Paragon Banking Group PLC

2018 Half-Year Financial Report

paragon

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OUTLOOK

The Group is in the middle of a major restructuring and transitioning of its business model from a wholesale funded buy-to-let lender to a more broadly-based bank. Paragon Bank, which effectively subsumed the Group from the beginning of this financial year, has laid the foundations for its future growth and diversification plans. This is already evident in the progress seen in the first six months of the year. New lending has increased by 29% with all originating divisions making strong progress. Furthermore, the various pipelines across the Group suggest that lending for the year as a whole will continue to remain strong.

The Group's most established and mature product line, buy-to-let mortgage lending, has benefitted from an increased focus towards professional landlords. Over 86% of the pipeline, materially up on last year, is dedicated to those more complex customers where our bespoke approach and service proposition gives us a genuine competitive advantage.

The acquisition of portfolios and full businesses has been a core element of the Group's strategy. Idem Capital has continued to apply strict disciplines on pricing and risk in a market that has become increasingly competitive. However, further progress has been achieved in broadening the product range. The recent acquisition of Iceberg, a leading professional services financier, was supported by strong organic growth in the wider Commercial Lending division, which in aggregate delivered a 49% increase in originations.

The funding diversification strategy was clearly evident in the period. Deposit balances increased to £4.3bn, representing 64% of all post 2010 funding. The Group accessed nearly £1bn of TFS debt and, shortly after the half year ended, completed its latest securitisation at record low pricing.

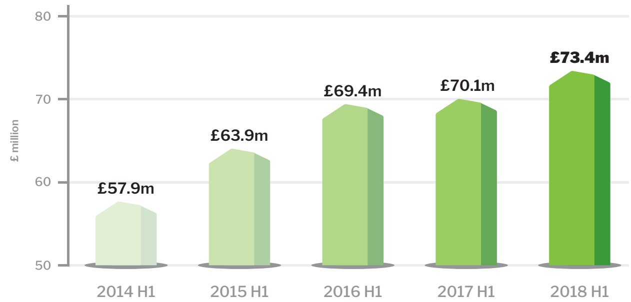
The strategic development of the Group across recent years has been significant. The combination of strong organic growth, enhanced by carefully identified and executed acquisitions, is helping to support an increasingly broad range of customers in specialist lending markets. A number of the newer product lines are still in their infancy and, with increased operational leverage, there is significant potential to build on their early successes.

> “ The success of our changing business model has enabled the Group to support an increasing number of customers, whether they be landlords, small businesses or consumers. We are helping to support individual investment and retirement plans, create jobs in the real economy and even build homes across the country. Our deposit products are providing market leading rates to customers starved of income in a low interest environment. We are building a leading specialist retail bank to deliver outstanding products and services to our customers with strong and sustainable returns to our shareholders. The Group has delivered much in recent years on this journey but considerable opportunities exist to build on this progress for the future. ”
>
> Nigel Terrington, Chief Executive

FINANCIAL HIGHLIGHTS

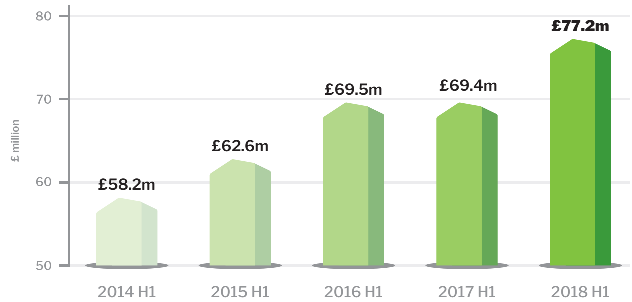
UNDERLYING PROFIT BEFORE TAX
£73.4 million

4.7% higher (2017 H1: £70.1 million)



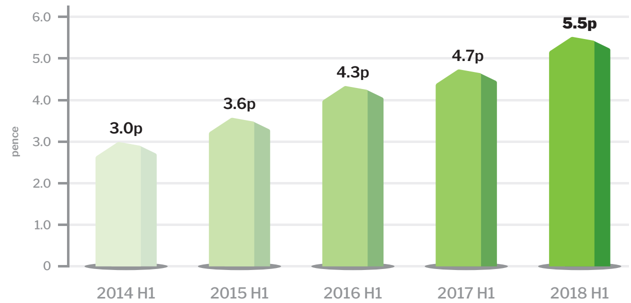
PROFIT BEFORE TAX
£77.2 million

11.2% higher (2017 H1: £69.4 million)



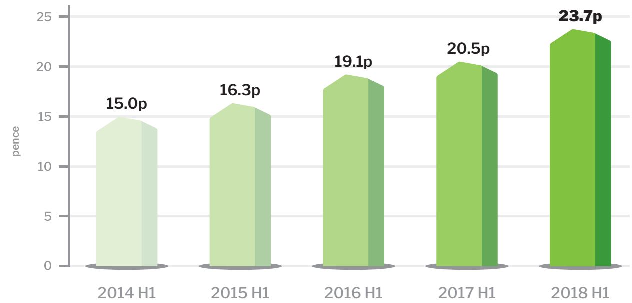
DIVIDEND PER SHARE
5.5 pence

17.0% higher (2017 H1: 4.7 pence)



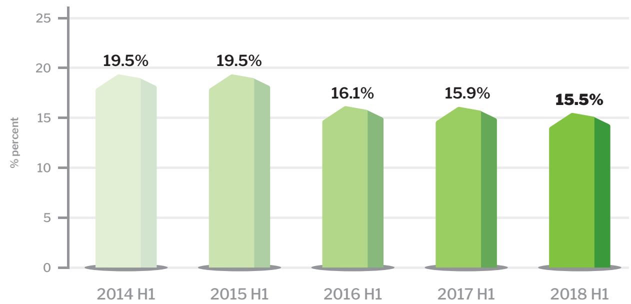
BASIC EARNINGS PER SHARE
23.7 pence

15.6% higher (2017 H1: 20.5 pence)



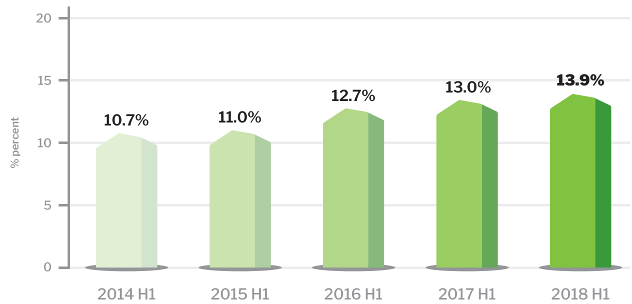
CAPITAL - CET 1 ratio
15.5%

Remains strong (2017 H1: 15.9%)



RETURN ON TANGIBLE EQUITY
13.9%

(2017 H1: 13.0%)



INTERIM MANAGEMENT REPORT

1. STRATEGY REVIEW

Over the last six months the Group has continued its development into an increasingly diversified banking group, building on the restructuring announced in September 2017. The restructure will deliver significant liquidity benefits, together with a notable reduction in the need to issue debt over the medium term. This reduces the Group's funding costs over time as it increasingly accesses the retail deposit market to support its lending activities.

Overall, the Group's core strategy has remained unchanged in the period. It is a leading UK specialist lender, supporting the needs of consumers, property investors and SMEs. It is seeking to develop its presence further in these broad markets by increasing product diversification whilst utilising its highly effective centralised processes, systems and technology. Organic growth has been strong, and is expected to continue into the future. This has been supplemented by carefully selected and excecuted M&A activity, where appropriate. The Group has an outstanding through-the-cycle track record in challenging markets with excellent risk metrics, reflective of the cautious and prudent approach it takes to its risk appetite alongside its highly efficient operating model.

The Group has made good progress in delivering improved profits and strong organic new business generation. Underlying profit before tax (Appendix B) rose by 4.7% to £73.4 million compared to the same period last year (2017 H1: £70.1 million) having absorbed the start-up costs of new lending lines and significant investment in systems and processes to address business and regulatory developments. On the same basis, which excludes the impact of fair value items, basic earnings per share ('EPS') increased by 8.7% to 22.5 pence (2017 H1: 20.7 pence) (Appendix B) and return on tangible equity ('RoTE') improved to 13.3% (2017 H1: 13.2%) (Appendix B).

On the statutory basis, profit before tax increased by 11.2% to £77.2 million (2017 H1: £69.4 million). Basic EPS increased by 15.6% to 23.7 pence (2017 H1: 20.5 pence) (note 13) and RoTE improved to 13.9% (2017 H1: 13.0%) (note 4).

Lending

The year has seen continued strong growth levels in organic business generation with new advances rising by 28.9% to £990.3 million compared to £768.4 million in the first half of last year. The increased level of advances contributed to net loan growth of 2.0% to £11,346.7 million over the last six months (30 September 2017: £11,124.1 million).

The Group's most established business remains its buy-to-let franchise. The UK private rented sector continues to see strong levels of demand from tenants which is expected to continue for the foreseeable future. The buy-to-let market has experienced a long period of disruption following a series of fiscal and regulatory changes aimed at both landlords and lenders. However, no new changes have been introduced in the period and some stability is slowly returning to the market, albeit with new house purchase funding activity lower than that seen in previous years.

Against this backdrop the Group's performance has been strong, with its twenty-year experience of servicing the complex needs of professional landlords differentiating it from other lenders and allowing it to make market share gains against the same period in 2017. New buy-to-let lending increased by 20.6% from the level in the first six months of the previous year, to £670.5 million in the six months to 31 March 2018 (2017 H1: £556.2 million), with the Group's share of this market, as measured by the figures reported by UK Finance ('UKF'), increasing to 3.7% (2017 H1: 3.1%).

From 1 October 2017 the most recent regulatory changes in the buy-to-let market required lenders to collect and analyse more information about the landlord's property portfolio and wider business than had previously been common in the market. The Group's initial analysis of the impact of these changes is that some lenders are restricting their buy-to-let activity as a result of the increased demands of a complex underwriting process. The Group's expertise in this particular market segment positions it well to benefit from these changes and further increase its market share.

The Group's other mortgage product lines comprise second charge mortgages, where new origination levels were broadly stable at £27.9 million in the period (2017 H1: £31.1 million) and specialist residential lending, which remains in its pilot phase with limited distribution. New specialist residential volumes totalled £22.6 million during the period (2017 H1: £0.4 million).

Further asset and income diversification is being delivered by the Group's Commercial Lending division. The principal activity of the division is asset finance and strong progress has been made both organically and with the acquisition of Iceberg in the period. The Group's asset finance operations are strategically broadening their offerings to service a wider mid-market range of SME customers, and this is helping to drive increased volumes which will enhance returns in the medium term.

Asset finance advances for the six months increased by 53.7% compared to the same period in 2017, to £163.8 million (2017 H1: £106.6 million). Customer credit profiles are generally stronger in this larger sector, with yields commensurately lower. The Group's motor finance business also saw strong growth in the period. Operating in the hire and lease purchase segments of the market (with no exposure to personal contract purchase products), new business origination grew by 38.9% to £70.4 million during the period (2017 H1: £50.7 million), its specialist focus shielding it, to some extent, from the pressures in the market more generally.

The division's development finance operation, providing funding to small-scale property developers, saw significant progress in the period, both in terms of operations and performance, with new drawings totalling £35.1 million in the period (2017 H1: £23.4 million). This market offers attractive opportunities and the offering is now being expanded to cover more parts of the UK.

The acquired Iceberg business (note 5), providing short term funding to solicitors and their clients, was purchased for £18.6 million in December 2017. It performed well in the period since acquisition, with new loans of £42.4 million and £32.9 million of loan assets at the period end (at acquisition: £2.0 million).

Following the period end, the Group made the first advances under its structured lending offering, which provides funding solutions to non-bank financial institutions. Further deals are expected to complete through the course of the second half year.

The Group's portfolio purchase division, Idem Capital, is an established purchaser of secured and unsecured portfolios. While it participated in a number of significant sale processes in the period, the yields on offer were insufficiently attractive to meet the Group's requirements and as a result no deals were completed. Idem Capital has retained its credit and pricing discipline and will continue to do so going forward.

Funding

The Group's funding has become increasingly diversified over the last four years. Retail deposits now represent the Group's primary source of funding for new lending, with its historical securitisation approach taking a more tactical role as and when conditions in that market are attractive.

In the six months ended 31 March 2018 retail savings balances had increased by 18.5% to £4,285.8 million from £3,615.4 million at 30 September 2017.

After the end of the period the Group launched its first securitisation since late 2015. Paragon Mortgages (No. 25) PLC raised £435.3 million of new non-recourse external funding, in what was not only the largest transaction undertaken by the Group in ten years but which also achieved the cheapest funding rate and longest expected term. Additional notes were retained by the Group which can be used to access central bank funding if required, further enhancing the Group's financial flexibility.

Term Funding Scheme ('TFS') drawings had reached £944.4 million by the time the scheme closed for new drawings in February 2018 (30 September 2017: £700.0 million). The Group also accessed other Bank of England facilities in the period.

Capital

The Group's core equity tier 1 ratio ('CET1') at 31 March 2018, calculated using the Standardised Approach to credit risk ('SA'), was marginally lower at 15.5% (30 September 2017: 15.9%), as a result of balance sheet growth and higher distributions to shareholders through share buy-backs and enhanced dividend levels. The Group's total capital ratio was 18.2% at 31 March 2018 (30 September 2017: 18.7%). Free cash resources totalled £141.2 million at the end of the period (30 September 2017: £305.5 million).

Enhancing shareholder returns on a sustainable basis is a key objective for the Group and basic earnings per share for the half year was 15.6% higher than a year earlier (8.7% on the underlying basis). In November 2017 the Group announced its intention to also adopt a formulaic approach to its interim dividend levels, with the interim dividend per share for any given year being one half of the final dividend declared in the preceding period in normal circumstances. After consideration of all relevant factors an interim dividend of 5.5 pence per share is being declared in line with that policy.

The Group's share buy-back programme has progressed well, with half of the £50.0 million of buy-backs announced in November 2017 having been completed. The total amount invested to date is £190.0 million and the cumulative target remains at up to £215.0 million.

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 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:

2. Lending review	3. Funding review	4. Financial review	5. Operational review
Lending, performance and markets	Retail deposits, wholesale funding and capital management	Results for the period, assets and liabilities	Governance, people, risk and regulation

2. LENDING REVIEW

The Group's operations are organised into three divisions, based on product types and origination and servicing capabilities. This review is based on the organisational structure adopted in September 2017 and amounts from the March 2017 half year report, previously disclosed on the basis of the Group's former operational structure, have been reanalysed on the basis of the new segments.

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

	Advances and investments in the period			**Investments in loans at the period end**		
	Six months ended 31 March 2018	Six months ended 31 March 2017	Year ended 30 September 2017	**31 March 2018**	31 March 2017	30 September 2017
	£m	£m	£m	**£m**	£m	£m
Mortgages	**721.0**	587.7	1,464.5	**10,119.5**	9,795.3	9,953.9
Commercial Lending	**269.3**	180.7	388.9	**680.1**	468.9	558.8
Idem Capital	**-**	95.4	98.0	**547.1**	676.0	611.4
	990.3	863.8	1,951.4	**11,346.7**	10,940.2	11,124.1

2.1 MORTGAGES

The Group's Mortgages division offers buy-to-let first charge and owner-occupied first and second charge mortgages on residential property in the UK. In all its offerings, it targets niche markets where its focus on detailed case-by-case underwriting and its robust and informed approach to property risk differentiate it from mass market lenders.

As part of the Group restructuring in September 2017 all lending on residential property was brought into this division, creating efficiencies and enhancing the service delivered to our customers and intermediaries.

Housing and mortgage market

The UK mortgage market remains finely balanced and activity remains subdued. New mortgage approvals, reported by the Bank of England, in the six months to 31 March 2018, at £118.6 billion were broadly similar to the comparable period in the previous year, (six months ended 31 March 2017: £118.5 billion).

House prices, on the other hand, have seen historically low levels of growth, with the Nationwide House Price Index reporting modest annual growth of only 2.1%, with London seeing a decline in prices.

This mixed picture results from the interaction of opposing economic forces, with the effects of low interest rates, government intervention to support home ownership, high employment and improving wage levels being offset by regulatory moves to tighten credit conditions, squeezed household incomes, pessimism about the impact of potential interest rate increases and economic uncertainty more broadly.

Across the whole of the mortgage industry, the low interest rate environment has led to benign conditions for some time, with low arrears and a negligible level of forced sales. Overall the economic environment for the mortgage market currently appears both positive and sustainable.

The downside risks centre on the impact of any potential economic downturn, whether as a result of the Brexit process or otherwise. The Group seeks to mitigate its exposure to such conditions through a robust approach to property valuation, employing an experienced in-house property team who undertake around two thirds of valuations and conduct validation work on 100% of valuations by third party surveyors.

Buy-to-let mortgage market

The six months ended 31 March 2018 have seen the buy-to-let mortgage market continuing to reshape following a period of sustained regulatory intervention. Following changes to tax and stamp duty affecting landlords, the Prudential Regulation Authority ('PRA') introduced new rules on the conduct of buy-to-let underwriting, which came into force partly in the 2017 financial year and partly at the start of the current period.

The regulatory changes were implemented in two phases:

- From 1 January 2017 the PRA imposed common standards for affordability testing in the buy-to-let sector, similar, in principle, to the approach adopted by the FCA for owner-occupied lending under the Mortgage Conduct of Business ('MCOB') rules. Most lenders, including the Group, were able to adopt these changes without serious disruption
- From 1 October 2017, lenders were required to underwrite portfolio buy-to-let cases on a much more specialised basis, differentiating between portfolio and non-portfolio landlords, based on the number of properties owned with buy-to-let finance. This caused little disruption to the Group's business model as the PRA approach was well aligned with that already adopted and the required specific changes had been put in place in July 2017. The market in general was slow to reflect these changes in published criteria, leading to some disruption around the implementation date, due to lack of clarity as to lenders' requirements

Overall, following these changes, activity levels in the buy-to-let market began to strengthen in the period. UKF reported that completions in the six months ended 31 March 2018 were £18.3 billion, compared to £17.9 billion in the same period in 2017, following a fall in activity in the second half of 2017. However, new lending for buy-to-let property purchases saw a decrease, from £5.3 billion to £4.9 billion. Remortgaging levels grew, but with a material increase in the take-up of longer term fixed rate loans, the potential capacity for remortgage activity will reduce in the longer term.

Activity in the market in the period has served to support the Group's analysis of the likely impact of the regulatory changes, with clear evidence of a polarisation of the landlord population between portfolio landlords and those with single properties. The proportion of portfolio landlords operating through corporate structures has also continued to increase.

These changes have increased the level of cost input required to underwrite a buy-to-let mortgage for many lenders, though not significantly for the Group, which makes the Group's operation more competitive.

In response to this, the positions of the lenders active in the market have also become more clearly defined, with some major lenders, including some of the largest, not offering a portfolio landlord proposition, some addressing portfolio landlords only in a limited way and a smaller group of specialised lenders, including the Group, offering a full range of products. This has been driven by the availability of experienced resource, system and process capability, together with lenders' varying risk appetites.

Overall the Group considers these changes to be positive, with a more sharply focussed class of buy-to-let landlords emerging. These should be motivated to provide a better service to tenants and their funding requirements are a good match for the products offered by the Group, providing an opportunity for the Group to grow its market share, albeit in a potentially smaller market.

Lending activity

The new lending activity in the division during the year is set out below:

	Six months ended 31 March 2018	Six months ended 31 March 2017	Year ended 30 September 2017
	£m	£m	£m
First charge buy-to-let	**670.5**	556.2	1,399.9
First charge owner-occupied	**22.6**	0.4	3.9
Second charge	**27.9**	31.1	60.7
	721.0	587.7	1,464.5

Total mortgage lending in the Group increased by 22.7% in the six months ended 31 March 2018, compared to the same period in the previous year. The majority of this increase arose from the division's core buy-to-let products, but the recently developed residential mortgage proposition also began to contribute.

The Group's buy-to-let lending increased by 20.6% year-on-year, despite the disruption in the market described above and the consequent pressure on volumes. The pipeline of buy-to-let loans in process at the period end was £787.6 million, an increase of 30.4% on the position six months earlier (30 September 2017: £604.2 million, 31 March 2017: £742.3 million).

The changes in the way in which buy-to-let landlords are addressing the market, driven by the recent regulatory changes, can be seen in the analysis of the Group's new buy-to-let lending by customer type, compared to six months earlier. In the table below, complex customers are those with large portfolios or specialist properties and corporate customers are those operating through limited companies.

	31 March 2018	**31 March 2018**	31 March 2017	31 March 2017
	£m	**%**	£m	%
Buy-to-let advances				
Corporate customers	**248.0**	**37.0%**	91.6	16.5%
Other complex customers	**233.4**	**34.8%**	244.2	43.9%
Total corporate and complex	**481.4**	**71.8%**	335.8	60.4%
Non-complex customers	**189.1**	**28.2%**	220.4	39.6%
	670.5	**100.0%**	556.2	100.0%

These advances showed a marked move towards the concentration of buy-to-let activity among more professional investors, many operating through corporate structures. This trend is set to continue in the second half of the year, with 86.3% of pipeline cases being either corporate or complex (31 March 2017: 66.2%).

The Group has also seen a significant increase in customer preference for new buy-to-let mortgage loans which have an initial fixed rate period of five years, rather than the shorter terms typically chosen previously. At 72.2%, the proportion of the Group's new buy-to-let loans in the period which were five year fixes had more than doubled since the same period last year (2017 H1: 35.6%). This reflects the trend in the wider buy-to-let market, where UKF reported that five year fixes represented 46% of new accounts in the six months ended 31 March 2018 (2017 H1: 22%), a trend also evident, to a lesser extent in the wider mortgage market. This should increase the stability of the Group's balance sheet, reducing customers' likelihood of redemption.

The Group continued to develop its pilot offering in specialist sectors of the owner-occupied mortgage market during the period. This is intended to address the needs of customers who are less well-served by mainstream lenders and who might benefit from a more bespoke approach to underwriting, including customers with irregular incomes, more complex employment patterns or those who might wish to borrow into retirement.

The Group's approach to these cases involves a much more broadly-based assessment of the proposition, speaking directly to customers and their financial advisers to understand the case in the round. The costs of such underwriting are higher than for commodity products and therefore the careful management of margins on this lending is a priority.

The initial phase of the project proved the validity of the approach in broad terms and during the period the offering was expanded to a wider network of selected specialist intermediaries, while development of internal systems and processes also took place. Further increases in capacity will be phased in over the second half of the year, with the business not expected to reach its full capability until after the end of the current financial year.

The Group's second charge mortgage lending remained stable compared to the same period in 2017, in line with its risk appetite. The second charge mortgage market as a whole is currently stable with total lending of £482 million in the six months ended 31 March 2018 reported by the Finance and Leasing Association ('FLA') (six months ended 31 March 2017: £469 million, year ended 30 September 2017: £1,003 million), and a significant part of this total does not fall within the risk profile required by the Group.

For its new second charge mortgage lending, the Group addresses the population of customers seeking to access equity in their property while protecting an existing beneficial first mortgage rate, in addition to those seeking to refinance consumer debt and adopts a cautious approach to credit quality in this area.

Performance

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

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Post 2010 assets			
First charge buy-to-let	**3,982.0**	3,306.4	3,661.1
First charge owner-occupied	**26.6**	0.4	3.9
Second charge	**113.8**	78.1	98.4
	4,122.4	3,384.9	3,763.4
Legacy assets			
First charge buy-to-let	**5,984.7**	6,393.6	6,175.4
First charge owner-occupied	**12.4**	16.8	15.1
	10,119.5	9,795.3	9,953.9

At 31 March 2018 the balance on the Group's mortgage portfolio was 3.3% higher than a year earlier.

The annualised redemption rate on post 2010 buy-to-let mortgage assets was 18.2% in the six months to 31 March 2018. The rate for the full year in 2017 was 22.7%, peaking in the second half of the year ahead of the implementation of the regulatory changes on 1 October 2017. The annualised redemption rate on pre-2010 legacy assets, at 5.7%, has marginally reduced from the 6.0% seen in the year ended 30 September 2017 (2017 H1: 6.2%).

Greater numbers of the Group's customers have opted to re-fix their loans during the period, both on products which reached the end of their initial fixed rates and also on those already on reversionary rates. While the Group earns a smaller margin on these switch products, the customers should then stay with the Group for a longer period on their new fixed rates, offsetting the reduction in margin over the medium term.

Average yields on the major product lines (Appendix E) are set out below.

	Average yield			**Average balance**		
	31 March 2018	31 March 2017	30 September 2017	**31 March 2018**	31 March 2017	30 September 2017
	%	%	%	**£m**	£m	£m
Post 2010 buy-to-let	**4.08%**	4.42%	4.29%	**3,815.6**	3,121.0	3,326.8
Second charge	**4.48%**	4.60%	4.57%	**105.8**	65.2	76.7
Legacy assets	**2.12%**	2.00%	2.00%	**6,079.7**	6,503.1	6,386.3

Strong growth in fixed rate lending in the portfolio, driven in part by existing customers wishing to re-fix their rates has led to some tightening of yields while generating the compensating benefit in reduced redemption rates described above. Market pricing has remained broadly stable on new loans and overall yields in this division remain broadly in line with expectations and at sustainable levels.

Arrears on the buy-to-let book have remained stable in the year at 0.09% (30 September 2017: 0.08%, 31 March 2017: 0.09%), with arrears on post-2010 lending standing at 0.01% (30 September 2017: 0.02%). These arrears remain very low compared to performance in the national buy-to-let market, with UKF reporting arrears of 0.42% across the sector at 31 March 2018 (31 March 2017: 0.47%, 30 September 2017: 0.45%). This exemplary performance reflects the Group's focus in underwriting on the credit quality and financial capability of its customers, underpinned by a detailed and thorough assessment of the value and suitability of the property as security.

Second charge mortgage arrears returned to zero from 0.06% at 30 September 2017 (31 March 2017: zero), with performance remaining strong despite the book's increased seasoning.

The Group's receiver of rent process for buy-to-let assets helps to reduce the level of bad debt by giving direct access to the rental flows from the underlying properties. At the period end 792 properties were managed by a receiver on the customer's behalf, a reduction of 3.5% over the six months (30 September 2017: 821 properties, 31 March 2017: 873 properties) as cases on the old book resolve and post-2010 cases perform well.

Outlook

Looking forward, the Group's mortgage business is strongly positioned as a specialist participant in a market restructuring itself following fiscal and regulatory change. Its focus on specific customer requirements is key to growing volumes and enhancing earnings.

The business is well placed to withstand potential instability in the UK economy, with its strong credit standards and robust assessment of security condition and value affording it a high degree of protection. Average loan-to-value ratios on new buy-to-let lending remain at around 70% with stressed affordability levels in line with or above the PRA requirements. Continued strong rental demand and good affordability suggests the Group's customers will be resilient in the face of anticipated rate rises. Exposure on owner-occupied lending is low, and the risk position on second charge lending has been carefully managed.

The Group continues to explore new opportunities in the wider mortgage market and believes the division is well placed to deploy its core skills of bespoke assessment of credit risk, good customer service, expert understanding of property valuation and modern systems and processes, across a variety of niche markets in the residential mortgage field, as well as in its existing core buy-to-let specialism.

As the mortgage business moves into the second half of the financial year, its strong performance, increased pipeline and attractive products leave it well placed to meet management expectations and the previously stated target of total lending in excess of £1.6 billion anticipated for the full year.

2.2 COMMERCIAL LENDING

Building on the asset finance operation acquired in 2015, the Group's Commercial Lending division brings together a number of streams of mostly asset-backed lending to, or through, commercial organisations. The principal customer focus of the division is on lending to SME and mid-sized corporate customers, which is an important differentiator from the rest of the Group's business. The business has seen growth in all areas in the period.

While asset and motor finance form the largest parts of the division's operations and finance leasing is its principal product, offerings are tailored to respond to specific needs identified in the marketplace.

The commercial lending market place includes a wide variety of lenders of differing scopes and sizes, and the period has seen entities undergoing ownership changes or revisions to their business models, while there has been pressure on pricing generally.

The asset finance market in the UK remains very large with the FLA reporting £75.2 billion of outstanding balances at 31 March 2018 (30 September 2017: £74.7 billion) and £15.5 billion of advances in the half year (year ended 30 September 2017: £31.3 billion). It addresses customers in a wide variety of industries and provides funding for many different asset types. However, the largest part of this funding is provided by commodity lenders who focus on offering volume propositions. The Group targets niches within this market, less served by larger lenders, where its particular skill sets can be best applied.

Examples of such niches are the financing of waste collection vehicles for local authorities, construction equipment and complex veterinary equipment. Outside the leasing market, the division also has niche offerings including invoice factoring, development finance and structured finance lending.

Access to customers is generally through specialist brokers, including the Group's in-house brokers, or equipment suppliers, and the markets in which the division operates tend to be fragmentary, with different brokers focussed on different asset types.

The common themes of these diverse business lines are a lending approach based on understanding, and engaging with, the customer alongside the valuation of any security, together with expertise in collections and security realisation. In common with the rest of the Group, the division's focus is on the maintenance of strong credit standards and it does not pursue business volumes at the expense of margins. The division relies heavily on specialist teams to address its separate product lines, either sourced externally or developed internally.

Acquisition of Iceberg

During December 2017 the Group acquired the assets and business of Iceberg, a specialist broker and lender, which had operated through two limited liability partnerships (note 5). Iceberg focuses principally on short-term unsecured business funding for professionals such as solicitors and accountants and, through solicitors, in lending to parties in inheritance and matrimonial proceedings based upon the strength of their prospects. The consideration paid was £6.8 million in cash, with deferred consideration of up to £13.0 million payable, dependent upon performance.

The combination of the market intelligence and contacts in the Iceberg business with the Group's funding capabilities is expected to create additional value in the asset finance business over time, adding a new specialist product set and increasing lending volumes.

At acquisition Iceberg was passing on the majority of its originations for funding by other lenders. Access to Group funding will enable the value of the Iceberg loan portfolio to grow over time with a consequent increase in revenues and contribution.

Loan balances of £2.0 million were acquired with the business and, by 31 March 2018 there were £32.9 million of Iceberg generated assets on the Group's balance sheet. Advances in the three months since acquisition were £42.4 million.

The process of integrating the Iceberg operations with those of the Group continues. Progress in the first three months has been good and the prospects for future benefits from the acquisition are encouraging.

Lending activity

The new lending activity in the segment during the period is set out below.

	Six months ended 31 March 2018	Six months ended 31 March 2017	Year ended 30 September 2017
	£m	£m	£m
Asset finance – ongoing operations	**121.4**	106.6	220.0
Asset finance – acquired Iceberg operation	**42.4**	-	-
Asset finance - total	**163.8**	106.6	220.0
Motor finance	**70.4**	50.7	120.0
Development finance	**35.1**	23.4	48.9
	269.3	180.7	388.9

The asset finance business has seen a 53.7% growth in new advances compared to the corresponding period in 2017. This demonstrates the impact of the changes made following acquisition and the contribution from Iceberg. Organic growth was 13.9%.

Asset finance advances include the Group's first aviation loans, and although the operation is still in its earliest stages, the quality of customers is good.

This growth has taken place against a backdrop of aggressive competition in the market and continuing economic nervousness in UK industry, leading to some reluctance by SMEs to take on new finance commitments.

The asset finance business also made a significant investment in assets for hire under operating leases, both term and spot, acquiring £9.0 million of assets to generate future income (year ended 30 September 2017: £12.9 million).

The motor finance business continues its development phase with a 38.9% increase in new lending, compared to the first six months of the previous period, as its distribution network expands. This rate of growth is expected to moderate as the business becomes more mature. The business is carefully directed to address specialist propositions in the motor finance market where distinctive products can generate appealing returns. This includes funding less mainstream vehicle types, such as light commercial vehicles and motorhomes.

The Group's development finance business provides funding for small-scale property developments with an average facility size of around £2.0 million, a significantly underserved market. It was launched at the end of the 2016 financial year on a pilot basis and moved to a regional launch in London and the South East, during 2017. In the six month period ended 31 March 2018 it has seen advances grow 50.0% over those in the first six months of the 2017 financial year, and expanded into new areas of the country, including the Midlands and Yorkshire. Undrawn facilities and committed pipeline at 31 March 2018 of £109.6 million should ensure a positive start to the second half of the year.

Following the end of the period, the first of the Group's structured lending facilities, with Liberis, the business cash flow lender, went live. The structured lending team was established to provide senior debt to the UK non-bank lending market and deploys loans to help support 'best-in-class' businesses working across consumer and commercial lending. The Group will work alongside clients to help fund their growth. Transactions are secured on underlying assets and structured using established robust methodologies. The business addresses certain segments where the Group may be under-weight or has no exposure at all and where working with a recognised industry expert is preferable to organic expansion.

Performance

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

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Asset finance	**361.8**	289.0	325.0
Motor finance	**195.4**	124.0	163.0
Development finance	**57.0**	31.2	42.3
Invoice factoring	**15.3**	11.5	14.8
Unsecured business lending	**46.5**	10.3	11.0
Other loans	**4.1**	2.9	2.7
	680.1	468.9	558.8

The motor finance business continued to mature in the year, with its distribution networks expanding and internal systems and process developments supporting its growth. The Group focusses on the specialist part of the market, rather than commodity lending, and has no exposure to the personal contract purchase and similar product types which have caused concern to commentators and regulators over recent months.

The development finance business has seen an increasing number of cases complete their life cycles and repay their facilities, affirming the viability of the proposition. Credit quality has been good, and the overall performance of the projects has been in line with expectations. This experience confirms the Group's original analysis of the potential for both demand and attractive returns in this business sector, with the products addressing a real need in the UK economy for such projects to be facilitated.

Unsecured business lending includes Iceberg assets, similar assets generated in the ongoing business, receivables financing and other unsecured lending to business.

Across all business lines growth has been carefully controlled with credit quality and margins prioritised over expansion.

Average yields on the major product lines (Appendix E) are set out below.

	Average yield			**Average balance**		
	31 March 2018	31 March 2017	30 September 2017	**31 March 2018**	31 March 2017	30 September 2017
	%	%	%	**£m**	£m	£m
Asset finance	**6.66%**	8.76%	8.11%	**385.3**	292.0	311.1
Motor finance	**4.99%**	4.68%	4.89%	**176.6**	107.4	125.7
Development finance	**10.10%**	9.00%	9.57%	**46.8**	19.9	29.2

Yields in the segment have remained strong. While the figures for motor and development finance are affected by their growth trajectories and the increasing size of the balances, the decline in the yield in asset finance reflects its strategic repositioning to address the larger, higher quality but lower yielding mid-range segment of the market, which will cause average yields to trend downward over time as assets season.

Arrears on the segment's business remain low with arrears in the asset finance business at 0.97% and motor finance at 0.78% (30 September 2017: 0.97% and 0.56% respectively), comparable to those in the wider sector, with the FLA reporting average arrears for asset finance at 0.80% and car finance at 2.50% at 31 March 2018 (30 September 2017: 0.60% and 2.20%).

Development finance accounts are monitored on a case-by-case basis by management and the Credit and Property Risk functions. At 31 March 2018, this monitoring identified no cases where a loss was expected, based on project progress and performance and potential development value (30 September 2017: none). The average loan to gross development value for the portfolio at the period end, a measure of security cover, was broadly stable at 60.1% (30 September 2017: 60.6%). This is a reflection of the Group's initially cautious approach to lending in this field and is expected to increase in line with risk appetite as the business matures.

Overall debt impairments in the segment resulted in a charge of only £0.3 million (2017 H1: credit of £0.3 million), representing both the quality of the lending and the Group's success in realising security on defaulted cases, with realisations exceeding provisions in the previous period.

Outlook

The Group's intention is to continue to develop its businesses, both increasing the reach of its existing offerings and adding further product lines or specialisms, either organically or through M&A activity. It seeks to be responsive and flexible in addressing the market, but its UK focus means that it is exposed to a downturn in investment amongst UK business as a whole.

The remainder of the year will see further development in the product lines, with a fuller deployment of the promising development finance proposition and the continued expansion of the aviation finance and structured lending products. A particular priority will be the on-going integration of the acquired Iceberg business into the division, both operationally and commercially.

Further potential niche markets have been identified which might be addressed through organic development using existing business processes, creation of a new separate business line, or acquisition.

Overall the division has a good platform on which to build and increasing scale will enable a better return to be generated from its resources, control framework and investments in systems. The performance in the period, together with the additional flows which will be generated from the Iceberg business have enabled the Group to increase its previous forecast of aggregate new advances for the current financial year to over £0.6 billion (previous guidance: £0.5 billion).

2.3 IDEM CAPITAL

The Group's Idem Capital division includes its acquired consumer finance portfolios, together with legacy consumer portfolios originated before 2010.

Idem Capital has a strong capability in loan administration and flexible systems, allowing it to respond to regulatory developments and more specialised portfolio requirements. Unlike many market participants, Idem Capital is able to deploy retail funding and securitisation funding to support its investment.

The division's focus is on acquiring portfolios where it can enhance value through its collections process and access to funding, using its analytical skills base, which it sees as a core differentiator, to identify and evaluate portfolios brought to market. Its principal area of focus over recent years has been on portfolios of UK paying secured and unsecured consumer finance balances.

In the market the division's strategy has been to seek better returns, with a greater interest in transactions with a bespoke aspect. It is also willing to consider transactions, deal by deal, on a partnership basis, having acted as a co-investor, servicer or both in various deals in the past.

Overall Idem Capital's success rests on understanding assets, strong analytics, advanced servicing capabilities and the efficient use of funding.

Lending activity

The portfolio purchase market has been busy in the half year, however while the operation participated in all the significant bid processes in the period for assets in its target classes, including some very large transactions, it was not successful and new investments in the period were £nil (31 March 2017: £95.4 million). Activity in the asset sales market tends to be 'lumpy' and the level of investment will reflect the number, type and quality of portfolios offered, together with the levels of return other market participants are willing to accept.

The Group believes that its ability to accurately evaluate a potential acquisition is a core strength and it is not willing to compromise on credit quality or target return levels in pursuit of volumes. Idem Capital remains on the panels of all the principal UK vendors.

The Group also disposed of assets with a carrying value of £5.9 million during the period. These were assets where the Group had exhausted its collection procedures and therefore chose to dispose of the assets to other institutions whose systems are more suited to serving these customers and addressing such balances.

Performance

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

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Second charge mortgage loans	**357.5**	431.0	392.3
Unsecured consumer loans	**189.6**	245.0	219.1
	547.1	676.0	611.4

The reduction in balances is a result of the scale of realisations from the brought forward portfolio. 120 month Estimated Remaining Collections on acquired assets reduced from £688.8 million at 30 September 2017 to £615.2 million at the period end (note 6).

Yields on the major product lines, based on average monthly balances outstanding (Appendix E) are set out below.

	Average yield			**Average balance**		
	31 March 2018	31 March 2017	30 September 2017	**31 March 2018**	31 March 2017	30 September 2017
	%	%	%	**£m**	£m	£m
Secured loans	**15.34%**	14.50%	13.13%	**373.4**	451.8	432.6
Unsecured assets	**17.66%**	14.91%	17.73%	**205.8**	246.1	237.7

Yields in the segment have remained broadly stable. The movements in the period can be attributed principally to mix variances caused by portfolios with differing yields amortising at different rates and the disposal of low yield assets in the period.

Customer complaints and compliance issues in the portfolios remained low in the period. Flows of redress cases, where the original lender is required to compensate the customer for conduct issues on acquired accounts, have increased in the period. It should be noted that the terms of loan acquisitions generally leave responsibility for pre-acquisition conduct issues, such as PPI, with the vendor, not the Group. The Group's recorded complaint levels, on the measures published by the Financial Ombudsman Service, remain very low with only 50 new complaints, while the Group's overturn rate, where the ombudsman reversed the Group's decision, at 31%, is better than the 34% average for the industry. Operational improvements have continued to be made in systems, processes and employment patterns which are expected to generate operational efficiencies in future periods.

Arrears on the segment's secured lending business remain in line with recent performance at 19.9% (30 September 2017: 17.5%), which while higher than the average for the sector reflects the seasoning of the balances, which are mostly more than ten years old. Average arrears for secured lending of 10.6% at 31 March 2018 were reported by the FLA (30 September 2017: 11.1%).

None of the division's portfolios at the year end were regarded as materially underperforming, with strong overall cash generation. The Group monitors actual cash receipts from acquired portfolios against those forecast in the evaluation which informed the purchase price. Up to 31 March 2018 such collections were 109.4% of those forecast to that point (30 September 2017: 109.3%, 31 March 2017: 109.2%).

Overall the impairment in the segment generated a £0.4 million credit to profit (2017 H1: £0.8 million charge), representing the largely stable arrears position and the impact of improving house prices on secured provisioning.

Outlook

External research suggests that the flow of UK portfolio transactions will continue into the second half year, but potentially with an increasing focus on sales of performing assets, rather than non-performing loan disposals. The Group's strategic focus in this market will be on transactions which are more idiosyncratic in nature and therefore make best use of its core skills in pricing, data, operations and account management in generating value.

The business will continue to maintain its detailed and disciplined approach to evaluating, pricing and bidding on portfolios, not compromising on yields and risk and thereby generating appropriate shareholder value.

While Idem Capital has the most significant experience in secured and unsecured consumer loan transactions, it has access to specialists in other asset classes across the Group, enabling it to bid on a wider range of asset classes. It will also look for opportunities to deploy retail and corporate funding, with access to these funding sources giving it a potential competitive advantage.

The principal strategic objective of the division in the short term, following the Group's 2017 reorganisation, is to develop ways of leveraging its membership of a banking group to provide an advantage in transactions, whether operationally, or through capital and funding.

3. FUNDING REVIEW

The Group's reorganisation in September 2017 represented a major stage in its transition from an entirely wholesale funded lender, with equity representing a high proportion of working capital, to a funding structure reflecting more closely a typical bank with retail deposits at its core. Following the reorganisation that process has accelerated as the changes have bedded in.

3.1 DEBT AND DEPOSIT FUNDING

During the period, the Group continued its strategy of making increased use of its retail savings capability, where possible. The availability of central bank funding at attractive rates to support lending in the year impacted on the Group's use of other wholesale funding, with no securitisation transactions taking place until April 2018, when strong investor demand and attractive rates available in the wholesale funding markets enabled the Group to structure its first deal since 2015.

The Group's funding at 31 March 2018 is summarised as follows:

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Retail deposit balances	**4,285.8**	2,347.4	3,615.4
Securitised and warehouse funding	**6,471.2**	8,940.1	7,781.8
Central bank facilities	**974.4**	345.0	700.0
Tier 2 and retail bonds	**445.1**	554.6	444.8
Total on balance sheet funding	**12,176.5**	12,187.1	12,542.0
Off balance sheet central bank facilities	**108.9**	108.8	109.0
	12,285.4	12,295.9	12,651.0

The Group's present medium term strategic funding objective is principally focussed on retail deposits, while optimising the use of central bank facilities. Securitisation is used tactically if market conditions are favourable, or where it is appropriate for particular transactions and the Group's present expectation is that one securitisation per year is likely, if conditions are right.

The Group actively prepares its interest rate exposure position for likely increases in UK interest rates indicated by Bank of England guidance. The risk of a downward movement in rates in recent years has been limited by an apparent absolute lower bound on market rates. This will no longer be the case in a higher rate environment and this will be addressed in treasury policy. The Group's funding and hedging policies are also influenced by the levels of longer-dated fixed rate products now being offered, and it is seeking to increase the levels of maturity matching in its overall balance sheet position.

Retail funding

Retail deposits generally represent a reliable, cost-effective and scalable source of finance. As a consequence of the reliance on retail funding in the Group funding strategy, the volume of retail deposits has continued to grow significantly during the period, with balances at 31 March 2018, at £4,285.8 million, having increased by 18.5% over the six month period (30 September 2017: £3,615.4 million, 31 March 2017: £2,347.4 million).

However, this represents only a small proportion of the UK savings market, with household savings balances reported by the Bank of England increasing by 4.1% in the six months to 31 March 2018 to £1,164.9 billion (30 September 2017: £1,118.8 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 decreased from 1.26% in September 2017 to 1.05% in March 2018, although rates on one-year bonds had increased slightly from 0.78% in September to 0.81% in March. It does not appear, therefore, that the withdrawal of the TFS is having any material impact on rates in the savings market, as yet.

The Group's savings model provides customers with a range of deposit options, offering value for money and competitive rates, combined with the protection provided by the Financial Services Compensation Scheme ('FSCS'). It provides a stable funding platform, with a focus on term funding to manage interest rate risk and the ability to limit product availability to short periods of time.

New entrants to the banking market have adopted similar approaches to the savings market as the Group, and therefore competition for internet-sourced deposits is increasing. This forces the Group to remain competitive on pricing, products and service. Even so, rates may be influenced by the funding needs of other participants in the market, which are beyond the Group's control.

The Group's products, processes and approach have been commended in the industry and by customers, and the Group has been nominated in four separate savings categories for the 2018 Moneyfacts Consumer awards, including Best Bank Savings Provider, the fourth consecutive year it has been recognised at these awards.

In customer feedback 91% of those opening a savings account in the six month period, who provided data, stated that they would 'probably' or 'definitely' take a second product with the Group (2017 H1: 87%). The net promoter score in the same survey, measuring customers' likelihood to recommend the product, was +62, up from +59 in the first six months of the 2017 financial year.

Savings balances at the period end are analysed below.

	Average interest rate		Average initial balance		Proportion of deposits	
	31.03.18	30.09.17	**31.03.18**	30.09.17	**31.03.18**	30.09.17
	%	%	**£000**	£000	**%**	%
Fixed rate deposits	**1.90%**	1.89%	**22**	24	**74.9%**	74.0%
Variable rate deposits	**1.30%**	1.21%	**17**	19	**25.1%**	26.0%
All balances	**1.75%**	1.71%	**21**	23	**100.0%**	100.0%

The average initial term of fixed rate deposits at 31 March 2018 was 27 months (30 September 2017: 28 months).

The proportion of short term deposits (easy access and those available at three months' notice or less) has increased in the period to 24.2% (30 September 2017: 22.6%), representing £1,035.4 million of the balance. This has been driven by market requirements, as customer anticipation of rate rises in the near term leads to a preference for short-dated deposits.

The Group's outsourced administration platform continues to meet its needs and provides a cost-effective, stable and scalable solution in the medium to long term, with a new agreement having been signed in the period to provide longer-term security to this important commercial relationship.

The Group intends to expand its offering in the savings field over the coming period, both in terms of products and routes to market, to ensure its access to deposit monies is not restricted by competitive pressures and that it is able to manage its increasing volumes of maturing retail liabilities effectively.

Wholesale funding

UK wholesale funding markets have performed well in the six month period, with more activity than in recent periods, partially as a result of the cessation of the TFS, while pricing has been generally attractive, though subject to some volatility.

The Group's strategic objective of creating a better balanced funding base, coupled with the availability of attractively priced funding from the Bank of England during the period, has meant that its use of securitisation and similar funding tools is presently limited to those instances where a particularly compelling case can be made in terms of the tenor, cost and availability of the funding. As a result, the Group did not access the public securitisation market between November 2015 and March 2018. In April 2018, just after the period end, Paragon Mortgages (No. 25) PLC ('PM25') was launched, the largest value and lowest interest margin transaction completed by the Group since 2007.

PM25, backed by a mixture of new and legacy buy-to-let mortgage assets, closed on 25 April 2018, raising £435.3 million of external funding in sterling Mortgage Backed Floating Rate Notes. The senior notes were rated AAA by Fitch and Aaa by Moodys and bear interest at LIBOR plus a margin of 0.65%. The initial average rate on the external notes was 0.72% above LIBOR.

The transaction has a number of novel features, which enhance its value to the Group's funding strategy. It has the capacity to accept further loans, rather than repaying redemption monies immediately. This extends the expected life to five years, rather than four and makes the funding both more cost-effective and more suitable for the five-year fixed rate mortgage products which are becoming increasingly popular in the market. The deal has also created internally held rated notes which may either be sold later or used as collateral for Bank of England facilities, giving the Group significantly enhanced funding and liquidity options.

During the period one of the Group's legacy mortgage securitisation transactions was paid down and refinanced initially with retail deposits, releasing significant cash balances for use elsewhere in the Group. Further such refinancing transactions should be expected over the coming years.

As a consequence of the increased focus on retail deposit funding, the Group's warehouse capacity, which had been used to fund buy-to-let mortgage originations, was rationalised, reducing from £550.0 million at 30 September 2017 to £350.0 million at 31 March 2018. The remaining warehouse provides a standby capability and an alternative to retail deposit funding.

Central bank facilities

The Group has continued to access the borrowing facilities offered by the Bank of England, which provide flexible, low-cost collateralised funding designed to reinforce the transmission of low base rates to households and businesses.

The most significant of these facilities for the Group has been the TFS, which was available for new drawings until February 2018 and was used by the Group to support new lending. Drawings on this facility are made against the security of pools of mortgage loans. The interest cost of TFS funding was very attractive, compared with either retail deposits or securitisation, and repayment is due four years after the drawing, in 2021/22. In common with many UK institutions, the Group made extensive use of the TFS up to its withdrawal and drawings had increased to £944.4 million at the end of the period (31 March 2017: £275.0 million, 30 September 2017: £700.0 million).

Following the closure of the TFS to new drawings, the Group accessed the Indexed Long-Term Repo scheme ('ILTR') during March. Drawings on the ILTR at 31 March 2018 were £30.0 million (31 March 2017: £70.0 million, 30 September 2017: £nil).

The Group's liquidity drawdown under the Funding for Lending Scheme ('FLS'), which provides liquidity of £108.9 million (31 March 2017: £108.8 million) remained in place throughout the period. The terms of this facility are such that neither the drawing nor the liquidity provided appear on the Group's balance sheet.

The Group has also pre-positioned further mortgage loans and certain other assets with the Bank of England to act as collateral for further drawings on central bank funding lines, if and when required.

Funding for Idem Capital assets

Idem Capital has continued its funding strategy of financing smaller scale acquisitions from Group equity; accessing retail funding for assets of appropriate quality; and introducing external funding if and when asset volumes and types and the availability of appropriate facilities make that economically beneficial.

Since 2015, Idem Capital has had a non-recourse funding facility with Citibank, which it uses to fund assets from time to time, releasing group working capital. No new drawings on the facility were made in the period.

Certain legacy assets, principally second charge mortgage balances, are also funded through securitisation structures arranged shortly after their origination.

At 31 March 2018 the funding of the assets in the Idem Capital segment was distributed as shown below.

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Purchased assets by funding source			
External non-recourse funding	**239.4**	296.4	270.8
Retail deposit funding	**221.7**	302.1	247.0
Funded through central group resources	**86.0**	103.3	93.6
	547.1	701.8	611.4

This demonstrates the flexibility in the Group's funding for its debt purchase activities, and its ability to access third party funding and retail funding for appropriate transactions. This is particularly useful when bidding for performing portfolios, which the operation has targeted.

The assets funded through the Group's central resources also provide an opportunity to raise further liquidity, should it be required.

Corporate funding

While the Group's working capital has been primarily provided by equity since 2008, in recent years it has expanded its use of corporate debt funding, issuing both retail bonds and Tier 2 corporate bonds. This has facilitated a diversification of the Group's funding base and extended the tenor of its borrowings. All the Group's working capital debt funding has been raised since the credit crisis and therefore there are no legacy issues relating to these borrowings.

The Group is rated by Fitch Ratings, which reviewed its rating in the light of the Group's 2017 reorganisation and, on 6 April 2018, upgraded its Long-Term Issuer Default Rating to BBB from BBB- rating with a stable outlook. The BB+ rating on the Group's £150.0 million Tier 2 Bond was also upgraded to BBB- at the same time.

Although no corporate debt was issued in the period, such borrowings continue to form part of the Group's long-term funding strategy and the enhanced rating will support further long-dated corporate debt issuance in both scale and pricing terms.

Summary

The Group's overall debt funding position remains strong. The performance of the securitisation market is encouraging, the Group's retail offerings are performing well, despite a competitive market place, and its contingent liquidity position is robust.

Further information on all the above borrowings is given in note 21.

3.2 CAPITAL MANAGEMENT

The Group's funding model places primary reliance on retail deposit funding, which has fundamentally changed the working capital cycle of the Group, reducing the variability in working capital demand and hence enabling an on-going reduction in working capital levels relative to the size of the balance sheet.

The Group has continued to enjoy strong cash generation during the period. Available cash balances were £141.2 million at 31 March 2018 (30 September 2017: £305.5 million) (note 14) after the acquisition of Iceberg, share buy-backs and the increased liquidity required by the growth in retail deposits. The Company sees opportunities to deploy capital to support organic growth and potentially to invest in portfolio purchases and further M&A opportunities, but also recognises the opportunity to return more of this cash to its shareholders.

Dividend and dividend policy

In its 2017 results announcement the Company announced a policy of targeting a dividend cover ratio of 2.75 times in 2017 and 2.50 times in the current financial year and thereafter, subject to the requirements of the business and the availability of cash resources. The final dividend for the year ended 30 September 2017 was declared in accordance with that policy.

To provide greater transparency, the Company also indicated that its interim dividend per share will normally be 50% of the previous final dividend, in the absence of any indicators which might make such a level of payment inappropriate.

In determining the level of the interim dividend for the present year, the Board has considered the dividend policy, but has also taken into account the Group's strategy, capital requirements, principal risks, the level of available retained earnings in the Company, its cash resources and the objective of enhancing shareholder value.

On this basis, the Board is proposing an interim dividend of 5.5p per share (2017 H1: 4.7p), 50% of the final dividend for the previous year, payable to shareholders on the register on 6 July 2018. This represents an increase of 17.0% from 2017.

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 issues 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 in the event of severe losses being incurred by the Group. During the period the PRA determined that the amount of the regulatory capital required should be disclosed by firms in their public reporting.

The Group maintains extremely strong capital and leverage ratios, with a total capital ratio of 18.2% at 31 March 2018 (30 September 2017: 18.7%) and a UK leverage ratio at 6.8% (30 September 2017: 6.6%) (note 4(d)). The CET1 ratio, 15.5% at 31 March 2018 fell marginally in the period (30 September 2017: 15.9%), with the effect of share buy-backs and dividends mostly offset by the Group's profit in the period. The Group's medium term CET1 target is 13.0%.

The Group's total regulatory capital at 31 March 2018 was £1,039.9 million (30 September 2017: £1,030.5 million) well in excess of the amount required by the PRA guidance, including the £659.7 million required in respect of Pillar 1 and Pillar 2a. This amount includes variable and fixed components and further capital buffers, either specific to the Group or applicable across the sector, may also be required.

In December 2017, the Basel Committee on Banking Supervision ('BCBS') published its final proposals regarding amendments to the assessment of institutions' capital adequacy, in its document 'Basel III: Finalising post-crisis reforms'. This addresses both the Standardised Approach ('SA') for credit risk, presently used by the Group and the Internal Ratings Basis ('IRB'), which is based on firms' own internal calculations and subject to supervisory approval.

The most material change for the Group relates to an increase in the risk weightings applicable to buy-to-let lending assets. The proposals may also serve to limit the comparative advantage available to IRB users over SA users through the use of floors, setting minimum capital requirements where the IRB is used. The final proposals are much less severe in their treatment of buy-to-let, amongst other asset classes, than the proposals published two years earlier, but would still require the Group to carry increased capital. The final version of the framework still needs to be enacted into EU law to take effect and there are important areas where discretion is given to national supervisors or other competent bodies. Therefore, the full impact of the reforms will not be certain until the legislative process is complete and the appropriate bodies have made their intended use of their discretions clear. The Group will be closely monitoring developments as this process progresses.

The Group also notes the steps taken by the PRA towards using its assessment of Pillar 2 capital to reduce the perceived capital disadvantage of banks using the SA compared with IRB banks, which they regard as distortive to the market. The regulator published its final policy statement on this in October 2017, and the Group is considering its potential impact, when taken with the Basel reforms described above.

IRB approach

The Group continues to progress the development of its own IRB approach, notwithstanding the outcome of the CRD and PRA processes. It has substantial performance data, excellent credit metrics and experience in analytics to support the adoption of an IRB approach for determining appropriate risk weightings for its buy-to-let mortgage assets. Other UK institutions currently using an IRB approach for their buy-to-let portfolios achieve materially lower risk weightings than the 35% required by the present SA, with PRA benchmark figures, most recently updated in October 2017, being typically in the low to mid-teen percentages.

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, and it has continued to progress a project to prepare an application to the PRA to adopt an IRB in future. This 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.

The Group expects to be in a position to apply formally for IRB authorisation for its buy-to-let portfolio in early 2019. This will be the first portfolio for which authorisation is sought, with development work continuing for further asset classes which will be added on a phased basis to achieve the coverage required by the IRB rules.

Gearing and share buy-backs

The Group's reorganisation, shortly before the start of the period, coupled with the strong capital base and low leverage in the Company's balance sheet, provides the opportunity for the business to reduce its over-reliance on equity capital, improving returns for shareholders. The future requirement to raise debt for liquidity purposes has been reduced by its access to retail deposit funding and the Group is able to take a long term view of opportunities available to it in the corporate debt markets to optimise its funding, working capital and regulatory capital position over time.

At the same time the Company continues to monitor any excess equity position and consider whether any adjustment is required, either through further changes in the dividend policy or through share buy backs.

In November 2014 the Company announced a share buy-back programme, which had been extended to £215.0 million by November 2017. During the period the Company bought back 5.1 million of its ordinary shares at a cost of £25.2 million, including stamp duty and transaction expenses (note 26); these shares being held in treasury. Up to £25.0 million of the announced amount was still to be utilised at 31 March 2018 and the programme will continue, as appropriate, during the second half of the financial year. Any shares acquired will also be initially held in treasury. Treasury shares may subsequently be cancelled.

Since the programme commenced in 2014 the Company's issued share capital has reduced from 306.7 million shares to 260.7 million shares, a decrease of 15.0%. The size of the programme is reviewed periodically to take account of anticipated investment opportunities and the balance of the Group's debt and equity capital resources.

The Company currently has the necessary shareholder approval to undertake such share buy-backs under an authority granted at its 2018 Annual General Meeting, when a special resolution authorising the purchase of up to 26.5 million of its own shares (10% of the issued share capital excluding treasury shares) was approved by shareholders.

The share buy-back programme has continued to reduce the amount of the Group's central funding represented by equity at 31 March 2018 to 76.8% from 87.6% six months earlier (note 4(c)), with this trend expected to continue.

Capital outlook

The appropriate level of capital for the business to meet its operational requirements and strategic development objectives is kept under review by the Board. The strength of its business lines, the diversification which has been achieved in the funding base in recent years and the further opportunities for growth and sustainability opened up by the group reorganisation in 2017, have created the foundations upon which to develop the Group's next phase of growth.

4. FINANCIAL REVIEW

Over the half year period the Group's results continue to be driven by the impact of its strategic focus on growing and diversifying its loan portfolios, managing its funding structures and investing in the future of the business.

The six months ended 31 March 2018 saw the Group's underlying profit (Appendix B) increase by 4.7% to £73.4 million (2017 H1: £70.1 million) while on the statutory basis profit before tax increased by 11.2% to £77.2 million (2017 H1: £69.4 million), the additional growth being an impact of fair value hedging gains.

Earnings per share increased by 15.6% to 23.7p (2017 H1: 20.5p) on the statutory basis, and by 8.7% to 22.5p excluding the effect of the fair value gains (2017 H1: 20.7p) (Appendix B).

4.1 RESULTS FOR THE PERIOD

CONSOLIDATED RESULTS

For the six months ended 31 March 2018

	2018 H1	2017 H1
	£m	£m
Interest receivable	**213.3**	203.8
Interest payable and similar charges	**(92.0)**	(90.3)
Net interest income	**121.3**	113.5
Other operating income	**8.8**	10.2
Total operating income	**130.1**	123.7
Operating expenses	**(54.9)**	(50.4)
Provisions for losses	**(1.8)**	(3.2)
	73.4	70.1
Fair value net gains / (losses)	**3.8**	(0.7)
Operating profit being profit on ordinary activities before taxation	**77.2**	69.4
Tax charge on profit on ordinary activities	**(15.2)**	(13.0)
Profit on ordinary activities after taxation	**62.0**	56.4

	2018 H1	2017 H1
Basic earnings per share	**23.7p**	20.5p
Diluted earning per share	**23.0p**	19.9p
Dividend - rate per share for the period	**5.5p**	4.7p

The results above include revenues of £0.5 million from the Iceberg operations, acquired in the year, which broke even in the three months since acquisition (note 5).

Total operating income increased by 5.2% to £130.1 million (2017 H1: £123.7 million). Within this, net interest income in the period increased by 6.9% to £121.3 million from £113.5 million for the six months ended 31 March 2017. The increase principally reflects the growth in the size of the average loan book, which rose by 3.7% to £11,235.4 million (2017 H1: £10,838.9 million) (Appendix C), and also the repayment of the Group's £110.0 million Corporate Bond in April 2017.

Annualised net interest margin ('NIM') was marginally improved in the six months to 31 March 2018 to 2.16% from the 2.09% achieved in the corresponding period last year (Appendix C). For the full year the Group expects NIM to improve by around 5 basis points. The variance from the guidance given at the year end arises primarily from volatility in Idem Capital income, where no new portfolios were purchased in the period, together with the effect of increased product switching in the Mortgages operation, which reduces margin but increases longevity in the portfolio and the impact of competition in the Group's lending and deposit funding markets.

Other operating income was £8.8 million for the six months, compared with £10.2 million in the corresponding period in 2017. The reduction principally results from lower levels of external broker commission as the Group's in-house brokers increasingly focus their efforts on generating business for its lending operations.

Operating expenses for the period increased by 8.9% to £54.9 million from £50.4 million for the six months ended 31 March 2017, partly reflecting a 2.5% increase in the average number of employees to 1,349 (2017 H1: 1,316) and the acquisition of Iceberg. The period has also seen significant investments in systems and personnel, to support the development, launch and start-up phases of new product lines such as development finance, structured finance and aviation finance; to enable expansion of existing product lines; and to generate operational efficiencies following the Group's reorganisation in September 2017.

This investment increased the Group's cost:income ratio in the period to 42.2% (Appendix A) from the 40.7% recorded in the first half of 2017. The Board remains focused on controlling operating costs through the application of rigorous budgeting and monitoring procedures, and expects that the overall cost:income ratio will improve over time as acquired and start-up operations are integrated into the Group and it starts to see the benefits of income growth from its new and expanded operations and from efficiencies created by its investments in systems. The Group's expectation remains that the cost base for the financial year will be in the £105.0 million to £115.0 million range.

The charge of £1.8 million for loan impairment has reduced from the already low level seen in the first half of the previous year (2017 H1: £3.2 million). As an annualised percentage of average loans to customers the impairment charge has fallen to 0.03% from the 0.06% for the six months ended 31 March 2017 (Appendix C). The Group has continued to see 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, while performance on the Group's newer portfolios remains strong and in line with expectations.

With effect from 1 October 2018, at the start of the next financial year, the introduction of IFRS 9 will have a significant impact on the Group's approach to provisioning for impairment. Preparations are well in hand for these changes and quantitative information on their impact will be given at the time of the announcement of the final results for the current year.

Yield curve movements during the period resulted in hedging instrument fair value net gains of £3.8 million (2017 H1: £0.7 million net loss), 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 which is excluded from the Group's underlying profit. The Group remains appropriately economically hedged.

Tax has been charged at an effective rate of 19.7%, compared with 18.7% for the corresponding period last year; the increase arising from the application of the Bank Tax Surcharge to a greater proportion of the Group's operations being partly offset by the reduction in the rate of UK Corporation Tax applying to the Group in the period from 19.5% to 19.0%.

Profits after taxation of £62.0 million (2017 H1: £56.4 million) have been transferred to equity, which totalled £1,020.6 million at the period end (31 March 2017: £994.2 million). This represents a tangible net asset value of £3.47 per share (31 March 2017: £3.27) and an underlying net asset value of £3.94 per share (31 March 2017: £3.65) (Appendix D).

The information on related party transactions required by DTR 4.2.8(1) of the Disclosure and Transparency Rules is given in note 31.

4.2 SEGMENTAL RESULTS

Following the group reorganisation in September 2017, the Group now analyses its results between three segments, which are the principal divisions for which performance is monitored:

- Mortgages, including the Group's buy-to-let, and owner-occupied first and second charge mortgage lending and related activities
- Commercial Lending, including the Group's motor finance and other equipment leasing activities, together with other offerings targeted towards SME customers
- Idem Capital, including loan assets acquired from third parties and legacy assets which share certain credit characteristics with them

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

Results for the six months ended 31 March 2017, previously reported on the pre-reorganisation basis have been restated below.

The underlying operating profits of these divisions are detailed fully in note 7 and are summarised below.

	Six months to 31 March 2018	Six months to 31 March 2017
	£m	£m
Segmental profit		
Mortgages	**72.3**	68.5
Commercial Lending	**6.2**	6.6
Idem Capital	**37.5**	39.6
	116.0	114.7
Unallocated central costs	**(42.6)**	(44.6)
	73.4	70.1

Mortgages

Trading activity during the period in the Mortgages division remained strong and an improved retention performance, low arrears levels, and efficient funding resulted in the segmental profit increasing to £72.3 million, up 5.5% from the corresponding period in the previous year (2017 H1: £68.5 million) on a mortgage book which itself had increased, at 31 March 2018, by 3.3% from a year earlier.

Commercial Lending

Segmental profit in Commercial Lending totalled £6.2 million in the period (2017 H1: £6.6 million). The Group continued to invest in enhancing the business, with several new product lines in the early stages of development and rollout in the period. The principal reduction in the segment result however arose as a result of gains made in the comparator period on the exercise of security on defaulted accounts, which resulted in a credit to provision of £0.3 million in that period compared to a charge of £0.3 million in the current half year. Such gains are essentially one-off transactions outside the control of the business.

Contribution from the acquired Iceberg operation was not significant in the period, but it is expected to enhance earnings going forward as the originated portfolio grows.

Loan assets were substantially increased, especially in asset finance, with the segment's loans to customers at 31 March 2018 increasing 45.0% from the position twelve months earlier, including the effect of Iceberg lending post-acquisition.

Idem Capital

The Idem Capital division's portfolios continued to perform well in the six months ended 31 March 2018. However, the portfolio balance continued to reduce as customers made repayments while no new deals were completed, with loans to customers 19.1% lower than a year earlier. This consequently reduced earnings, with segment profit falling by 5.3% to £37.5 million (2017 H1: £39.6 million).

4.3 ASSETS AND LIABILITIES

The Group's balance sheet is summarised in the table below:

SUMMARY BALANCE SHEET

31 March 2018

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Free cash	**141.2**	277.2	305.5
Other cash	**921.4**	896.4	1,191.4
Investment in customer loans	**11,346.7**	10,940.2	11,124.1
Derivative financial assets	**763.4**	1,044.0	906.6
Other assets	**53.7**	68.9	50.2
Intangible assets	**120.3**	104.6	104.4
Total assets	**13,346.7**	13,331.3	13,682.2
Retail deposits	**4,285.8**	2,347.4	3,615.4
Borrowings	**7,890.7**	9,839.7	8,926.6
Sundry liabilities	**119.8**	111.6	101.0
Pension deficit	**29.8**	38.4	29.8
Equity	**1,020.6**	994.2	1,009.4
Total equity and liabilities	**13,346.7**	13,331.3	13,682.2

The Group's loan assets include:

- Buy-to-let and owner-occupied first mortgage assets in the Mortgages segment
- Second charge mortgages, with new originations in Mortgages and purchased and similar legacy assets in Idem Capital
- Other unsecured consumer lending in Idem Capital
- Asset finance and motor finance loans in the Commercial Lending segment
- Development finance loans in the Commercial Lending segment
- Other funding solutions for small and medium sized businesses and professional services firms in the Commercial Lending segment

The allocation of these loan assets between segments is set out below.

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Mortgages	**10,119.5**	9,795.3	9,953.9
Commercial Lending	**680.1**	468.9	558.8
Idem Capital	**547.1**	676.0	611.4
	11,346.7	10,940.2	11,124.1

An analysis of the Group's financial assets by type is shown in note 16. 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 the Group's results while the exchange movements have a broadly equal and opposite impact on borrowings.

Cash flows from the Group's securitisation vehicle companies and the acquired portfolios remain strong. These, together with increased levels of retail deposit funding, financed the Iceberg acquisition, the capital and liquidity requirements of the lending operations and credit enhancement for mortgage originations. Cash was also utilised in the share buy-back programme, which commenced during December 2014 and where £191.4 million (including costs) had been deployed by 31 March 2018. Free cash balances were £141.2 million at 31 March 2018 (31 March 2017: £277.2 million), part of the reduction being due to additional cash held at 31 March 2017 to fund the repayment of the Group's £110.0 million Corporate Bond in April 2017.

Movements in the Group's funding, including retail deposit balances and wholesale borrowings, are discussed in the funding review section.

The IAS 19 valuation of the Group's pension scheme deficit remained stable in the period, with the impact of contributions under the recovery plan being offset by a reduction in the bond yields which drive the discounting used in this valuation. During the period a Pension Funding Partnership ('PFP') arrangement was agreed with the Trustee, effectively granting the Plan a charge over the Group's head office building as security for its agreed contributions and thereby reducing the Plan's funding risk.

While the valuation under IAS 19 is that which is required to be disclosed in the accounts, pension trustees generally use the technical provisions basis as provided in the Pensions Act 2004 to measure scheme liabilities. On this basis, the valuation at 31 March 2018, excluding the effect of the PFP asset, was £19.6 million (30 September 2017: £14.9 million), representing an 83% funding level (30 September 2017: 87%).

5. OPERATIONS REVIEW

5.1 MANAGEMENT AND PEOPLE

The Group has always recognised that its people are key to its future growth and development, with over 1,300 employees throughout the period. The training and development of its employees together with a rigorous recruitment and selection process are a key part of the Group's organic growth strategy and underpin the strong progress made and the Group's Investors in People Champion status.

Governance and management

As had been announced during February 2018, on 10 May 2018 Robert Dench resigned as both Chairman and director after fourteen years on the Board, having become Chairman in 2007. His tenure in the chair has seen major challenges and changes for the Group, covering the credit crisis, the Group's return to lending, the launch of Paragon Bank and most recently the transition to a specialist banking group. Throughout these events Bob has chaired the Board in a collegiate, but challenging way and has been a supportive Chairman to the management team, with his wealth of banking experience being an invaluable asset to the Group throughout his tenure. He leaves the Group in excellent health.

Bob takes up a new challenge as Chairman of The Co-operative Bank p.l.c, and departs with the sincere thanks and good wishes of his fellow directors and other colleagues.

Fiona Clutterbuck succeeded Bob as Chairman on 10 May 2018, having previously been Senior Independent Director and an independent non-executive director of the Group. She also succeeds Bob as Chairman of the Nomination Committee and ceases to be a member of the Audit Committee.

This appointment was the result of a thorough and independent recruitment process, involving both internal and external candidates, during which it became clear that Fiona was the best candidate to become Chairman. She has a strong knowledge of the Group, having served on the Board since 2012 and has a wealth of financial services experience, having held senior positions at leading UK and international banks. She was most recently Head of Strategy, Corporate Development and Communications at the Phoenix Group, until March 2018, while also serving as a non-executive director at a number of prominent listed companies.

Once regulatory approval has been obtained, Fiona's successors as Senior Independent Director and Chairman of the Remuneration Committee will be announced.

The Group's succession planning strategy continues to be an important area of focus, with key leadership and specialist roles in the Group identified. 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, with a particular focus on nurturing female candidates. This area will remain a priority for the Board, with the assistance of the Nomination Committee, during the remainder of the year.

The Group's second annual statement under the Modern Slavery Act 2015 was published on its website in March 2018. Relevant policies have been reviewed and updated as appropriate. All employees have completed an annual e-learning module on this subject to raise awareness and understanding.

People and development

The Group has managed an efficient operation over the past six months, increasing employee numbers by 2.7% over the period. It maintains its accreditation from the UK Living Wage Foundation and minimum pay continues to meet the levels set by the Foundation. We believe the Group's people are well positioned to support its future growth strategy.

The Group prides itself on the high retention rate of its workforce. Its annual employee attrition rate of 8.7% is below the national average and 28% of its people have been with the Group for more than ten years, with 10.6% having achieved over 20 years' service. We believe this is due to the provision of quality development opportunities and ensuring the Group remains a place where people want to work. This in turn has meant that knowledge and experience have been retained in all the Group's specialist areas, which form the foundation of its strategic focus on specialist lending.

During the period work has continued to embed the internal mentoring programme, accredited by the Chartered Management Institute, which helps to support succession planning strategy and develop future leaders. The Group has continued to draw down on Apprenticeship Levy funds to support its development objectives and the internal Team Leader Academy was certified with the CMI to facilitate this. There are typically over 100 people completing professional qualifications at any one time across the Group. The Group currently has 23 apprentices registered under the levy scheme, utilising 56% of its levy pot. Whilst a higher take up would be desirable, the requirement for apprentices to spend 20% of their time out of the business makes identifying suitable roles challenging.

Regulatory and other training programmes have also taken place internally to ensure employees remain competent to deliver good customer outcomes. The Group has continued to work with local secondary schools, colleges and universities, with industrial placements and apprenticeships becoming a feature for some of the Group's specialist areas.

The health and wellbeing of the Group's employees is an important element of its people strategy. During the period the Group continued to offer lifestyle assessments and discounted gym memberships, while promoting its employee assistance programme with external occupational health support. In addition, mental health awareness sessions were delivered to line managers across the Group and an internal team of emotional wellbeing volunteers has been identified and trained with the support of the charity Mind. These people will provide additional support to individuals experiencing issues within their personal life or at work, which may impact on their emotional, psychological or social wellbeing.

Diversity and equality

Diversity has continued to be a focus for the Board and the Group as a whole, and in January 2018 the first progress report on the Group's internal targets under the Women in Finance Charter, set in January 2017, was published on its website. The targets include female representation in senior management roles reaching 35% by January 2022, increasing from 26% at the time the targets were set.

After the first year, the Group has already achieved five of its seven targets and whilst it is pleased with progress to date, relative to other similar organisations, it recognises that there is still much work to do. It is confident, however, that the measures put in place will help provide individuals with the opportunities they deserve and the Group with the workforce it needs to achieve its strategic goals. A full list of the Group's diversity targets can be found on the 'Corporate Responsibility' section of the Group's website.

The Group reported its full Gender Pay Gap information at the end of March 2018, having included the headline numbers in its Annual Report for the year ended 30 September 2017. These results, based on the April 2017 pay date, can be found on the 'Corporate Responsibility' section of the Group's website.

The Group's published data covered all its operations, going beyond the requirements of the legislation to provide a more complete view of its position. The median gender pay gap reported for the whole Group at 30.4% was not dissimilar to those for other smaller financial entities, and was considerably better than some. The Group welcomes the interest in this issue generated by the new disclosure requirements, but would favour a review of the detail of the legislation in the light of the first year's experience to ensure all the disclosures required are appropriate.

The Group continues to analyse its gender pay data, overall, within business areas and by comparing similar positions across the business. Policies are in place to ensure equality of opportunity in recruitment, promotion and remuneration and the effectiveness of these is monitored on an ongoing basis.

The Group provides annual diversity awareness training for managers and additional communication events are planned in the coming months. The Group carries out an annual voluntary and anonymous diversity survey of its employees with the 2017 survey producing a response rate of 78%, significantly above industry average. The 2018 survey will be conducted during the second half of 2018 and results will be reported at the year end. Actions to promote equal opportunities within recruitment, learning and career development continue to be an important element of the Group's people strategy.

The Nomination Committee, as the Board Committee responsible for diversity issues across the Group, oversees these policies and receives information on performance. While the Group is confident that there is no systematic gender bias in its recruitment or remuneration practices, it is conscious of the underrepresentation of women at senior levels in the financial services sector and it anticipates that one of the effects of its Women in Finance initiative will be to erode the gender pay gap over time by increasing female representation at senior levels.

5.2 RISK

The effective management of risk is crucial to the achievement of the Group's strategic objectives. It operates a risk governance framework, designed around a formal three lines of defence model (business areas, Risk and Compliance function and Internal Audit) supervised at Board level.

In the last six months, the Group has continued to enhance its ability to manage all categories of risk. In particular it has focussed on:

- The continuing evolution of its risk appetite statements and embedding them in the processes of the Group's businesses
- Embedding the new operational risk management system in business areas for use on a day-to-day basis
- Reviewing cyber security controls and the evaluation of ongoing investment in systems resilience and security
- Supporting the integration of acquired businesses and the development of new activities, to ensure they are fully captured by the Group's risk management framework

Investment has also continued in appropriately skilled resources and this, along with the ongoing investment in systems is intended to ensure that the Risk and Compliance function has sufficient capability and capacity to provide effective oversight of the Group's expanding activities.

The risk function, in particular its extensive credit risk expertise, has been deployed in the period in the continuing development of the Group's IFRS 9 approach and IRB models, where specialist resource is also available within the division.

The principal challenges in the risk environment faced by the Group during the six month period and going forward include:

- The potential impact of the changes in capital requirement regulations finalised by the BCBS in December 2017
- Ongoing execution and transitional risks arising from recent business acquisitions and the internal reorganisation in September 2017
- The impact of continuing uncertainty as to the terms on which the UK will leave the EU in March 2019 and their impact on the Group's businesses and the regulatory regimes it operates under
- The impact of fiscal and regulatory changes introduced in preceding periods on the scope and nature of the demand for buy-to-let mortgages in the UK
- Compliance with the new regulatory requirements relating to the underwriting of buy-to-let mortgages in the UK
- Heightened cyber-security risks as a result of the increasing sophistication and frequency of cyber-attacks affecting the financial services sector
- Major regulatory developments including the impending implementation of the General Data Protection Regulation ('GDPR')

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

A summary of the principal risks and uncertainties faced by the Group is given on page 30.

5.3 REGULATION

Paragon Bank, which now encompasses the majority of the Group's activities for regulatory purposes, is authorised by the PRA and regulated by the PRA and the FCA. The Group is subject to consolidated supervision by the PRA and a number of its subsidiaries are authorised and regulated by the FCA. As a result, current and projected regulatory changes, particularly revisions to the Basel supervisory regime, continue to pose a significant risk for the Group, both as a result of their impact and of the pace of change.

The governance and control structures within the Group continue to be developed to ensure that the impacts of all new regulatory requirements on the business are clearly understood and that appropriate preparations are made before these requirements are implemented. Regular reports on key regulatory developments are received at both executive and board risk committees, assessing the potential implications for the Group, along with necessary actions.

Whilst the Group is impacted by a broad range of prudential and conduct regulations, given the nature of its operations, the following recent and current developments are of particular note:

- The PRA completed the implementation of major policy changes to underwriting standards for buy-to-let mortgage contracts from 1 October 2017. The principal changes are outlined under 'Mortgages' in the lending review above. The Group began operating in line with the new requirements well ahead of the regulatory deadline and the changes are now embedded within the business
- In March 2017, the FCA issued a policy statement regarding Payment Protection Insurance ('PPI'), setting a deadline of 29 August 2019 for any new PPI complaints and new rules and guidance on the handling of such matters. Impacts from this process have, so far, been minimal and this is expected to remain the case
- The impacts of the Second Payment Services Directive ('PSD2') have been evaluated with the support of external advice. It was determined that the Group is compliant with the regulations based on the current product suite. Consideration of PSD2 will form part of all future product development
- The Senior Managers and Certification Regime ('SMCR') will be extended to cover a wider section of persons employed in financial services during 2019. This will increase the number of the Group's employees within the SMCR and the oversight activities required to ensure compliance with the extended rules. These systems have been developed in the period and training modules for all impacted people have taken place across the Group
- The development of proposals, led by the Bank of England and the FCA, to establish SONIA (the Sterling Overnight Index Average, administered by the Bank of England) as the primary sterling interest rate benchmark by the end of 2021, in place of LIBOR, continues to be monitored to assess any potential impact on the Group. The regulators announced the next stage of this process in November 2017
- The GDPR will come into force with effect from 25 May 2018 and represents the most significant revision to data protection legislation for some twenty years. A project continues, drawing on external specialist advice as required, to ensure all areas of the Group will comply with the legislation from implementation

The Group, along with the rest of the UK corporate sector, does not yet have clear visibility on potential regulatory changes that may be introduced following the UK's decision to leave the EU in March 2019. However, given its current business model and activities, it does not have any EU passporting issues that need to be considered.

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

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

6. CONCLUSION

At 31 March 2018 the Group continued to be engaged in a major restructuring process, transitioning its business model from a wholesale funded buy-to-let lender to a more broadly-based bank. Paragon Bank, which effectively subsumed the Group from the beginning of this financial year, has laid the foundations for its future growth and diversification plans. This is already evident in the progress seen in the first six months of the year. New lending has increased by 28.9% with the originating divisions making strong progress. Furthermore, the various pipelines across the Group suggest a strong lending performance for the year as a whole.

The Group’s most established and mature product line, buy-to-let mortgage lending, has benefitted from an increased focus towards professional landlords. 86.3% of the pipeline, a materially higher figure than at 31 March 2017, is dedicated to more complex customers where the Group’s bespoke approach and service proposition gives it a genuine competitive advantage.

The acquisition of loan portfolios and businesses has been a core element of the Group’s strategy. Idem Capital has continued to apply strict disciplines on pricing and risk in a market that has become increasingly competitive. However, elsewhere in the business, further progress has been achieved in broadening the product range. The December 2017 acquisition of Iceberg, a leading provider of finance to professional services firms and their clients, was supported by strong organic growth in the wider Commercial Lending division, which saw originations increase by 25.6% excluding the impact of Iceberg.

The funding diversification strategy continued to reshape the Group’s balance sheet. Deposit balances increased to £4.3 billion, representing 64% of all post 2010 funding. TFS drawings increased to nearly £1 billion and, shortly after the half year ended, the Group completed its latest securitisation with record low pricing.

The strategic development of the Group over recent years has been significant. The combination of strong organic growth, enhanced by carefully identified and executed acquisitions, is helping to support an increasingly broad range of customers in specialist lending markets. A number of the newer product lines are still in their early stages of development and, with increased operational leverage, there is significant potential to build on their early successes.

PRINCIPAL RISKS AND UNCERTAINTIES

There are a number of potential risks and uncertainties which could have a material impact on the Group's performance over the remaining six months of the financial year and could cause actual results to differ materially from expected and historical results. In the opinion of the directors these have not changed materially from those described in section A2.2 of the last annual report and accounts of the Company for the year ended 30 September 2017. These are summarised below.

CATEGORY	RISK	DESCRIPTION
Business	Economic	The Group could be materially affected by a severe downturn in the UK economy given its income is wholly derived from activities within the UK. This is more difficult to forecast given current uncertainties on the terms on which the UK will leave the EU in March 2019, which might result in economic turbulence and negative short-term consequences. This could reduce demand for the Group's loan products, increase the number of customers that default on their loans and cause security asset values to fall.
	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 manage major internal reorganisations or integrate acquired businesses safely and effectively could adversely affect the Group's business plans and damage its reputation.
Credit	Customer	Inaccurate targeting and underwriting of credit decisions could result in Customers becoming less able to service debt, exposing the Group to unexpected material loss.
	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	If the Group fails to deliver fair outcomes for its customers this could impact both on its reputation and on its financial performance through loss of business or regulatory sanction.
Operational	Systems and IT Security	The risk that the Group's systems may be unable to support its operational requirements or that the Group fails to adequately protect itself and its customers against cyber crime.
	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 and strategic objectives.
	Regulation	The risk that the Group's strategic plans could be materially impacted by any significant, regulatory or legal changes and that it might suffer loss or reputational damage if it fails to identify and respond to such changes effectively.
Liquidity and Capital	Funding	If access to funding became restricted, either through market movements or regulatory intervention, this might result in the scaling back or cessation of some business lines.
	Capital	Changes in capital requirements for lending secured on residential property currently in progress 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 pension plan might deplete resources.

The Group has considered and responded to all these risks, mitigating the exposure as far as is practicable to ensure that its risk profile remains within the Board's stated risk appetite.

DIRECTORS' RESPONSIBILITES

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

- The condensed financial statements have been prepared in accordance with International Accounting Standard 34 – 'Interim Financial Reporting', issued by the IASB and as adopted and endorsed by the European Union
- The Interim Management Report includes a fair review of the information required by Section 4.2.7R of the Disclosure Guidance and Transparency Rules, issued by the UK Listing Authority (that being an indication of important events that have occurred during the first six months of the current financial year and their impact on the condensed financial statements and a description of the principal risks and uncertainties for the remaining six months of the financial year); and
- The Interim Management Report includes a fair review of the information required by Section 4.2.8R of the Disclosure Guidance and Transparency Rules, issued by the UK Listing Authority (that being disclosure of related party transactions that have taken place in the first six months of the current financial year and that have materially affected the financial position or the performance of the enterprise during that period; and any changes in the related party transactions described in the last annual report which could do so)

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

Pandora Sharp
Company Secretary

24 May 2018

Board of Directors
F J Clutterbuck
N S Terrington
R J Woodman
J A Heron
A K Fletcher
P J N Hartill
H R Tudor
P J Newberry
B A Ridpath
F F Williamson
G H Yorston

CONDENSED FINANCIAL STATEMENTS

Consolidated Income Statement

For the six months ended 31 March 2018 (Unaudited)

	Note	**Six months to 31 March 2018**	Six months to 31 March 2017	Year to 30 September 2017
		£m	£m	£m
Interest receivable	*8*	**213.3**	203.8	409.2
Interest payable and similar charges	*9*	**(92.0)**	(90.3)	(176.6)
Net interest income		**121.3**	113.5	232.6
Other leasing income		**7.4**	7.6	14.4
Related costs		**(6.0)**	(5.5)	(11.4)
Net leasing income		**1.4**	2.1	3.0
Other income	*10*	**7.4**	8.1	17.2
Other operating income		**8.8**	10.2	20.2
Total operating income		**130.1**	123.7	252.8
Operating expenses		**(54.9)**	(50.4)	(102.3)
Provisions for losses		**(1.8)**	(3.2)	(5.3)
Operating profit before fair value items		**73.4**	70.1	145.2
Fair value net gains / (losses)	*11*	**3.8**	(0.7)	(0.4)
Operating profit being profit on ordinary activities before taxation		**77.2**	69.4	144.8
Tax charge on profit on ordinary activities	*12*	**(15.2)**	(13.0)	(27.6)
Profit on ordinary activities after taxation		**62.0**	56.4	117.2

	Note	**Six months to 31 March 2018**	Six months to 31 March 2017	Year to 30 September 2017
Basic earnings per share	*13*	**23.7p**	20.5p	43.1p
Diluted earnings per share	*13*	**23.0p**	19.9p	41.9p
Dividend - rate per share for the period	*27*	**5.5p**	4.7p	15.7p

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

Consolidated Statement of Comprehensive Income

For the six months ended 31 March 2018 (Unaudited)

	Note	**Six months to 31 March 2018**	Six months to 31 March 2017	Year to 30 September 2017
		£m	£m	£m
Profit for the period		**62.0**	56.4	117.2
Other comprehensive income / (expenditure)				
Items that will not be reclassified subsequently to profit or loss				
Actuarial (loss) / gain on pension plan	*23*	**(0.6)**	20.7	29.0
Tax thereon		**0.1**	(3.9)	(5.5)
		(0.5)	16.8	23.5
Items that may be reclassified subsequently to profit or loss				
Cash flow hedge gains / (losses) taken to equity		**0.6**	(0.6)	0.5
Tax thereon		**(0.1)**	0.1	(0.1)
		0.5	(0.5)	0.4
Other comprehensive income for the period net of tax		**-**	16.3	23.9
Total comprehensive income for the period		**62.0**	72.7	141.1

Consolidated Balance Sheet

31 March 2018 (Unaudited)

	Note	**31 March 2018 £m**	31 March 2017 £m	30 September 2017 £m	30 September 2016 £m
Assets					
Cash – central banks	*14*	**628.5**	408.5	615.0	315.0
Cash – retail banks	*14*	**434.1**	765.1	881.9	922.6
Short term investments	*15*	**10.0**	-	-	7.1
Loans to customers	*16*	**11,325.1**	10,947.7	11,115.4	10,750.0
Derivative financial assets	*18*	**763.4**	1,044.0	906.6	1,366.4
Sundry assets		**13.1**	18.4	12.7	12.7
Property, plant and equipment		**52.2**	43.0	46.2	39.2
Intangible assets	*19*	**120.3**	104.6	104.4	105.4
Total assets		**13,346.7**	13,331.3	13,682.2	13,518.4
Liabilities					
Short term bank borrowings		**1.0**	1.1	0.6	1.2
Retail deposits	*20*	**4,278.8**	2,347.7	3,611.9	1,874.7
Derivative financial liabilities	*18*	**6.2**	12.1	7.1	15.8
Asset backed loan notes	*21*	**5,457.7**	7,491.9	6,475.8	8,374.1
Secured bank borrowings	*21*	**1,013.5**	1,448.2	1,306.0	1,573.0
Retail bond issuance	*21*	**295.9**	295.5	295.7	295.3
Corporate bond issuance	*21*	**149.2**	259.1	149.1	259.0
Central bank facilities	*21*	**974.4**	345.0	700.0	-
Sundry liabilities	*22*	**99.1**	77.5	74.6	78.7
Current tax liabilities		**15.5**	15.3	17.4	16.7
Deferred tax liabilities		**5.0**	5.3	4.8	2.0
Retirement benefit obligations	*23*	**29.8**	38.4	29.8	58.4
Total liabilities		**12,326.1**	12,337.1	12,672.8	12,548.9
Called up share capital	*24*	**281.5**	296.5	281.5	295.9
Reserves	*25*	**837.1**	783.4	811.0	736.1
Own shares	*26*	**(98.0)**	(85.7)	(83.1)	(62.5)
Total equity		**1,020.6**	994.2	1,009.4	969.5
Total liabilities and equity		**13,346.7**	13,331.3	13,682.2	13,518.4

The condensed financial statements for the half year were approved by the Board of Directors on 24 May 2018.

Consolidated Cash Flow Statement

For the six months ended 31 March 2018 (Unaudited)

	Note	**Six months to 31 March 2018**	Six months to 31 March 2017	Year to 30 September 2017
		£m	£m	
Net cash flow generated by operating activities	*28*	**515.9**	324.3	1,474.7
Net cash (utilised) / generated by investing activities	*29*	**(17.2)**	4.9	3.2
Net cash (utilised) by financing activities	*30*	**(933.4)**	(393.1)	(1,218.0)
Net (decrease) / increase in cash and cash equivalents		**(434.7)**	(63.9)	259.9
Opening cash and cash equivalents		**1,496.3**	1,236.4	1,236.4
Closing cash and cash equivalents		**1,061.6**	1,172.5	1,496.3
Represented by balances within:				
Cash	*14*	**1,062.6**	1,173.6	1,496.9
Short term bank borrowings		**(1.0)**	(1.1)	(0.6)
		1,061.6	1,172.5	1,496.3

Consolidated Statement of Movements in Equity

For the six months ended 31 March 2018 (Unaudited)

Six months ended 31 March 2018

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Cash flow hedging reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m	£m
Transactions arising from								
Profit for the period	-	-	-	-	-	**62.0**	-	**62.0**
Other comprehensive income	-	-	-	-	**0.5**	**(0.5)**	-	-
Total comprehensive income	-	-	-	-	**0.5**	**61.5**	-	**62.0**
Transactions with owners								
Dividends paid (note 27)	-	-	-	-	-	**(28.9)**	-	**(28.9)**
Shares cancelled	-	-	-	-	-	-	-	-
Own shares purchased	-	-	-	-	-	-	**(25.2)**	**(25.2)**
Shares issued to ESOP	-	-	-	-	-	-	-	-
Exercise of share awards	-	**0.1**	-	-	-	**(10.3)**	**10.3**	**0.1**
Charge for share based remuneration	-	-	-	-	-	**2.4**	-	**2.4**
Tax on share based remuneration	-	-	-	-	-	**0.8**	-	**0.8**
Net movement in equity in the period	-	**0.1**	-	-	**0.5**	**25.5**	**(14.9)**	**11.2**
Opening equity	**281.5**	**65.5**	**28.7**	**(70.2)**	**2.5**	**784.5**	**(83.1)**	**1,009.4**
Closing equity	**281.5**	**65.6**	**28.7**	**(70.2)**	**3.0**	**810.0**	**(98.0)**	**1,020.6**

Six months ended 31 March 2017

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Cash flow hedging reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m	£m
Transactions arising from								
Profit for the period	-	-	-	-	-	56.4	-	56.4
Other comprehensive income	-	-	-	-	(0.5)	16.8	-	16.3
Total comprehensive income	-	-	-	-	(0.5)	73.2	-	72.7
Transactions with owners								
Dividends paid (note 27)	-	-	-	-	-	(25.4)	-	(25.4)
Shares cancelled	-	-	-	-	-	-	-	-
Own shares purchased	-	-	-	-	-	-	(27.0)	(27.0)
Shares issued to ESOP	-	-	-	-	-	-	-	-
Exercise of share awards	0.6	0.9	-	-	-	(3.8)	3.8	1.5
Charge for share based remuneration	-	-	-	-	-	2.3	-	2.3
Tax on share based remuneration	-	-	-	-	-	0.6	-	0.6
Net movement in equity in the period	0.6	0.9	-	-	(0.5)	46.9	(23.2)	24.7
Opening equity	295.9	64.6	13.7	(70.2)	2.1	725.9	(62.5)	969.5
Closing equity	296.5	65.5	13.7	(70.2)	1.6	772.8	(85.7)	994.2

Year ended 30 September 2017

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Cash flow hedging reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m	£m
Transactions arising from								
Profit for the year	-	-	-	-	-	117.2	-	117.2
Other comprehensive income	-	-	-	-	0.4	23.5	-	23.9
Total comprehensive income	-	-	-	-	0.4	140.7	-	141.1
Transactions with owners								
Dividends paid (note 27)	-	-	-	-	-	(38.0)	-	(38.0)
Shares cancelled	(15.0)	-	15.0	-	-	(45.1)	45.1	-
Own shares purchased	-	-	-	-	-	-	(69.7)	(69.7)
Shares issued to ESOP	-	-	-	-	-	-	-	-
Exercise of share awards	0.6	0.9	-	-	-	(4.0)	4.0	1.5
Charge for share based remuneration	-	-	-	-	-	4.2	-	4.2
Tax on share based remuneration	-	-	-	-	-	0.8	-	0.8
Net movement in equity in the year	(14.4)	0.9	15.0	-	0.4	58.6	(20.6)	39.9
Opening equity	295.9	64.6	13.7	(70.2)	2.1	725.9	(62.5)	969.5
Closing equity	281.5	65.5	28.7	(70.2)	2.5	784.5	(83.1)	1,009.4

SELECTED NOTES TO THE ACCOUNTS

For the six months ended 31 March 2018 (Unaudited)

1. GENERAL INFORMATION

The condensed financial statements are prepared for Paragon Banking Group PLC and its subsidiary companies ('the Group') on a consolidated basis.

The condensed financial statements for the six months ended 31 March 2018 and for the six months ended 31 March 2017 have not been audited, as defined in section 434 of the Companies Act 2006.

The figures shown above for the years ended 30 September 2017 and 30 September 2016 are not statutory accounts. A copy of the statutory accounts for each year has been delivered to the Registrar of Companies. The auditors reported on those statutory accounts and their reports 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.

A copy of the half-yearly financial report will be posted to those shareholders who have requested to receive one and additional copies can be obtained from the Company Secretary, Paragon Banking Group PLC, 51 Homer Road, Solihull, West Midlands, B91 3QJ.

This half-yearly financial report is also available on the Group's website at www.paragonbankinggroup.co.uk.

2. ACCOUNTING POLICIES

The condensed financial statements are presented in accordance with the requirements of International Accounting Standard 34 – 'Interim Financial Reporting'.

The Group prepares its annual financial statements in accordance with International Financial Reporting Standards as endorsed by the European Union. The condensed financial statements have been prepared on the basis of the accounting policies set out in the Annual Report and Accounts of the Group for the year ended 30 September 2017, which are expected to be used in the preparation of the financial statements of the Group for the year ending 30 September 2018.

The critical accounting estimates and judgements affecting the condensed financial information are the same as those described in note 6 to the accounts of the Group for the year ended 30 September 2017.

Change of presentation

In compiling the financial statements of the Group for the year ended 30 September 2017, certain presentational adjustments were made in response to an internal reorganisation carried out in September 2017. These changes have been reflected in the preparation of the financial information for the half year.

The changes made affect the presentation only, with the most significant change compared to the 31 March 2017 half year report being in the ordering of the balance sheet.

As a result of the new organisational structure, new reporting segments were adopted for the purposes of International Financial Reporting Standard 8 – 'Operating Segments' and thus the amounts in respect of the half year ended 31 March 2017 presented in note 7 differ from those originally reported.

Further information on these changes may be found in the Annual Report and Accounts for the year ended 30 September 2017.

New and revised reporting standards

No new or revised reporting standards significantly affecting the Group's accounting have been issued since the approval of the Group's financial statements for the year ended 30 September 2017.

The new accounting standard for financial instruments, IFRS 9, will apply to the Group for the first time for its financial statements for the year ending 30 September 2019. This standard has a significant impact on financial institutions, particularly on their provisioning for losses on loans, where recognition moves from an incurred to an expected loss basis. The impact of this standard on the Group and its project to ensure it is able to comply with it are described in note 3 of the financial statements for the year ended 30 September 2017.

During the period since that report the Group has continued to make progress towards implementation on 1 October 2018 and is confident that work so far completed, and the plans currently in place, will enable that target to be met.

A more detailed report on progress, together with the quantitative indications required by IAS 8 – 'Accounting Policies, Changes in Accounting Estimates and Errors' will be given in the Annual Report and Accounts for the year ending 30 September 2018.

Going concern basis

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 Interim Management Report on pages 6 to 28. The principal risks and uncertainties affecting the Group in the forthcoming six months are described on page 30.

Note 7 to the accounts for the year ended 30 September 2017 includes an analysis of the Group's working capital position and policies, while notes 8 to 11 include a detailed description of its funding structures, its use of financial instruments, its financial risk management objectives and policies and its exposure to credit, interest rate and liquidity risk. Note 6 to those accounts discusses critical accounting estimates affecting the results and financial position disclosed therein. The position and policies described in these notes remain materially unchanged to the date of this half-yearly report, subject to the changes in funding described in note 21.

The Group has a formalised process of budgeting, reporting and review. The Group's planning procedures forecast its profitability, capital position, funding requirement and cash flows. Detailed plans are produced for two year periods with longer term forecasts covering a five year period which include detailed income forecasts. These plans provide information to the directors which is used to ensure the adequacy of resources available for the Group to meet its business objectives, both on a short-term and strategic basis.

The Group's retail deposits of £4,285.8m (note 20) are repayable within five years, with 58.5% of this balance (£2,505.9m) 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 Committee. The Group is required to hold liquid assets in Paragon Bank to mitigate this liquidity risk. At 31 March 2018 Paragon Bank held £554.6m of the balance sheet assets for liquidity purposes, including £549.5m of central bank deposits (note 14) and £5.1m of short term investments (note 15). A further £108.9m of liquidity was provided by the Bank of England Funding for Lending Scheme, bringing the total to £663.5m.

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 pre-positioned assets give access to an additional £506.4m of further drawings.

The Group's securitisation funding structures ensure that both a substantial proportion of its originated loan portfolio and a significant amount of its acquired Idem Capital assets are match-funded. This proportion was increased by the issue of the Paragon Mortgages (No. 25) PLC securitisation in April 2018, after the period end. 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 earliest maturity of any of the Group's working capital debt is in December 2020, when the oldest of the Group's retail bond issues matures.

The Group's cash analysis continues to show strong free cash balances, even after allowing for significant discretionary cash flows, and its securitisation investments produce substantial cash flows.

The Group has demonstrated its ability to raise retail and corporate bond debt when required through its Euro Medium Term Note Programme and other programmes, while it accessed the long-term securitisation debt market in April 2018. The Group's access to debt is also enhanced by its corporate BBB- rating, upgraded to BBB by Fitch Ratings in April 2018, after the period end, and its status as an issuer is evidenced by the BB+ rating of its £150.0 million Tier-2 bond at issue (upgraded to BBB- in April 2018).

At 31 March 2018 the Group had free cash balances of £141.2m immediately available for use (note 14).

As described in note 4 the Group's capital base is subject to consolidated supervision by the PRA. Its capital at 31 March 2018 was in excess of regulatory requirements and group forecasts show this continuing to be the case.

Accounting standards require the directors to assess the Group's ability to continue to adopt the going concern basis of accounting. In performing this assessment, the directors consider all available information about the future, the possible outcomes of events and changes in conditions and the realistically possible responses to such events and conditions that would be available to them, having regard to those aspects of the 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting' published by the Financial Reporting Council in September 2014 applicable to half-yearly reporting.

In order to assess the appropriateness of the going concern basis the directors considered the Group's financial position, the cash flow requirements laid out in its forecasts, its access to funding, the assumptions underlying the forecasts and potential risks affecting them.

After performing this assessment, the directors concluded that it was appropriate for them to continue to adopt the going concern basis in preparing the half-yearly report.

3. FAIR VALUES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

IFRS 7 – 'Financial Instruments: Disclosures' requires that where assets are measured at fair value these measurements should be classified using a fair value hierarchy reflecting the inputs used, and defines three levels.

- Level 1 measurements are unadjusted market prices
- Level 2 measurements are derived from observable data, such as market prices or rates
- Level 3 measurements rely on significant inputs which are not derived from observable data

As quoted prices are not available for level 2 and 3 measurements, the valuation is derived from cash flow models based, where possible, on independently sourced parameters. The accuracy of the calculation would therefore be affected by unexpected market movements or other variances in the operation of the models or the assumptions used.

The Group had no financial assets or liabilities in the period ended 31 March 2018 or the year ended 30 September 2017 valued using level 3 measurements.

The Group has not reclassified any of its measurements during the period.

The methods by which fair value is established for each class of financial assets and liabilities are set out below.

a) Assets and liabilities carried at fair value

Derivative financial assets and liabilities

Derivative financial instruments are stated at their fair values in the accounts. The Group uses a number of techniques to determine the fair values of its derivative assets and liabilities, for which observable prices in active markets are not available. These are principally present value calculations based on estimated future cash flows arising from the instruments, discounted using a risk adjusted interest rate. The principal inputs to these valuation models are LIBOR benchmark interest rates for the currencies in which the instruments are denominated, being sterling, euros and dollars. The cross-currency basis swaps have a notional principal related to the outstanding currency borrowings and therefore the estimated rate of repayment of these notes also affects the valuation of the swaps. In order to determine the fair values, management applies valuation adjustments to observed data where that data would not fully reflect the attributes of the instrument being valued, such as particular contractual features or the identity of the counterparty. Management reviews the models used on an ongoing basis to ensure that the valuations produced are reasonable and reflect all relevant factors. These valuations are based on market information and they are therefore classified as level 2 measurements. Details of these assets are given in note 18.

Short term investments

The short term investments described in note 15 are freely traded securities for which a market price quotation is available and are classified as level 1 measurements.

b) Assets and liabilities carried at amortised cost

Cash, bank loans and securitisation borrowings

The fair values of cash and cash equivalents, bank loans and overdrafts and asset backed loan notes, which are carried at amortised cost are considered to be not materially different from their book values. In arriving at that conclusion market inputs have been considered but because all the assets mature within three months of the period end and the interest rates charged on financial liabilities reset to market rates on a quarterly basis, little difference arises.

While the Group's asset backed loan notes are listed, the quoted prices for an individual note may not be indicative of the fair value of the issue as a whole, due to the specialised nature of the market in such instruments and the limited number of investors participating in it.

As these valuation exercises are not wholly market based they are considered to be level 2 measurements.

Corporate debt

The Group's retail and corporate bonds are listed on the London Stock Exchange and there is presently a reasonably liquid market in the instruments. It is therefore appropriate to consider that the market price of these borrowings constitutes a fair value, however trading values have been subdued, which might lead to divergence of the quoted prices from a true market price. As this valuation is based on a market price, it is considered to be a level 1 measurement.

Retail deposits

To assess the likely fair value of the Group's retail deposit liabilities, the directors have considered the estimated cash flows expected to arise based on a mixture of market based inputs, such as rates and pricing and non-market based inputs such as redemption rates. Given the mixture of observable and non-observable inputs, these are considered to be level 2 measurements.

Loan assets

To assess the likely fair value of the Group's loan assets in the absence of a liquid market, the directors have considered the estimated cash flows expected to arise from the Group's investments in its loans to customers based on a mixture of market based inputs, such as rates and pricing and non-market based inputs such as redemption rates. Given the mixture of observable and non-observable inputs these are considered to be level 2 measurements.

Sundry assets and liabilities

Fair values of financial assets and liabilities disclosed as sundry assets and sundry liabilities are not considered to be materially different to their carrying values.

The fair values for financial assets and liabilities held at amortised cost, other than those where carrying values are so low that any difference would be immaterial, determined in accordance with the methodologies set out above is summarised below.

	31 March 2018	**31 March 2018**	31 March 2017	31 March 2017	30 September 2017	30 September 2017
	Carrying amount	**Fair value**	Carrying amount	Fair value	Carrying amount	Fair value
	£m	**£m**	£m	£m	£m	£m
Financial assets						
Loans and receivables						
Loans to customers	**11,346.7**	**11,424.2**	10,940.2	10,970.6	11,124.1	11,191.9
Cash and cash equivalents	**1,062.6**	**1,062.6**	1,173.6	1,173.6	1,496.9	1,496.9
	12,409.3	**12,486.8**	12,113.8	12,144.2	12,621.0	12,688.8
Financial liabilities						
Other liabilities						
Asset backed loan notes	**4,278.8**	**4,278.8**	7,491.9	7,491.9	6,475.8	6,475.8
Corporate and retail bonds	**445.1**	**483.4**	554.6	583.3	444.8	480.4
Retail deposits	**4,285.8**	**4,281.5**	2,347.4	2,354.7	3,615.4	3,615.1
Bank loans	**1,013.5**	**1,013.5**	1,448.2	1,448.2	1,306.0	1,306.0
	10,023.2	**10,057.2**	11,842.1	11,878.1	11,842.0	11,877.3

4. CAPITAL MANAGEMENT

The Group's objectives in managing capital are:

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

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

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

(a) Dividend policy

The Company is committed to a long term sustainable dividend policy. Ordinarily, dividends will increase in line with earnings, subject to the requirements of the business and the availability of cash resources. The Board reviews the policy at least twice a year in advance of announcing its results, taking into account the Group's strategy, capital requirements, principal risks and the objective of enhancing shareholder value. In determining the level of dividend for any year, the Board expects to follow the dividend policy, but will also take into account the level of available retained earnings in the Company, its cash resources and the cash and capital requirements inherent in its business plans.

The Board reviewed its dividend policy following the Group's reorganisation in September 2017, concluding that the changes made would make the Group's use of working capital more efficient and that there was, therefore, less need to retain earnings to support future growth. It therefore determined that the targeted dividend cover ratio would be reduced from 3.00 times, initially to 2.75 times for the year ended 30 September 2017 and then, subject to the requirements of the business, to 2.50 times. The Company considers it has access to sufficient cash resources to pay dividends at this level and that its distributable reserves are abundant for this purpose.

To provide greater transparency, the Company has also indicated that its interim dividend per share will normally be 50% of the previous final dividend, in the absence of any indicators which might make such a level of payment inappropriate, and the interim dividend for the current year has been set in accordance with this policy (note 27).

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

RoTE is defined by the Group by comparing the profit after tax for the period, 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 annualised RoTE for the six months ended 31 March 2018 is derived as follows:

	31 March 2018	31 March 2017	30 September 2017	30 September 2016
	£m	£m	£m	£m
Profit for the period	**62.0**	56.4	117.2	116.0
Amortisation of intangible assets	**0.9**	0.8	1.6	1.6
Adjusted profit	**62.9**	57.2	118.8	117.6
Divided by				
Opening equity	**1,009.4**	969.5	969.5	969.5
Opening intangible assets	**(104.4)**	(105.4)	(105.4)	(7.7)
Opening tangible equity	**905.0**	864.1	864.1	961.8
Closing equity	**1,020.6**	994.2	1,009.4	969.5
Closing intangible assets	**(120.3)**	(104.6)	(104.4)	(105.4)
Closing tangible equity	**900.3**	889.6	905.0	864.1
Average tangible equity	**902.6**	876.8	884.5	913.0
Return on Tangible Equity	**13.9%**	13.0%	13.4%	12.9%

(c) Gearing

The Board of Directors regularly review the proportion of working capital represented by debt and equity. Net debt is calculated as total debt, other than securitised and warehouse debt, valued at principal value, less free cash up to a maximum of the total debt. Adjusted equity comprises all components of equity (i.e. share capital, share premium, minority interest, retained earnings, and revaluation surplus) other than amounts recognised in equity relating to cash flow hedges.

The debt and equity amounts at 31 March 2018 were as follows:

	Note	**31 March 2018**	31 March 2017	30 September 2017	30 September 2016
		£m	£m	£m	£m
Debt					
Corporate bond		**150.0**	260.0	150.0	260.0
Retail bonds		**297.5**	297.5	297.5	297.5
Bank overdraft		**1.0**	1.1	0.6	1.2
Less: Applicable free cash	*14*	**(141.2)**	(277.2)	(305.5)	(383.1)
Net debt		**307.3**	281.4	142.6	175.6
Equity					
Total equity		**1,020.6**	994.2	1,009.4	969.5
Less: cash flow hedging reserve	*25*	**(3.0)**	(1.6)	(2.5)	(2.1)
Adjusted equity		**1,017.6**	992.6	1,006.9	967.4
Total working capital		**1,324.9**	1,274.0	1,149.5	1,143.0
Debt		**23.2%**	22.1%	12.4%	15.4%
Equity		**76.8%**	77.9%	87.6%	84.6%
Total working capital		**100.0%**	100.0%	100.0%	100.0%

(d) 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, which the Group is required to hold relative to its risk weighted assets in order to safeguard depositors from loss in the event of severe losses being incurred by the Group. This is defined by the international Basel III rules, set by the Basel Committee on Banking Supervision ('BCBS') and currently implemented in UK law by EU Regulation 575/2013, referred to as the Capital Requirements Regulation ('CRR').

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.

The tables below demonstrate that at 31 March 2018 the Group's total regulatory capital of £1,039.9m (31 March 2017: £1,021.9m, 30 September 2017: £1,030.5m) was comfortably in excess of the amounts required by the regulator, including £659.7m in respect of Pillar 1 and Pillar 2a capital, which is comprised of fixed and variable elements. The CRR also requires firms to hold additional capital buffers, including a Capital Conservation Buffer of 1.875% of risk weighted assets (at 31 March 2018) and a Counter Cyclical Buffer, currently 0% of risk weighted assets but increasing to 0.5% in June 2018. Firm specific buffers may also be required.

The Group's regulatory capital differs from its equity as certain adjustments are required by the CRR or the regulator. A reconciliation of the Group's equity to its regulatory capital determined in accordance with CRD IV at 31 March 2018 is set out below.

	Note	**31 March 2018**	31 March 2017	30 September 2017	30 September 2016
		£m	£m	£m	£m
Total equity	§	**1,020.6**	994.2	1,009.4	969.5
Deductions					
Proposed final dividend	*27*	**(14.2)**	(12.8)	(28.9)	(25.5)
Committed share buy-backs	‡	**-**	(10.8)	-	-
Intangible assets	*19*	**(120.3)**	(104.6)	(104.4)	(105.4)
Common Equity Tier 1 ('CET1') capital		**886.1**	866.0	876.1	838.6
Other tier 1 capital		**-**	-	-	-
Total tier 1 capital		**886.1**	866.0	876.1	838.6
Corporate bond		**150.0**	260.0	150.0	260.0
Less: amortisation adjustment	†	**-**	(108.8)	-	(97.8)
		150.0	151.2	150.0	162.2
Collectively assessed credit impairment allowances		**3.8**	4.7	4.4	4.8
Total tier 2 capital		**153.8**	155.9	154.4	167.0
Total regulatory capital		**1,039.9**	1,021.9	1,030.5	1,005.6

§ Including results for the six months ended 31 March 2018 which have been verified by the Group's external auditor for regulatory purposes.

‡ Buy-backs for which irrevocable purchase authority had been given to the Group's brokers under the share buy-back programme.

† When tier 2 capital instruments have less than five years to maturity the amount eligible as regulatory capital reduces by 20% per annum on a straight line basis. The Group's £110.0m Corporate Bond matured in April 2017 and therefore such an amortisation adjustment was required up to that date. No such adjustment is required in respect of the remaining Tier 2 Corporate Bond which matures in 2026.

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

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Credit risk			
Balance sheet assets	**5,066.1**	4,847.0	4,907.7
Off balance sheet	**79.4**	89.5	68.3
Total credit risk	**5,145.5**	4,936.5	4,976.0
Operational risk	**464.9**	445.7	464.9
Market risk	**-**	-	-
Other	**103.9**	59.4	67.8
Total risk exposure	**5,714.3**	5,441.6	5,508.7
Solvency ratios	**%**	%	%
CET1	**15.5**	15.9	15.9
Total regulatory capital	**18.2**	18.8	18.7

This table is not covered by the Independent Review Report

The CRD IV risk weightings for credit risk exposures are calculated using the Standardised Approach. Operational risk is calculated using the Basic Indicator Approach.

The table below shows the calculation of the UK leverage ratio, based on the consolidated balance sheet assets adjusted as shown below:

		Note	31 March 2018	31 March 2017	30 September 2017
			£m	£m	£m
Total balance sheet assets			**13,346.7**	13,331.3	13,682.2
Add:	Credit fair value adjustments on loans to customers	*16*	**21.6**	-	8.7
	Debit fair value adjustments on retail deposits	*20*	**7.0**	-	3.5
Adjusted balance sheet assets			**13,375.3**	13,331.3	13,694.4
Less:	Derivative assets	*18*	**(763.4)**	(1,044.0)	(906.6)
	Central bank deposits	*14*	**(628.5)**	(408.5)	(615.0)
	CRDs		**(2.4)**	-	(1.6)
On-balance sheet items			**11,981.0**	11,878.8	12,171.2
Less: Intangible assets		*19*	**(120.3)**	(104.6)	(104.4)
Total on balance sheet exposures			**11,860.7**	11,774.2	12,066.8
Derivative assets		*18*	**763.4**	1,044.0	906.6
Potential future exposure on derivatives			**170.7**	217.7	191.3
Total derivative exposures			**934.1**	1,261.7	1,097.9
Post offer pipeline at gross notional amount			**492.7**	458.9	417.9
Adjustment to convert to credit equivalent amounts			**(246.3)**	(229.5)	(208.9)
Off balance sheet items			**246.4**	229.4	209.0
Tier 1 capital			**886.1**	866.0	876.1
Total leverage exposure			**13,041.2**	13,265.3	13,373.7
UK leverage ratio			**6.8%**	6.5%	6.6%

This table not covered by the Independent Review Report

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

This leverage ratio is prescribed by the PRA and differs from the Basel / CRR ratio due to the exclusion of central bank deposits from exposures.

5. ACQUISITION OF ICEBERG

On 13 December 2017 the Group acquired the trade and assets of The Iceberg Partnerships LLP and on 20 December 2017 it acquired the trade and assets of Iceberg Client Credit LLP. These entities (together 'Iceberg') were related to each other. Iceberg is a finance broker and lender dealing with specialist business lending to mid-sized UK law firms and similar concerns. The acquisition allows the Group to increase the reach of its commercial finance operations to new products and customer groups.

The consideration for the acquisition will be satisfied entirely in cash. Cash transferred on completion was £6.6m, with a further payment made, following the agreement of completion accounts, of £0.2m.

Further contingent consideration is payable in cash, up to a maximum of £13.0m based on the future performance of the acquired business. £11.8m 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 £0.2m have been included in operating expenses for the six months ended 31 March 2018.

The post-acquisition contribution of Iceberg to consolidated revenue for the six months ended 31 March 2018 was £0.5m and its contribution to consolidated profit before tax for the period was £nil.

Had the acquisition taken place on 1 October 2017, the consolidated revenue of the Group for the six months ended 31 March 2018 would have been £222.3m and its consolidated profit before tax for the period would have been £77.2m.

The amounts recognised in the consolidated accounts on acquisition in respect of the identifiable assets acquired 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 period 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 2018.

	Note	**£m**
Assets		
Loans to customers	*a*	**2.0**
Intangible assets	*b*	**0.1**
Total net identifiable assets		**2.1**
Goodwill	*c*	**16.5**
Consideration	*d*	**18.6**

a) Loans to customers

The financial assets acquired comprised loans to individuals in advance of amounts which become payable in respect of probate and matrimonial legal processes. Their fair value was £2.0m, the gross contractual value was £2.1m and the contractual flows not to be collected were £0.1m.

b) Intangible assets

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

c) Goodwill

The goodwill of £16.5m 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	**6.6**
Consideration paid on agreement of completion accounts	**0.2**
Contingent consideration	**11.8**
Total consideration	**18.6**

6. 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 31 March 2018, 31 March 2017 and 30 September 2017 are analysed as follows:

	31 March 2018		31 March 2017		30 September 2017	
	£m	**%**	£m	%	£m	%
Buy-to-let mortgages	**9,966.7**	**87.9%**	9,700.0	88.7%	9,836.5	88.4%
Owner-occupied mortgages	**39.0**	**0.3%**	17.2	0.2%	19.0	0.2%
Total first mortgages	**10,005.7**	**88.2%**	9,717.2	88.9%	9,855.5	88.6%
Second charge mortgage loans	**471.3**	**4.2%**	509.2	4.6%	490.7	4.4%
Loans secured on residential property	**10,477.0**	**92.4%**	10,226.4	93.5%	10,346.2	93.0%
Development finance	**57.0**	**0.5%**	31.2	0.3%	42.3	0.4%
Commercial mortgages	**1.1**	**-**	2.9	-	2.7	-
Loans secured on property	**10,535.1**	**92.9%**	10,260.5	93.8%	10,391.2	93.4%
Motor finance loans	**195.4**	**1.7%**	124.0	1.1%	163.0	1.5%
Other consumer loans	**189.6**	**1.7%**	244.9	2.2%	219.1	2.0%
Asset finance loans	**361.8**	**3.2%**	289.0	2.7%	325.0	2.9%
Professions finance	**36.7**	**0.3%**	-	-	-	-
Factoring and discounting balances	**22.7**	**0.2%**	20.9	0.2%	23.8	0.2%
Other commercial loans	**5.4**	**-**	0.9	-	2.0	-
Total loans to customers	**11,346.7**	**100.0%**	10,940.2	100.0%	11,124.1	100.0%

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

Professions finance includes loans originated by the acquired Iceberg business (note 5). These are generally short term unsecured loans made to lawyers and accountants for working capital purposes.

An analysis of the indexed loan to value ratio ('LTV') for those loan accounts secured on residential property by value at 31 March 2018 is set out below. For acquired accounts the effect of any discount on purchase is allowed for.

	31 March 2018		31 March 2017		30 September 2017	
	First mortgages	**Secured loans**	First mortgages	Secured loans	First mortgages	Secured loans
	%	**%**	%	%	%	%
Loan to value ratio						
Less than 70%	**60.0**	**58.4**	61.0	53.1	62.1	56.7
70% to 80%	**27.9**	**18.1**	23.1	17.7	25.0	17.5
80% to 90%	**9.2**	**11.4**	10.9	11.9	9.5	11.5
90% to 100%	**0.9**	**6.4**	2.7	8.3	1.3	7.1
Over 100%	**2.0**	**5.7**	2.3	9.0	2.1	7.2
	100.0	**100.0**	100.0	100.0	100.0	100.0
Average loan to value ratio	**66.5**	**68.8**	67.1	71.9	66.3	70.0
of which						
Buy-to-let	**66.6**		67.2		66.4	
Owner-occupied	**44.6**		27.5		30.9	

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 increase of 0.4% during the six months ended 31 March 2018 and annual increases of 2.1% in the year ended 31 March 2018 and 2.0% in the year ended 30 September 2017.

The increase in the loan to value ratio for owner occupied accounts relates to the greater numbers of new lending accounts, which have higher LTV levels than old legacy cases.

The number of accounts in arrears by asset class, based on the most commonly quoted definition of arrears for the type of asset, at 31 March 2018, 31 March 2017 and 30 September 2017, compared to the industry averages at those dates published by UK Finance ('UKF') and the Finance and Leasing Association ('FLA'), was:

	31 March 2018	31 March 2017	30 September 2017
	%	%	%
First mortgages			
Accounts more than three months in arrears			
Buy-to-let accounts including receiver of rent cases	**0.09**	0.09	0.08
Buy-to-let accounts excluding receiver of rent cases	**0.02**	0.01	0.02
Owner-occupied accounts	**2.60**	3.00	3.55
UKF data for mortgage accounts more than three months in arrears			
Buy-to-let accounts including receiver of rent cases	**0.42**	0.47	0.45
Buy-to-let accounts excluding receiver of rent cases	**0.38**	0.43	0.41
Owner-occupied accounts	**0.90**	0.99	0.95
All mortgages	**0.81**	0.90	0.86
Second charge mortgage loans			
Accounts more than 2 months in arrears			
All accounts	**18.17**	17.52	17.55
Post-2010 originations	**0.00**	0.00	0.06
Legacy cases	**16.94**	16.67	16.75
Purchased assets	**21.06**	19.24	19.69
FLA data for second mortgages	**10.60**	11.90	11.10
Car loans			
Accounts more than 2 months in arrears	**0.78**	0.45	0.67
FLA data for consumer hire purchase	**2.50**	2.00	2.20
Asset finance loans			
Accounts more than 2 months in arrears	**0.97**	0.98	0.97
FLA data for business lease / hire purchase loans	**0.80**	0.70	0.60

No published industry data for asset classes comparable to the Group's other books has been identified. Where revised data at 31 March 2017 or 30 September 2017 has been published by the FLA or UKF, the comparative industry figures above have been amended.

Arrears information is not given for development finance or factoring activities as the structure of the products means that such a measure is not relevant. Other consumer loans consist primarily of purchased credit impaired assets.

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

The number of accounts in arrears will naturally be higher for legacy books, such as the Group's legacy second charge mortgages and residential first mortgages than for comparable active ones, as performing accounts pay off their balances, leaving arrears accounts representing a greater proportion of the total.

The figures shown above for secured 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. However this will lead to higher than average reported arrears.

The payment status of the carrying balances of the Group's live loan assets, before provision for impairment, at 31 March 2018, 31 March 2017 and at 30 September 2017 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, shown in note 17, 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

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Performing accounts (less than 3 months arrears)	**9,986.6**	9,694.9	9,836.8
Impairment population	**32.6**	37.0	33.2
	10,019.2	9,731.9	9,870.0

Consumer and Asset Finance

	Second charge mortgage loans	**Motor finance loans**	**Asset finance loans**	**Total**
	£m	**£m**	**£m**	**£m**
31 March 2018				
Performing accounts (less than 2 months arrears)	**403.1**	**195.1**	**410.1**	**1,008.3**
Impairment population	**68.7**	**1.5**	**6.4**	**76.6**
	471.8	**196.6**	**416.5**	**1,084.9**
31 March 2017				
Performing accounts (less than 2 months arrears)	433.2	124.0	293.4	850.6
Impairment population	81.0	0.8	4.9	86.7
	514.2	124.8	298.3	937.3
30 September 2017				
Performing accounts (less than 2 months arrears)	421.3	163.0	325.3	909.6
Impairment population	73.6	1.3	4.0	78.9
	494.9	164.3	329.3	988.5

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

Almost all of the Group's unsecured consumer loan assets are part of purchased debt portfolios where the consideration paid will have been based on the credit quality and performance of the loans at the point of the transaction. Collections on purchased accounts have been comfortably in excess of those implicit in the purchase prices.

In the debt purchase industry, Estimated Remaining Collections ('ERC') is commonly used as a measure of the value of a portfolio. This is defined as the sum of the undiscounted cash flows expected to be received over a specified future period. In the Group's view, this measure may be suitable for heavily discounted, unsecured, distressed portfolios, 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.

However, to aid comparability, the 84 and 120 month ERC values for the Group's purchased assets are set out below. These are derived from the same models and assumptions used in the effective interest rate calculations.

	31 March 2018	31 March 2017	30 September 2017	30 September 2016
	£m	£m	£m	£m
Carrying value				
Loans to customers	**452.3**	555.8	503.5	533.9
84 Month ERC				
Loans to customers	**543.5**	670.8	608.9	651.3
120 Month ERC				
Loans to customers	**615.2**	762.4	688.8	740.7

Amounts shown as loans to customers above include loans disclosed as consumer loans and first mortgages (note 16).

7. SEGMENTAL RESULTS

Following the reorganisation announced in the previous year, the Group now analyses its operations, both for internal management information and external financial reporting, on the basis of the markets from which its assets are generated. The segments used are described below:

- Mortgages, including the Group's buy-to-let, and owner-occupied first and second charge lending and related activities
- Commercial Lending, including the Group's motor finance and other equipment leasing activities, together with other offerings targeted towards SME customers
- Idem Capital, including loan assets acquired from third parties and legacy assets which share certain credit characteristics with them

The acquired Iceberg business (note 5) is included in the Commercial Lending segment.

Dedicated financing and administration costs of each of these businesses are allocated to the segment. Shared central costs are not allocated between segments, and neither is income from central cash balances nor the carrying costs of unallocated savings balances.

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

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

Other assets are not allocated between segments.

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.

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

Six months ended 31 March 2018

	Mortgages	Commercial Lending	Idem Capital	Unallocated items	Total
	£m	£m	£m	£m	£m
Interest receivable	**145.1**	**19.6**	**46.8**	**1.8**	**213.3**
Interest payable	**(67.3)**	**(7.3)**	**(5.2)**	**(12.2)**	**(92.0)**
Net interest income	**77.8**	**12.3**	**41.6**	**(10.4)**	**121.3**
Other operating income	**3.8**	**4.7**	**0.3**	**-**	**8.8**
Total operating income	**81.6**	**17.0**	**41.9**	**(10.4)**	**130.1**
Direct costs	**(7.4)**	**(10.5)**	**(4.8)**	**(32.2)**	**(54.9)**
Provision for losses	**(1.9)**	**(0.3)**	**0.4**	**-**	**(1.8)**
	72.3	**6.2**	**37.5**	**(42.6)**	**73.4**

Six months ended 31 March 2017

	Mortgages	Commercial Lending	Idem Capital	Unallocated items	Total
	£m	£m	£m	£m	£m
Interest receivable	135.8	16.1	51.1	0.8	203.8
Interest payable	(62.3)	(5.1)	(5.8)	(17.1)	(90.3)
Net interest income	73.5	11.0	45.3	(16.3)	113.5
Other operating income	4.3	5.5	0.4	-	10.2
Total operating income	77.8	16.5	45.7	(16.3)	123.7
Direct costs	(6.6)	(10.2)	(5.3)	(28.3)	(50.4)
Provision for losses	(2.7)	0.3	(0.8)	-	(3.2)
	68.5	6.6	39.6	(44.6)	70.1

Year ended 30 September 2017

	Mortgages	Commercial Lending	Idem Capital	Unallocated items	Total
	£m	£m	£m	£m	£m
Interest receivable	274.7	33.8	98.9	1.8	409.2
Interest payable	(123.6)	(10.6)	(11.4)	(31.0)	(176.6)
Net interest income	151.1	23.2	87.5	(29.2)	232.6
Other operating income	9.6	9.9	0.7	-	20.2
Total operating income	160.7	33.1	88.2	(29.2)	252.8
Direct costs	(13.7)	(18.9)	(10.8)	(58.9)	(102.3)
Provision for losses	(3.7)	(0.1)	(1.5)	-	(5.3)
	143.3	14.1	75.9	(88.1)	145.2

The segmental profits disclosed above reconcile to the consolidated results as shown below:

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Results shown above	**73.4**	70.1	145.2
Fair value items	**3.8**	(0.7)	(0.4)
Operating profit	**77.2**	69.4	144.8

The assets of the segments listed above are:

	31 March 2018	31 March 2017	30 September 2017	30 September 2016
	£m	£m	£m	£m
Mortgages	**11,193.1**	11,292.1	11,393.2	11,519.8
Commercial Lending	**710.0**	468.9	582.2	391.0
Idem Capital	**581.1**	706.9	642.4	744.6
Total segment assets	**12,484.2**	12,467.9	12,617.8	12,655.4
Unallocated assets	**862.5**	863.4	1,064.4	863.0
Total assets	**13,346.7**	13,331.3	13,682.2	13,518.4

An analysis of the Group's loan assets by type and segment are shown in note 16.

8. INTEREST RECEIVABLE

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Interest receivable in respect of			
Loans and receivables	**198.0**	187.2	375.1
Finance leases	**11.6**	14.1	28.8
Factoring income	**1.2**	1.0	2.2
Interest on loans to customers	**210.8**	202.3	406.1
Other interest receivable	**2.5**	1.5	3.1
Total interest on financial assets	**213.3**	203.8	409.2

9. INTEREST PAYABLE AND SIMILAR CHARGES

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
On retail deposits	**37.8**	20.1	47.9
On asset backed loan notes	**27.2**	40.1	70.2
On bank loans and overdrafts	**8.8**	11.6	22.7
On corporate bonds	**5.5**	7.6	13.1
On retail bonds	**9.3**	9.2	18.6
On central bank facilities	**2.1**	0.3	1.1
Total interest on financial liabilities	**90.7**	88.9	173.6
On pension scheme deficit (note 23)	**0.4**	0.7	1.3
Discounting on contingent consideration	**0.2**	0.1	0.3
Other finance costs	**0.7**	0.6	1.4
	92.0	90.3	176.6

10. OTHER INCOME

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Loan account fee income	**4.3**	4.3	9.0
Broker commissions	**1.1**	1.9	3.6
Third party servicing	**1.5**	1.7	3.3
Other income	**0.5**	0.2	1.3
	7.4	8.1	17.2

11. FAIR VALUE NET GAINS / (LOSSES)

The fair value net gain / (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 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.

Foreign exchange gains of £158.8m on asset backed loan notes denominated in US Dollars and Euros (31 March 2017: gains of £322.0m; 30 September 2017: gains of £468.9m) have been offset against movements on the cross currency basis swaps used to hedge these liabilities as part of the cash flow hedge accounting treatment applied.

12. TAX CHARGE ON PROFIT ON ORDINARY ACTIVITIES

Income tax for the six months ended 31 March 2018 is charged at an effective rate of 19.7% (six months ended 31 March 2017: 18.7%, year ended 30 September 2017: 19.1%), representing the best estimate of the annual effective rate of income tax expected for the full year, applied to the pre-tax income of the period.

The increase in the period is principally attributable to the application of the Bank Corporation Tax Surcharge to a greater proportion of the Group's activities, partially offset by a reduction in the UK Corporation Tax rate applicable to the Group from 19.5% in the year ended 30 September 2017 to 19.0% in the current year.

13. EARNINGS PER SHARE

Earnings per ordinary share is calculated as follows:

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Profit for the period (£m)	**62.0**	56.4	117.2
Basic weighted average number of ordinary shares ranking for dividend during the period (m)	**262.1**	275.4	271.6
Dilutive effect of the weighted average number of share options and incentive plans in issue during the period (m)	**7.5**	7.4	8.0
Diluted weighted average number of ordinary shares ranking for dividend during the period (m)	**269.6**	282.8	279.6
Earnings per ordinary share			
- basic	**23.7p**	20.5p	43.1p
- diluted	**23.0p**	19.9p	41.9p

14. CASH AND CASH EQUIVALENTS

	31 March 2018	31 March 2017	30 September 2017	30 September 2016
	£m	£m	£m	£m
Balances with central banks	**628.5**	408.5	615.0	315.0
Balances with other banks	**434.1**	765.1	881.9	922.6
	1,062.6	1,173.6	1,496.9	1,237.6

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

Balances with central banks includes deposits which form part of the liquidity buffer of Paragon Bank PLC and are therefore not available for the Group's general purposes. Free cash may also be deposited at the Bank of England.

Cash held by the Trustees of the Paragon Employee Share Ownership Plans may only be used to invest in the shares of the Company, pursuant to the aims of those plans. This is shown as 'ESOP cash' below.

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

	31 March 2018	31 March 2017	30 September 2017	30 September 2016
	£m	£m	£m	£m
Free cash	**141.2**	277.2	305.5	383.1
Securitisation cash	**369.5**	485.5	574.0	537.1
Liquidity buffer	**549.5**	408.5	615.0	315.0
ESOP cash	**2.4**	2.4	2.4	2.4
	1,062.6	1,173.6	1,496.9	1,237.6

15. SHORT TERM INVESTMENTS

This amount represents treasury bills and other liquid securities 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 market value.

£5.1m of this balance is directly part of the bank's liquidity while £4.9m is prepositioned to give access to drawings on central bank facilities.

16. LOANS TO CUSTOMERS

	31 March 2018	31 March 2017	30 September 2017	30 September 2016
	£m	£m	£m	£m
Loans to customers	**11,346.7**	10,940.2	11,124.1	10,737.5
Fair value adjustments from portfolio hedging	**(21.6)**	7.5	(8.7)	12.5
	11,325.1	10,947.7	11,115.4	10,750.0

The Group's loan assets at 31 March 2018, analysed between the segments described in note 7 are as follows:

	Mortgages	**Commercial Lending**	**Idem Capital**	**Total**
	£m	**£m**	**£m**	**£m**
At 31 March 2018				
First mortgages	**10,005.7**	**-**	**-**	**10,005.7**
Consumer loans	**113.8**	**-**	**547.1**	**660.9**
Motor finance	**-**	**195.4**	**-**	**195.4**
Asset finance	**-**	**361.8**	**-**	**361.8**
Development finance	**-**	**57.0**	**-**	**57.0**
Other commercial loans	**-**	**65.9**	**-**	**65.9**
Loans to customers	**10,119.5**	**680.1**	**547.1**	**11,346.7**
At 31 March 2017				
First mortgages	9,717.2	-	-	9,717.2
Consumer loans	78.1	-	676.0	754.1
Motor finance	-	124.0	-	124.0
Asset finance	-	289.0	-	289.0
Development finance	-	31.2	-	31.2
Other commercial loans	-	24.7	-	24.7
Loans to customers	9,795.3	468.9	676.0	10,940.2
At 30 September 2017				
First mortgages	9,855.5	-	-	9,855.5
Consumer loans	98.4	-	611.4	709.8
Motor finance	-	163.0	-	163.0
Asset finance	-	325.0	-	325.0
Development finance	-	42.3	-	42.3
Other commercial loans	-	28.5	-	28.5
Loans to customers	9,953.9	558.8	611.4	11,124.1
At 30 September 2016				
First mortgages	9,640.6	-	-	9,640.6
Consumer loans	54.1	-	667.8	721.9
Motor finance	-	95.3	-	95.3
Asset finance	-	250.4	-	250.4
Development finance	-	9.1	-	9.1
Other commercial loans	-	20.2	-	20.2
Loans to customers	9,694.7	375.0	667.8	10,737.5

17. 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 30 September 2017	**89.1**	**18.3**	**3.2**	**110.6**
Provided in the period	**2.0**	**(0.4)**	**0.3**	**1.9**
Amounts written off	**(3.1)**	**(4.9)**	**(0.3)**	**(8.3)**
At 31 March 2018	**88.0**	**13.0**	**3.2**	**104.2**
At 30 September 2016	88.8	22.6	1.2	112.6
Provided in the period	2.8	1.2	1.0	5.0
Amounts written off	(1.9)	(3.3)	(0.1)	(5.3)
At 31 March 2017	89.7	20.5	2.1	112.3
At 30 September 2016	88.8	22.6	1.2	112.6
Provided in the period	3.8	2.3	2.2	8.3
Amounts written off	(3.5)	(6.6)	(0.2)	(10.3)
At 30 September 2017	89.1	18.3	3.2	110.6

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

	First mortgages	Other loans and receivables	Finance leases	Total
	£m	£m	£m	£m
At 31 March 2018	**76.2**	**-**	**0.5**	**76.7**
At 31 March 2017	75.6	-	0.1	75.7
At 30 September 2017	76.4	0.3	0.3	77.0

The amounts charged to the profit and loss account, net of recoveries of previously provided amounts are set out below.

	First mortgages	Other loans and receivables	Finance leases	Total
	£m	£m	£m	£m
Six months ended 31 March 2018				
Amounts provided in the period	**2.0**	**(0.4)**	**0.3**	**1.9**
Recovery of amounts previously provided	**(0.1)**	**-**	**-**	**(0.1)**
Net impairment for period	**1.9**	**(0.4)**	**0.3**	**1.8**
Six months ended 31 March 2017				
Amounts provided in the period	2.8	1.2	1.0	5.0
Recovery of amounts previously provided	(0.1)	(0.3)	(1.4)	(1.8)
Net impairment for period	2.7	0.9	(0.4)	3.2
Year ended 30 September 2017				
Amounts provided in the year	3.8	2.3	2.2	8.3
Recovery of amounts previously provided	(0.1)	(0.7)	(2.2)	(3.0)
Net impairment for year	3.7	1.6	-	5.3

18. DERIVATIVE FINANCIAL ASSETS AND LIABILITES

	31 March 2018	31 March 2017	30 September 2017	30 September 2016
	£m	£m	£m	£m
Derivative financial assets	**763.4**	1,044.0	906.6	1,366.4
Derivative financial liabilities	**(6.2)**	(12.1)	(7.1)	(15.8)
	757.2	1,031.9	899.5	1,350.6
Of which:				
Foreign exchange basis swaps	**738.1**	1,042.2	896.3	1,364.8
Other derivatives	**19.1**	(10.3)	3.2	(14.2)
	757.2	1,031.9	899.5	1,350.6

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.

19. INTANGIBLE ASSETS

Intangible assets at net book value comprise:

	31 March 2018	31 March 2017	30 September 2017	30 September 2016
	£m	£m	£m	£m
Goodwill	**114.6**	98.0	98.1	98.4
Computer software	**1.6**	1.9	2.0	2.1
Other intangibles	**4.1**	4.7	4.3	4.9
Total assets	**120.3**	104.6	104.4	105.4

Goodwill and the other intangibles at 31 March 2018 included the additions arising from the acquisition described in note 5.

20. 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:

	31 March 2018	31 March 2017	30 September 2017	30 September 2016
	£m	£m	£m	£m
Fixed rate	**3,210.6**	1,514.8	2,675.9	1,332.5
Variable rates	**1,075.2**	832.6	939.5	541.4
	4,285.8	2,347.4	3,615.4	1,873.9

The weighted average interest rate on retail deposits, analysed by charging method, was:

	31 March 2018	31 March 2017	30 September 2017	30 September 2016
	%	%	%	%
Fixed rate	**1.90**	1.99	1.89	2.11
Variable rates	**1.30**	1.22	1.21	1.65

The contractual maturity of these deposits is analysed below.

	31 March 2018	31 March 2017	30 September 2017	30 September 2016
	£m	£m	£m	£m
Amounts repayable				
In less than three months	**293.8**	115.6	211.4	55.7
In more than three months but not more than one year	**1,470.5**	823.6	1,399.6	690.3
In more than one year, but not more than two years	**1,081.8**	452.7	770.0	572.9
In more than two years, but not more than five years	**698.1**	396.4	629.7	283.9
Total term deposits	**3,544.2**	1,788.3	3,010.7	1,602.8
Repayable on demand	**741.6**	559.1	604.7	271.1
	4,285.8	2,347.4	3,615.4	1,873.9
Fair value adjustments for portfolio hedging	**(7.0)**	0.3	(3.5)	0.8
	4,278.8	2,347.7	3,611.9	1,874.7

21. BORROWINGS

On 6 April 2018, after the period end, Fitch Ratings announced an upgrade of the Group's Long-Term Issuer Default Rating and its senior unsecured debt rating to BBB from BBB-. Consequentially the rating of the Group's £150.0m Tier 2 Bond was also upgraded one notch from BB+ to BBB-.

All borrowings described in the Group Accounts for the year ended 30 September 2017 remained in place throughout the period, except as noted below.

During the period the Group continued to access facilities provided by the Bank of England. The Term Funding Scheme ('TFS') continued to be drawn upon until it ceased to be available for new drawings in February 2018 and since that time the Indexed Long-Term Repo ('ILTR') scheme has been accessed.

Of the Group's borrowings at 30 September 2017, the mortgage backed floating rate notes issued by Paragon Mortgages (No. 8) PLC were repaid in January 2018, following the purchase of its loan assets by other group companies, principally Paragon Bank PLC.

During the period, the warehouse facility in Paragon Seventh Funding Limited was not renewed and was paid down. This has reduced the Group's available warehouse capacity by £200.0m.

After the period end, on 25 April 2018, a Group company, Paragon Mortgages (No. 25) PLC, issued £435.3m of sterling mortgage backed floating rate notes to external investors at par. £375.0m of the notes were class A notes, rated AAA by Fitch and Aaa by Moody's, £31.8m were class B notes, rated AA by Fitch and Aa1 by Moody's and £28.5m were class C notes rated A- by Fitch and A1 by Moody's. The interest rates above LIBOR on the notes were 0.65% on the A notes, 0.95% on the B notes and 1.30% on the C notes. The initial average interest margin on the transaction was 0.72% and the proceeds were used to refinance existing short term liabilities. The Group retained £289.4m of notes of various classes meaning that its investment represented 39.9% of the issued notes.

Repayments made in respect of the Group's borrowings are shown in note 30.

22. SUNDRY LIABILITIES

Sundry liabilities include £43.5m of amounts falling due after more than one year (31 March 2017: £23.1m; 30 September 2017: £23.5m). Deferred consideration of £26.1m, falling due after more than one year, is included in the sundry liabilities balance (31 March 2017: £13.6m; 30 September 2017: £14.0m).

23. RETIREMENT BENEFIT OBLIGATIONS

The defined benefit obligation at 31 March 2018 has been calculated on a year-to-date basis. Since the last IAS 19 actuarial valuation at 30 September 2017 there have been movements in financial conditions, requiring an adjustment to the actuarial assumptions underlying the calculation of the defined benefit obligation at 31 March 2018. In particular, over the period since the 30 September 2017 actuarial valuation, the discount rate has decreased by 0.05% per annum, whereas expectations of long term inflation have decreased by 0.10% per annum.

The net effect of these changes together with the Group's contribution and the performance of the plan assets, has resulted in the value of the defined benefit obligation at 31 March 2018 remaining the same as at 30 September 2017. The impact of allowing for the change in actuarial assumptions has been recognised as an actuarial gain in other comprehensive income.

The movements in the deficit on the defined benefit plan during the six month period ended 31 March 2018 are summarised below.

	Six months to 31 March 2018	Six months to 31 March 2017	Year to 30 September 2017
	£m	£m	£m
Opening pension deficit	**29.8**	58.4	58.4
Service cost	**0.9**	1.3	2.4
Net funding cost (note 9)	**0.4**	0.7	1.3
Administrative expenses	**0.3**	0.2	0.4
Employer contributions	**(2.2)**	(1.5)	(3.7)
Amounts posted to other comprehensive income			
Return on plan assets not included in interest	**0.7**	(5.3)	(7.4)
Experience (gain) on liabilities	**-**	(4.3)	(4.2)
Actuarial (gain) from changes in financial assumptions	**(0.1)**	(4.4)	(10.7)
Actuarial (gain) from changes in demographic assumptions	**-**	(6.7)	(6.7)
Closing pension deficit	**29.8**	38.4	29.8

During the six month period, pursuant to the recovery plan agreed with the Trustee, the Group entered into a transaction with the pension plan, effectively granting a first charge over its freehold head office building as security for its agreed contributions.

24. CALLED-UP SHARE CAPITAL

Movements in the issued share capital in the period were:

	Six months to 31 March 2018	Six months to 31 March 2017	Year to 30 September 2017
	Number	Number	Number
Ordinary shares of £1 each			
At 1 October 2017	**281,489,701**	295,852,094	295,852,094
Shares issued	**7,583**	608,205	637,607
Shares cancelled	**-**	-	(15,000,000)
At 31 March 2018	**281,497,284**	296,460,299	281,489,701

During the period the Company issued 7,583 shares (six months ended 31 March 2017: 608,205; year ended 30 September 2017: 637,607) to satisfy options granted under sharesave schemes for a consideration of £22,548 (six months ended 31 March 2017: £1,495,848; year ended 30 September 2017: £1,575,925).

25. RESERVES

	31 March 2018	31 March 2017	30 September 2017	30 September 2016
	£m	£m	£m	£m
Share premium account	**65.6**	65.5	65.5	64.6
Capital redemption reserve	**28.7**	13.7	28.7	13.7
Merger reserve	**(70.2)**	(70.2)	(70.2)	(70.2)
Cash flow hedging reserve	**3.0**	1.6	2.5	2.1
Profit and loss account	**810.0**	772.8	784.5	725.9
	837.1	783.4	811.0	736.1

26. OWN SHARES

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Treasury shares			
At 1 October 2017	**66.6**	46.2	46.2
Shares purchased	**25.2**	27.0	65.5
Shares cancelled	**-**	-	(45.1)
At 31 March 2018	**91.8**	73.2	66.6
ESOP shares			
At 1 October 2017	**16.5**	16.3	16.3
Shares purchased	**-**	-	4.2
Shares subscribed for	**-**	-	-
Options exercised	**(10.3)**	(3.8)	(4.0)
At 31 March 2018	**6.2**	12.5	16.5
Total at 31 March 2018	**98.0**	85.7	83.1
Total at 1 October 2017	**83.1**	62.5	62.5
Number of shares held			
Treasury	**20,800,284**	21,910,963	15,693,643
ESOP	**1,608,146**	2,229,107	3,180,661
Total at 31 March 2018	**22,408,430**	24,140,070	18,874,304

27. EQUITY DIVIDEND

Amounts recognised as distributions to equity shareholders in the period:

	Six months to 31 March 2018	Six months to 31 March 2017	Year to 30 September 2017
	£m	£m	£m
Final dividend for the year ended 30 September 2017 of 11.0p per share	**28.9**	-	-
Final dividend for the year ended 30 September 2016 of 9.2p per share	**-**	25.4	25.5
Interim dividend for the year ended 30 September 2017 of 4.7p per share	**-**	-	12.5
	28.9	25.4	38.0

An interim dividend of 5.5p per share is proposed (2017: 4.7p per share), payable on 27 July 2018 with a record date of 6 July 2018. The amount expected to be absorbed by this dividend, based on the number of shares in issue at the balance sheet date is £14.2m (31 March 2017: £12.5m). The interim dividend will be recognised in the accounts when it is paid.

28. NET CASH FLOW FROM OPERATING ACTIVITIES

	Six months to 31 March 2018	Six months to 31 March 2017	Year to 30 September 2017
	£m	£m	£m
Profit before tax	**77.2**	69.4	144.8
Non-cash items included in profit and other adjustments			
Depreciation of property, plant and equipment	**0.9**	0.9	1.9
Profit on disposal of property, plant and equipment	**(0.1)**	(0.1)	(0.1)
Amortisation of intangible assets	**0.9**	0.8	1.6
Foreign exchange movement on borrowings	**(158.8)**	(322.0)	(468.9)
Other non-cash movements on borrowings	**2.9**	1.9	6.4
Impairment losses on loans to customers	**1.8**	3.2	5.3
Charge for share based remuneration	**2.4**	2.3	4.2
Net (increase) / decrease in operating assets			
Operating lease assets	**(6.6)**	(4.3)	(7.4)
Loans to customers	**(222.4)**	(205.9)	(391.9)
Derivative financial instruments	**143.2**	322.4	459.8
Fair value of portfolio hedges	**12.9**	5.0	21.2
Other receivables	**(0.4)**	(5.7)	-
Net increase / (decrease) in operating liabilities			
Retail deposits	**670.4**	473.5	1,741.5
Derivative financial instruments	**(0.9)**	(3.7)	(8.7)
Fair value of portfolio hedges	**(3.5)**	(0.5)	(4.3)
Other liabilities	**12.1**	1.4	(1.8)
Cash generated by operations	**532.0**	338.6	1,503.6
Income taxes (paid)	**(16.1)**	(14.3)	(28.9)
Net cash flow generated by operating activities	**515.9**	324.3	1,474.7

29. NET CASH FLOW USED IN INVESTING ACTIVITIES

	Six months to 31 March 2018	Six months to 31 March 2017	Year to 30 September 2017
	£m	£m	£m
Proceeds from sales of property, plant and equipment	**0.3**	0.4	0.3
Purchases of property, plant and equipment	**(0.5)**	(0.7)	(1.7)
Purchases of intangible assets	**(0.2)**	(0.3)	(0.9)
(Increase) / decrease in short term investments	**(10.0)**	7.1	7.1
Acquisition of business (note 5)	**(6.8)**	(1.6)	(1.6)
Net cash (utilised) / generated by investing activities	**(17.2)**	4.9	3.2

30. NET CASH FLOW FROM FINANCING ACTIVITIES

	Six months to 31 March 2018	Six months to 31 March 2017	Year to 30 September 2017
	£m	£m	£m
Shares issued (note 24)	**0.1**	1.5	1.5
Dividends paid (note 27)	**(28.9)**	(25.4)	(38.0)
Issue of asset backed floating rate notes	**-**	-	69.8
Repayment of asset backed floating rate notes	**(860.9)**	(561.6)	(1,503.0)
Repayment of corporate bonds	**-**	-	(110.0)
Movement on central bank facilities	**274.4**	345.0	700.0
Movement on other bank facilities	**(292.9)**	(125.6)	(268.6)
Purchase of shares (note 26)	**(25.2)**	(27.0)	(69.7)
Net cash (utilised) by investing activities	**(933.4)**	(393.1)	(1,218.0)

31. RELATED PARTY TRANSACTIONS

In the six months ended 31 March 2018, the Group has continued the related party relationships described in note 64 on page 215 of the Annual Report and Accounts of the Group for the financial year ended 30 September 2017. 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 (which increased to £15,000 per annum in respect of the year ending 30 September 2018).

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.

Except for the transactions referred to above, there have been no related party transactions in the six months ended 31 March 2018.

INDEPENDENT REVIEW REPORT

To Paragon Banking Group PLC

CONCLUSION

We have been engaged by the Company to review the condensed set of financial statements in the half-yearly financial report for the six months ended 31 March 2018 which comprises the consolidated income statement, consolidated statement of comprehensive income, consolidated balance sheet, consolidated cash flow statement, consolidated statement of movements in equity and related explanatory notes 1 to 31.

Based on our review, nothing has come to our attention that causes us to believe that the condensed set of financial statements in the half-yearly financial report for the six months ended 31 March 2018 is not prepared, in all material respects, in accordance with IAS 34 *Interim Financial Reporting* as adopted by the EU and the Disclosure Guidance and Transparency Rules ('the DTR') of the UK's Financial Conduct Authority ('the UK FCA').

Scope of review

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity* issued by the Auditing Practices Board for use in the UK. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. We read the other information contained in the half-yearly financial report and consider whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of financial statements.

A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK) and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Directors' responsibilities

The half-yearly financial report is the responsibility of, and has been approved by, the directors. The directors are responsible for preparing the half-yearly financial report in accordance with the DTR of the UK FCA.

As disclosed in note 2 the annual financial statements of the Group are prepared in accordance with International Financial Reporting Standards as adopted by the EU. The directors are responsible for preparing the condensed set of financial statements included in the half-yearly financial report in accordance with IAS 34 as adopted by the EU.

Our responsibility

Our responsibility is to express to the Company a conclusion on the condensed set of financial statements in the half-yearly financial report based on our review.

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

This report is made solely to the Company in accordance with the terms of our engagement to assist the Company in meeting the requirements of the DTR of the UK FCA. Our review has been undertaken so that we might state to the Company those matters we are required to state to it in this report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company for our review work, for this report, or for the conclusions we have reached.

Andrew Walker
for and on behalf of KPMG LLP
Chartered Accountants
One Snow Hill
Snow Hill Queensway,
Birmingham
B4 6GH
24 May 2018

ADDITIONAL FINANCIAL INFORMATION

For the six months ended 31 March 2018

Additional financial information supporting the amounts shown in the interim management report but not forming part of the condensed financial statements.

A. COST:INCOME RATIO

Cost:income ratio is derived as follows:

	31 March 2018	31 March 2017	30 September 2017
Operating expenses (£m)	**54.9**	50.4	102.3
Total operating income (£m)	**130.1**	123.7	252.8
Cost / Income	**42.2%**	40.7%	40.5%

B. UNDERLYING PROFIT

The Group reports underlying profit excluding fair value accounting adjustments arising from its hedging arrangements. This measure has been chosen as it is one widely used by investors and analysts following the Group's shares, and because management feel it better represents the underlying economic performance of the Group's business.

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Profit on ordinary activities before tax	**77.2**	69.4	144.8
Add back: Fair value adjustments	**(3.8)**	0.7	0.4
Underlying profit	**73.4**	70.1	145.2

Underlying basic earnings per share, calculated on the basis of underlying profit charged at the overall effective tax rate, is derived as follows.

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Underlying profit	**73.4**	70.1	145.2
Tax at effective rate (note 12)	**(14.5)**	(13.1)	(27.7)
Underlying earnings	**58.9**	57.0	117.5
Basic weighted average number of shares (note 13)	**262.1**	275.4	271.6
Underlying earnings per share	**22.5p**	20.7p	43.3p

Underlying return on tangible equity is derived using underlying earnings calculated on the same basis.

	31 March 2018	31 March 2017	30 September 2017
	£m	£m	£m
Underlying earnings	**58.9**	57.0	117.5
Amortisation of intangible assets	**0.9**	0.8	1.6
Adjusted underlying earnings	**59.8**	57.8	119.1
Average tangible equity (note 4(b))	**902.6**	876.8	884.5
Underlying RoTE	**13.3%**	13.2%	13.5%

C. INCOME STATEMENT RATIOS

The average net interest margin is calculated as follows:

	Six months to 31 March 2018 £m	Six months to 31 March 2017 £m	Year to 30 September 2017 £m
Opening loans to customers (note 16)	**11,124.1**	10,737.5	10,737.5
Closing loans to customers (note 16)	**11,346.7**	10,940.2	11,124.1
Average loans to customers	**11,235.4**	10,838.9	10,930.8
Net interest	**121.3**	113.5	232.6
Annualised net interest margin	**2.16%**	2.09%	2.13%
Impairment provision	**1.8**	3.2	5.3
Impairment as a percentage of average loan balance (annualised)	**0.03%**	0.06%	0.05%

D. NET ASSET VALUE

	Note	**Six months to 31 March 2018**	Six months to 31 March 2017	Year to 30 September 2017
Total equity (£m)		**1,020.6**	994.2	1,009.4
Outstanding issued shares (m)	*24*	**281.5**	296.5	281.5
Treasury shares (m)	*26*	**(20.8)**	(21.9)	(15.7)
Shares held by ESOP schemes (m)	*26*	**(1.6)**	(2.2)	(3.2)
		259.1	272.4	262.6
Net asset value per £1 ordinary share		**£3.94**	£3.65	£3.84
Tangible equity (£m)	*4*	**900.3**	889.6	905.0
Tangible net asset value per £1 ordinary share		**£3.47**	£3.27	£3.45

E. YIELD ON LOAN ASSETS

The yields presented in the management report are based on net interest income and average monthly portfolio balances. This represents a change from previous reports as a result of investor and analyst feedback. Comparative amounts have been restated in line with the new basis.

CONTACTS

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