.5	17.3
Service cost	1.7	1.7
Net funding cost	0.8	0.7
Administrative expenses	0.4	0.7
Employer contributions	(3.2)	(3.2)
<i>Amounts posted to other comprehensive income</i>		
Return on plan assets not included in interest	(7.7)	1.8
Actuarial loss from changes in financial assumptions	44.9	2.5
Closing pension deficit	58.4	21.5

NOTES TO THE FINANCIAL INFORMATION
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25. CONDUCT

Over recent years, in common with other financial services firms, the Group has followed guidance issued by the FCA in respect of redress to customers in respect of the misselling of payment protection insurance ('PPI'), though the sums involved have not been material.

In November 2014 the UK Supreme Court handed down its decision in *Plevin v Paragon Personal Finance Limited* ('Plevin'), which addressed potential liability in respect of PPI claims under section 140 of the Consumer Credit Act 1974, where commission charged to the customer was particularly high. On 2 October 2015 the FCA published a statement outlining proposed rules addressing the handling of PPI cases in the light of the Plevin decision and including a deadline beyond which no further new PPI claims would be required to be considered.

A balance of £1.9m is recognised in other liabilities in respect of such claims and other section 140 related issues.

The Group has reviewed its current exposure to such matters in the light of the Court's judgement in Plevin and the FCA proposals and its current expectation is that it will suffer no material additional costs from such claims. However, this assessment is based on our current interpretation of both the Plevin judgement and the draft rules, which may be revised before they are expected to be finalised and brought into force at the end of December 2016, while interpretations may develop as both the judgement and the rules are implemented. Therefore, it is possible that the maximum possible liability may be greater.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

26. NET CASH FLOW FROM OPERATING ACTIVITIES

	2016	2015
	£m	£m
Profit before tax	143.2	134.2
Non-cash items included in profit and other adjustments:		
Depreciation of operating property, plant and equipment	1.9	1.5
Profit on disposal of operating property, plant and equipment	(0.1)	-
Amortisation of intangible assets	1.6	1.4
Foreign exchange movement on borrowings	699.9	(30.8)
Other non-cash movements on borrowings	14.3	4.8
Impairment losses on loans to customers	7.7	5.6
Charge for share based remuneration	4.4	4.5
Net (increase) / decrease in operating assets:		
Operating lease assets	(5.4)	-
Loans to customers	(443.0)	(810.9)
Derivative financial instruments	(706.3)	33.8
Fair value of portfolio hedges	(7.3)	(4.7)
Other receivables	(2.1)	0.4
Net decrease / (increase) in operating liabilities:		
Retail deposits	1,165.2	648.6
Derivative financial instruments	9.1	5.6
Fair value of portfolio hedges	0.8	-
Other liabilities	4.9	2.7
Cash generated / (utilised) by operations	888.8	(3.3)
Income taxes (paid)	(23.6)	(22.6)
	<u>865.2</u>	<u>(25.9)</u>

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

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

27. NET CASH FLOW FROM INVESTING ACTIVITIES

	2016 £m	2015 £m
Proceeds from sales of operating property, plant and equipment	0.4	-
Purchases of operating property, plant and equipment	(1.5)	(0.7)
Purchases of intangible assets	(1.4)	(1.2)
Decrease/(increase) in short term investments	34.0	(1.7)
Acquisition (note 6)	(310.1)	-
Net cash (utilised) by investing activities	(278.6)	(3.6)

28. NET CASH FLOW FROM FINANCING ACTIVITIES

	2016 £m	2015 £m
Shares issued (note 18)	-	1.5
Dividends paid (note 20)	(33.9)	(29.1)
Issue of asset backed floating rate notes	531.0	823.8
Repayment of asset backed floating rate notes	(1,137.2)	(638.3)
Issue of retail bonds	-	111.3
Issue of corporate bonds	149.0	-
Movement on bank facilities	145.5	24.8
Purchase of shares	(59.9)	(56.9)
Net cash (utilised) / generated by financing activities	(405.5)	237.1

29. RELATED PARTY TRANSACTIONS

In the year ended 30 September 2015, the Group has continued the related party relationships described in note 62 on page 229 of the Annual Report and Accounts of the Group for the financial year ended 30 September 2016. Related party transactions in the period comprise the compensation of the Group's key management personnel, transactions with the Group Pension Plan and fees paid to a non-executive director in respect of his appointment as a director of the Corporate Trustee of the Group Pension Plan. There have been no changes in these relationships which could have a material effect on the financial position or performance of the Group in the period.

Save for the transactions referred to above, there have been no related party transactions in the year ended 30 September 2016.

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

30. INCOME STATEMENT RATIOS

The average net interest margin is calculated as follows:

	2016 £m	2015 £m
Opening loans to customers	10,062.4	9,255.9
Closing loans to customers	10,737.5	10,062.4
Average loans to customers	10,400.0	9,659.2
Net interest	223.2	197.4
Net interest margin	2.15%	2.04%
Impairment provision	7.7	5.6
Impairment as a percentage of average loan balance	0.07%	0.06%

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

31. COST:INCOME RATIO

Cost:income ratio is derived as follows:

	2016 £m	2015 £m
Cost – operating expenses	92.5	71.2
Total operating income	244.0	211.5
Cost / Income	37.9%	33.7%

Underlying cost:income ratio excluding the impact of acquisition costs is derived as follows:

	2016 £m	2015 £m
Cost – operating expenses	92.5	71.2
Acquisition related costs	(2.7)	-
	89.8	71.2
Total operating income	244.0	211.5
Acquisition related charges in income	0.4	-
	244.4	211.5
Cost / Income	36.7%	33.7%

Cost:income ratio excluding the impact of the acquired business is derived as follows:

	Note	2016 £m	2015 £m
Cost – operating expenses		92.5	71.2
Operating expenses of PBAF		(18.2)	-
		74.3	71.2
Total operating income		244.0	211.5
Operating income of PBAF		(24.9)	-
		219.1	211.5
Cost / Income		33.9%	33.7%

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

32. UNDERLYING PROFIT

Underlying profit is determined by excluding from the operating result one off costs relating to the acquisitions in the period, and fair value accounting adjustments arising from the Group's hedging arrangements.

	Note	2016 £m	2015 £m
Paragon Mortgages			
Profit before tax for the period	8	89.5	93.6
Less: Acquisition related costs		-	-
Less: Fair value (losses) / gains		0.4	0.4
		<u>89.9</u>	<u>94.0</u>
Idem Capital			
Profit before tax for the period	8	45.4	49.3
Less: Acquisition related costs		-	-
Less: Fair value (losses) / gains		-	-
		<u>45.4</u>	<u>49.3</u>
Paragon Bank			
Profit / (loss) before tax for the period	8	8.3	(8.7)
Less: Acquisition related costs		3.1	-
Less: Fair value (losses) / gains		0.2	0.1
		<u>11.6</u>	<u>(8.6)</u>
Total			
Profit before tax for the period	8	143.2	134.2
Less: Acquisition related costs		3.1	-
Less: Fair value (losses) / gains		0.6	0.5
		<u>146.9</u>	<u>134.7</u>

NOTES TO THE FINANCIAL INFORMATION
For the year ended 30 September 2016

33. UNDERLYING RETURN ON TANGIBLE EQUITY (EXCLUDING ACQUISITION COSTS)

The underlying RoTE excluding acquisition costs is calculated as follows:

	Note	2016 £m	2015 £m
Profit for the year		116.0	107.1
Amortisation of intangible assets		1.6	1.4
		<u>117.6</u>	<u>108.5</u>
Acquisition costs		3.1	-
Tax on allowable costs at effective rate		(0.2)	-
		<u>120.5</u>	<u>108.5</u>
Average tangible equity	3	<u>913.0</u>	<u>950.5</u>
Underlying Return on Tangible Equity excluding acquisition costs		<u>13.2%</u>	<u>11.4%</u>

34. NET ASSET VALUE

	Note	2016 £m	2015 £m
Total equity (£m)		<u>969.5</u>	<u>969.5</u>
Outstanding issued shares (m)	18	295.8	309.3
Treasury shares (m)		(15.3)	(12.4)
Shares held by ESOP schemes (m)		(3.6)	(1.6)
		<u>276.9</u>	<u>295.3</u>
Net asset value per £1 ordinary share		<u>£3.50</u>	<u>£3.28</u>
Tangible equity (£m)	3	<u>864.1</u>	<u>961.8</u>
Tangible net asset value per £1 ordinary share		<u>£3.12</u>	<u>£3.26</u>

**STATEMENT OF DIRECTORS' RESPONSIBILITIES
in relation to financial statements**

The responsibility statement below has been prepared in connection with the full annual accounts of the Company for the year ended 30 September 2016. Certain parts of these accounts are not presented within this announcement.

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations. The directors are required to prepare accounts for the Group in accordance with International Financial Reporting Standards ('IFRS') and have also elected to prepare company financial statements in accordance with IFRS. In respect of the financial statements for the year ended 30 September 2016, company law requires the directors to prepare such financial statements in accordance with International Financial Reporting Standards, the Companies Act 2006 and Article 4 of the IAS Regulation.

International Accounting Standard 1 – 'Presentation of Financial Statements' requires that financial statements present fairly for each financial year the Company's financial position, financial performance and cash flows. This requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the International Accounting Standards Board's 'Framework for the Preparation and Presentation of Financial Statements'. In virtually all circumstances, a fair presentation will be achieved by compliance with all applicable International Financial Reporting Standards. Directors are also required to:

- properly select and apply accounting policies;
- make an assessment of the ability of the Group's and the Company's ability to continue as a going concern;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information; and
- provide additional disclosures when compliance with the specific requirements in International Financial Reporting Standards is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and Company and the Group's profit or loss for the year

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company, for safeguarding the assets, for taking reasonable steps for the prevention and detection of fraud and other irregularities and for the preparation of a strategic report, directors' report, directors' remuneration report and corporate governance statement which comply with the applicable requirements of the Companies Act 2006.

The directors are responsible for the maintenance and integrity of the Company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements differs from legislation in other jurisdictions.

**STATEMENT OF DIRECTORS' RESPONSIBILITIES
in relation to financial statements**

The directors confirm that, to the best of their knowledge:

- the financial statements, prepared in accordance with International Financial Reporting Standards as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and of the Group taken as a whole;
- the Directors' Report, including those other sections of the Annual Report incorporated by reference, comprises a management report for the purposes of the Disclosure and Transparency Rules, which includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face; and
- the Annual Report, taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's performance, business model and strategy.

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

PANDORA SHARP

Company Secretary
23 November 2016

Board of Directors

R G Dench
N S Terrington
R J Woodman

J A Heron
A K Fletcher
P J N Hartill

F J Clutterbuck
H R Tudor

PRINCIPAL RISKS AND UNCERTAINTIES

The principal risks to which the Group is exposed and which could impact significantly on its ability to conduct its business successfully are summarised below.

Category	Risk	Description
Business	Economic	A downturn in the UK's economic performance in light of the 'Brexit' referendum decision to leave the European Union could impact demand for loans, customers' ability to re-pay outstanding balances and security values
	Concentration	The Group's business plans could be particularly affected by any downturn in the performance of the UK private rented sector and / or further regulatory intervention to control buy-to-let lending.
	Transition	Failure to integrate acquired businesses safely and effectively could adversely affect the Group's business plans and damage its reputation
Credit	Customer	Failure to target and underwrite lending effectively could result in customers becoming less able to service debt, exposing the Group to credit losses
	Counterparty	Failure of an institution holding the Group's cash deposits or providing hedging facilities for risk mitigation could expose the Group to loss or liquidity issues
Conduct	Fair outcomes	Failure to deliver appropriate customer outcomes could impact on the Group's reputation and its financial performance
Operational	People	Failure to attract or retain appropriately skilled key employees at all levels could impact upon the Group's ability to deliver its business plans
	Systems	The inability of the Group's systems to support its business operations effectively and/or guard against cyber security risks could result in reputational and financial losses.
	Regulation	Given the highly regulated sectors in which the Group operates, compliance failures or failures to respond effectively to new and emerging regulatory developments could result in reputational damage and financial loss
Liquidity and Capital	Funding	Increased volatility in wholesale markets could reduce the Group's funding and liquidity options, restricting its ability to lend.
	Capital	Proposals by the BCBS to change to the capital requirements for lending secured on residential property could have adverse financial implications for the Group
Market	Interest rates	Reduction in margins between market lending and borrowing rates or mismatches in the Group balance sheet could impact profits
Pension Obligation	Pensions	The obligation to support the Group's defined benefit pensions plan might deplete resources

The Group has considered and responded to all of these risks, undertaking mitigating actions where required to ensure that exposures are maintained within risk appetite as far as is practicable.