STRATEGIC REPORT

The Group's business, risk profile, performance and prospects

A1
Chair of the Board's introduction

Fiona Clutterbuck, Chair of the Board

> **Despite the present economic and political uncertainties facing the UK, I am confident that the Group is well placed to respond to the challenges in its markets...**

Dear Shareholder

I have the pleasure of introducing my second Annual Report and Accounts as Chair of the Board of Paragon Banking Group PLC, following a year which has seen continued progress in the Group's strategic development, after the major acquisitions of recent years, against a backdrop of an uncertain UK economy.

The year has seen two significant milestones in the development of the business. More than half of our lending portfolio now comprises balances advanced since 2014, the year Paragon Bank was authorised, whilst at the same time more than half our asset funding is derived from retail deposits, a significant change in the profile of the business over that period.

The development of the Group's Commercial Lending division, particularly the growth of newer and acquired businesses has also been particularly pleasing in the year. We continue to target investment and capital to support the Group's medium-term objective of improving net interest margin and cost efficiency, with increasing business volumes. At the same time, we aim to provide an additional, specialist choice to our customers, together with a continuing focus on customer service.

In preparing the annual report for this year we have made changes in our reporting of governance arrangements, in preparation for the introduction of a new corporate governance code in the coming year and to reflect the introduction of IFRS 9, bringing in substantial new disclosures around customer loans and derivatives. I hope you find this report useful in understanding our business and our progress in the year.

The business

The business is managed through three lending divisions, Mortgages, including buy-to-let, Commercial Lending and Idem Capital, with each division offering a range of specialist lending propositions.

The mortgages division continues its focus on specialist landlords in the private rented sector, which remains a fundamental part of the nation's housing provision.

The commercial lending division provides asset backed and other funding to SMEs and small corporates, while the development finance business provides funding particularly to small and medium scale residential developers in the UK, both underserved sectors of their respective markets.

Our Idem Capital division specialises in the acquisition of loan portfolios. The division's success builds on its extensive analytical skills and a servicing approach focussed on developing sustainable arrangements and fair outcomes for the personal lending customers it acquires.

Significant expenditure has been made in the development of the Group's business lines throughout the year and further investment in people and systems is anticipated in the year to come.

The Group's business is described more fully in Section A2

Results

The growth in the Group's new lending, up 8.5% to £2,532.4 million, together with improved margins, contributed to an increase in underlying profit by 5.0% to £164.4 million excluding items such as the £9.7 million gain on sale of PM12, which do not arise from the underlying operations of the business. Profit before tax on the statutory basis fell by 12.4% to £159.0 million, reflecting the £28.0 million gain on the disposal of Idem Capital assets reported in 2018.

This led to underlying earnings per share ('EPS') increasing by 6.0% to 51.1 pence (2018: 48.2 pence) and statutory EPS decreasing to 49.4 pence (2018: 55.9 pence). Underlying return on tangible equity reached 14.6% (2018: 14.0%), 14.1% on the statutory basis (2018: 16.1%).

Funding was enhanced with the growth of the Group's savings deposit base to £6.4 billion from £5.3 billion a year earlier, further utilisation of Bank of England facilities and a £364.3 million securitisation transaction. This increasing diversification led to retail deposits making up almost half of all Group funding.

The Group's capital position remains strong, with a regulatory Core Equity Tier 1 ('CET1') ratio of 13.7% (2018 (IAS 39): 13.8%).

The financial results and operational performance are reviewed in Section A3

Stakeholders

The Group takes its responsibility as a corporate citizen very seriously. It values its culture and views the current regulatory agenda of promoting the interests of stakeholders other than shareholders as being well aligned with its own priorities.

During the year steps were taken to embed the 'employee voice' provisions of the new Code in the Group, and I was gratified that the Group retained its Gold Investors in People status and that the number of female senior managers reached 35% of the total, our below-board Hampton-Alexander target.

The Group has always believed in the social benefits that can result from using its power as a buy-to-let lender to drive up standards in the private rented sector and from providing funds for housebuilding and has always acted to manage its environmental impact. I noted with interest the increased regulatory focus on sustainability during the year, particularly from the PRA, and am taking a close interest in the Group's progress in developing enhanced procedures in this area.

We recognise the importance of the contribution of the people who work within our businesses to the Group's results in the year and I would like to thank all of them for their hard work and dedication throughout the period.

Social responsibility issues are discussed in Section A5

Governance

Over the year my colleagues on the Board and I have spent considerable time and effort in enhancing the Group's governance process. We have updated processes to accord with the new Code, together with other new regulations and considered the results of our board evaluation. We have also finalised a new remuneration policy for shareholders' consideration at the forthcoming AGM.

As part of these developments we were able to meet with many shareholders and other stakeholder groups, and I thank them for their valuable time with us. During this exercise, I met 18 of the Group's major shareholders, representing over two-thirds of the total share capital, and the insight gained into their views of the business was extremely useful.

During the year, my board colleague John Heron, Director – Mortgages, decided to step down after being with the Group since 1986, establishing its buy-to-let business and becoming one of the leading figures in the buy-to-let sector in the UK. Peter Hartill, the Chair of the Group's Audit Committee, will also step down from the Board after nine years' service. I would like to thank both of them for their very meaningful contribution to the Group's development and the support they have given me as Chair.

In addition to our usual workload, the entire Board has been much involved with the further development of the Group's strategy, particularly the evaluation and monitoring of acquisitions and their integration into the Group. I thank my colleagues for their diligence in these matters.

The Group is committed to good corporate governance and we are confident that we are well placed to comply with the new code from the year ending 30 September 2020.

Corporate governance is discussed in Section B3

Risk

The Group continues to put considerable emphasis on the management of risk, with additional specialist resource recruited in the year and the embedding of enhanced risk management technology.

Particular focus has been given in the past year to cyber security and operational resilience capabilities, with additional investment in both systems and people. Systems for regulatory stress testing have also been enhanced. These areas will continue to be key priorities in future years. Significant focus also continues to be given to the Group's preparations for the regulatory approval process for its IRB approach for credit risk.

The Risk Management report is set out in Section B7

Shareholder returns

The positive result for the year has enabled the Board to enhance the dividends paid to shareholders, in accordance with the policy previously announced. We have declared a final dividend for the year of 14.2 pence per share, bringing the dividend for the year to 21.2 pence per share, up 9.3% from the 19.4 pence declared for 2018, subject to shareholder approval. £26.5 million (excluding costs) has also been spent on the share buy-back programme announced in July. Each of these actions enhances returns for shareholders.

Conclusion

The Group has continued to make progress towards its strategic goals. The market for a specialist, retail funded banking group, able to serve the needs of currently underserved SME, small corporate and personal borrowing and savings customers, clearly exists and the Group's strengths, experience and culture mean that it is well placed to do this.

Despite the present economic and political uncertainties facing the UK, I am confident that the Group is well placed to respond to the challenges in its markets. The Group's wealth of data and the well tested, through the cycle experience of its senior management team continues to provide the basis to deliver excellent service to its customers, strong and sustainable returns to its shareholders while enhancing its relationships with all of its stakeholders.

Fiona Clutterbuck

Chair of the Board

26 November 2019

A2

Business model and strategy

A2.1 Paragon at a glance

Paragon is a specialist banking group. We offer a range of savings and specialist lending products to individuals and SMEs in the UK. Listed on the London Stock Exchange, we are a FTSE 250 company, headquartered in Solihull, employing 1,360 people.

Established in 1985, we originally focused primarily on buy-to-let mortgages but since gaining our banking licence in 2014, not only have we expanded our operations in buy-to-let, we have also extended into a wide range of commercial lending markets and service a range of consumer loan portfolios through our subsidiary, Idem Capital. New lending is funded principally through an online personal savings operation and our vision is to be the UK's leading specialist banking group, meeting the needs of UK consumers and businesses.

Operating model

Paragon's operations are organised into three divisions, each with responsibility for achieving asset and profit growth, with new lending funded largely by retail deposits. These are supported by the Group through the provision of capital to underpin growth and, where appropriate, with central services including loan servicing, marketing, information technology and legal support. This operating model comprises local specialism with strong centralised resources enabling economies of scale to be achieved and centres of excellence to be developed.

Mortgages

Buy-to-let mortgage finance for landlords operating in the UK's private rented sector. We also offer a range of second charge mortgage products.

- £10.3 billion loan assets
- Over 62,000 buy-to-let loan accounts
- 3.7% of all new buy-to-let mortgages in the UK

Read more about Mortgages on page 16

Commercial Lending

A range of asset-backed loan products for consumers and SMEs operating across a number of markets.

- £1.5 billion loan assets
- £43.8 million profit segment

Read more about Commercial Lending on page 18

Idem Capital

Acquisition and servicing of UK loan portfolios.

- Over 79,000 customer accounts

Read more about Idem Capital on page 20

Funding

New lending funded principally from retail savings balances, complimented by a core expertise in wholesale funding.

Read more about Funding on page 21

Building a specialist bank

In 2014 we launched a strategic transformation from a monoline lender to a diversified, specialist bank.

2014

- Paragon Bank established and first savings accounts opened
- Launch of three lending product lines
- New lending in buy-to-let mortgages increased by 82%
- Paragon re-enters motor finance market

2015

- Paragon enters the SME finance market with the acquisition of Five Arrows Leasing Group
- Savings deposit base grows to more than £700 million

2016

- Purchase of Premier Asset Finance, one of the UK's leading asset finance brokers
- Launch of property development finance proposition
- Paragon Bank launches ISAs
- Paragon Bank PLC moves into profit

2017

- Transition into fully integrated banking group complete and Paragon Group of Companies PLC becomes Paragon Banking Group PLC
- Reorganisation of the Group into three operating units

2018

- Began offering finance to the legal profession with the acquisition of Iceberg
- Launch of Group's first structured lending facilities
- Acquisition of Titlestone accelerated progress of the Group's development finance offering

2019

- Savings deposits exceed £6 billion
- Specialist landlords account for almost 90% of all new buy-to-let lending
- Commercial Lending portfolio increased by 28.1%

Our business model and strategy

We help individuals and small businesses across the UK prosper and grow by focusing on customers in markets typically underserved by larger high street banks. We see specialisation as what makes us different, as our competitive advantage, and we seek to know more than our competitors about our customers and the markets in which we operate, the products and services we offer, and the risks we incur.

Our strategy is to build a specialist bank for our customers, which delivers sustainable growth and shareholder returns through a low risk and robust model.

Our strategic priorities

Specialisation

Focussing on building strong positions in our chosen markets

Diversification

Developing our range of savings and lending products in existing and new markets

Growth

Seeking opportunities for growth, both organically and through acquisition

Capital management

Recycling capital to reinvest in the business and provide shareholder returns

Sustainability

Ensuring our operations have a positive effect on our stakeholders and communities with which we interact

Our key differentiators

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

500 million items of customer data analysed each month

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

Cost of risk 0.07%

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

Underlying cost:income ratio 42.1%

4 Our people
We are committed to helping all our employees reach their potential and recognise the importance of diversity, thereby maintaining a skilled and engaged workforce.

Gold Investors in People accreditation

5 Technology
We are utilising technology to improve productivity and access new markets, and are well placed to take advantage of digital changes to enter new markets.

Intermediary portal for online applications launched in 2019

6 Management expertise
An experienced management team with a through-the-cycle track record.

16 years average length of service for executive management team

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

91% of employees feel Paragon has clear values[1]

8 Strong financial foundations
Efficiently utilising capital and debt positions to maintain balance sheet strength.

Underlying RoTE 14.6%

[1] Investors in People report, 2019

Creating value

A broad funding base...

The Group funds its assets using a variety of sources, including retail deposits, securitisation and bond issuance. It takes care to secure competitive funding over an appropriate term to underpin its assets, cover working capital requirements and maintain a strong financial position.

See page 21

...lending on diversified loan assets...

The Group focusses on building its asset base by originated new loans, developing new products, diversifying into new markets and acquiring loan portfolios.

See pages 16 to 20

...generating growing income...

The Group generates income from interest and fees earned on its mortgage, consumer and SME loan assets. It also earns fees from third parties for administering similar loans on their behalf.

...underpinned by a customer focused culture, based on eight core values, and an engaged, skilled and diverse workforce.

Our values

Fairness	**Commitment**
Professionalism	**Creativity**
Integrity	**Teamwork**
Humour	**Respect**

This approach enables us to create value for all our stakeholders

Shareholders

See page 38

Creating long-term shareholder value through growing profits and dividends

21.2p dividend per share

Customers

See pages 16 and 18

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

+65 Net promoter score for savings account opening[1]

Employees

See page 56

Helping all our people develop their career and reach their potential

Average training per employee in 2019: 6.9 days

(CIPD average 2.8 - 3.3 days)

Society

See page 62

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

Charitable contributions of £24,200 in 2019

Environment

See page 58

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

100% of electricity used by sites we are responsible for was from renewable energy sources in 2019

[1]Net Promoter Score of +65 for savings account opening process based on online survey of 3,900 savings customers between 1 October 2018 and 30 September 2019

Mortgages

We offer residential mortgages, with buy-to-let finance for landlords operating in the UK's Private Rented Sector (PRS) being our largest market. We were one of the first lenders to pioneer buy-to-let lending and, since 1996, we have originated £22.9 billion of buy-to-let accounts. In the year to 30 September 2019, we provided 3.7% of all new buy-to-let mortgages in the UK.

Our customer-focussed approach, combined with our expertise in property valuation and risk assessment, helps us support a wide range of customers, especially landlords with large-scale property portfolios, those investing in complex properties and those operating in corporate structures.

The UK's PRS provides a vital social function, delivering accommodation for people who want the flexibility that renting provides, as well as those who cannot afford to buy and need the security of a stable home. Paragon supports socially responsible investment in the PRS by promoting high standards in accommodation, ensuring minimum energy efficiency levels, supporting professionalism in the landlord community, and working with industry and government to improve the sector.

Raising service standards

We survey mortgage intermediaries and customers on a systematic basis to identify areas for improvement. This year, acting on intermediary feedback, we refined our mortgage application process by making a number of simple but significant improvements. As a result, intermediaries are now four times more likely to recommend Paragon to a colleague or a friend.

+60

Net promoter score[1]
September 2019

The underwriter was very good. Everyone I spoke to was helpful. I felt common sense was applied and it was a very good experience...

Intermediary feedback, July 2019

[1]Net Promoter Score for buy-to-let mortgages at offer stage, based on telephone survey of 1,220 intermediaries between 1 October 2018 and 30 September 2019

Market drivers

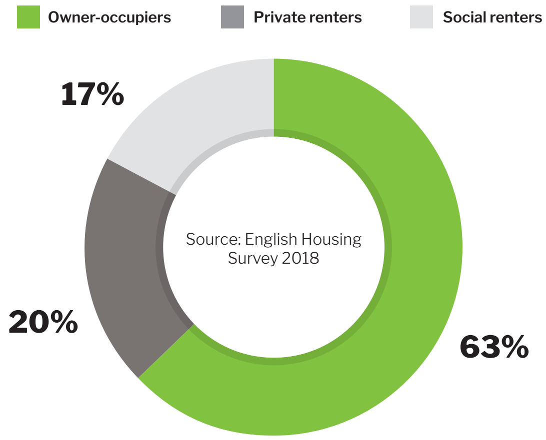
The UK's PRS has more than doubled in size since 2000. Today, it comprises 4.5 million households, almost 20% of the total[1]. After owner-occupation, renting in the PRS is the second most common housing tenure in the UK. Economic, social and demographic changes, together with the flexibility that renting provides, have combined to make renting in the PRS an increasingly popular choice.

Factors driving demand for PRS accommodation include:

- Low investment in social housing
- Mortgage affordability constraints
- Population growth
- Rising participation in higher education
- A tendency to settle down later in life
- Changing housing needs

Housing tenure

The PRS makes up 20% of the English housing market



In the lettings market, the latest set of results... are indicative of demand from prospective tenants rising firmly for an eighth month in a row...

Source: RICS UK Residential Market Survey, September 2019

Market trends

- UK buy-to-let mortgage lending totalled £41 billion[2] in 2018, providing funding for approximately 35% of PRS homes
- After strong year-on-year lending growth following the financial crisis, tax changes for landlords announced in 2015 have resulted in more moderate growth
- Buy-to-let underwriting changes introduced in 2017 which encourage more detailed underwriting for larger-scale, portfolio landlords have also re-shaped the market, with specialist lenders like Paragon better equipped to service this segment

Market outlook

- Despite strong historic growth in the PRS, commentators forecast a further 1.2 million rental homes will be needed by 2023[3] to keep pace with tenant demand
- Landlords are continuing to invest in rental homes in the PRS but, given the tax changes, investment is more selective
- Evidence suggests larger-scale landlords are three times more likely to buy property than their smaller-scale counterparts[4] and Paragon is well-placed to grow its market share in this segment. At the year end, 91.4% of the buy-to-let pipeline was with specialist landlord customers

[1]MHCLG, English Housing Survey 2017-2018 [2]UK Finance [3]Knight Frank, Multi-housing 2019 - PRS Research [4]Paragon, PRS Trends Survey, Q2 2019

Commercial Lending

Our Commercial Lending division helps small UK businesses develop, in turn supporting the UK economy. We also help fund the UK's much needed expansion in housing and encourage investment in cleaner technologies to reduce the country's environmental footprint.

We provide finance to SMEs and small corporate customers operating in a wide range of commercial lending markets, as well as motor finance to UK based consumers. We focus on specialist assets and underserved markets in four main areas:

SME lending

A range of finance solutions for SMEs covering a wide array of sectors, including agriculture, aviation, construction, commercial vehicles and business equipment

Development finance

Competitive and flexible financing solutions targeted at experienced property developers

Structured finance

Finance for non-bank specialist lenders, either through wholesale funding or block discounting

Motor finance

Finance through approved intermediaries and dealers for cars, light commercial vehicles, motorhomes and caravans

Broker perceptions

During 2019 we undertook research with our brokers to understand how Paragon is perceived in the SME lending market and to identify potential further opportunities for improvement.

The results highlighted strengths including clear pricing and structure, flexibility, strong relationships and consistency of decision making, but identified opportunities to improve speed of processes and communication, and address variability of experiences.

"Documents are now available online which should speed things up.

"They've been very easy to deal with… professional, responsive – especially over the last couple of months.

"Clearer on pricing, documentation and underwriting appetite.

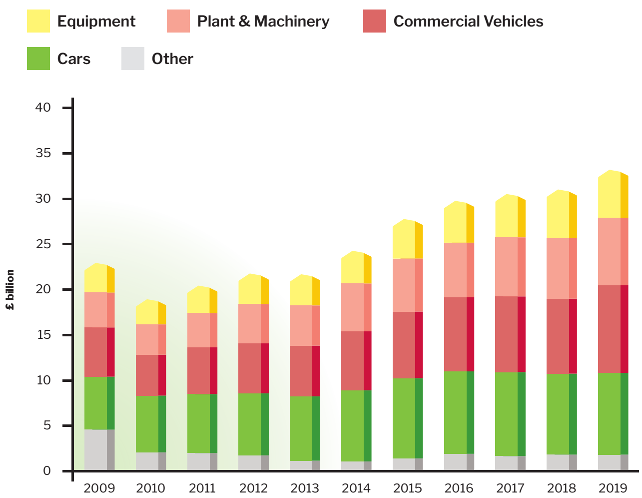
Broker feedback, May 2019

Market drivers

The commercial lending markets are broad and Paragon is focussed on specific asset classes. The general economic conditions within the UK influence activity in these markets and other key drivers include:

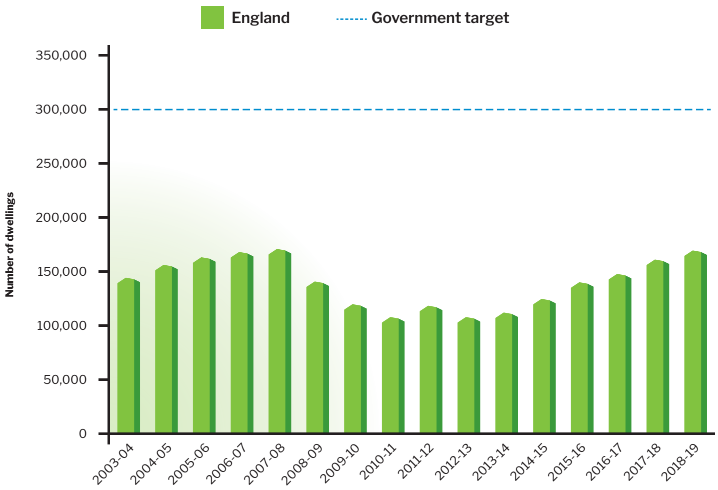
- The UK property market and rate of housebuilding driving the opportunities for development finance
- The rate of new work in commercial industries such as construction
- Uncertainty around the UK's economic future impacts buyer confidence and therefore our direct B2B and B2C lines, such as aviation and vehicle finance
- Advances in technology and SME growth continue to open up funding opportunities for our asset finance business
- Environmental concerns and the drive towards fuel efficiency prompting increased demand for lower emissions, and hybrid and electric vehicles

UK asset finance originations



Source: FLA

New homes completed



Source: MHCLG - House building: permanent dwellings completed

Market trends

- The asset finance market grew by 7% in the year ended 30 September 2019[1]
- The latest annual asset finance new business total (twelve months to September 2019) reached a record level of £33.2 billion[1]
- Housebuilding in England continues to fall well below the Government's target of 300,000 new homes per year
- In the year ended 30 September 2019, new business in the Commercial Vehicle finance market was 14% higher than the same period in 2018[1]
- Finance for new construction and agricultural equipment is relatively stable[1] but recent reports show a sharp drop in new construction work[3]
- In the year ended 30 September 2019, motor finance new business grew by 3% in value[1]

Market outlook

- The British Chambers of Commerce forecast 1.2% growth in GDP in 2019, 0.8% for 2020, and 1.2% for 2021
- A marginal 0.7% rise in new car finance is forecast for 2019, with growth forecast to revive to 2.7% in 2020 as uncertainty around Brexit recedes[2]
- One million new electric vehicles ('EVs') are forecast to be sold in the UK by 2025 and 11 million by 2040 with consumers increasingly likely to purchase EVs over conventional vehicles
- The outlook for construction work remains among the weakest since 2012 as clients respond to economic and political uncertainty[3]

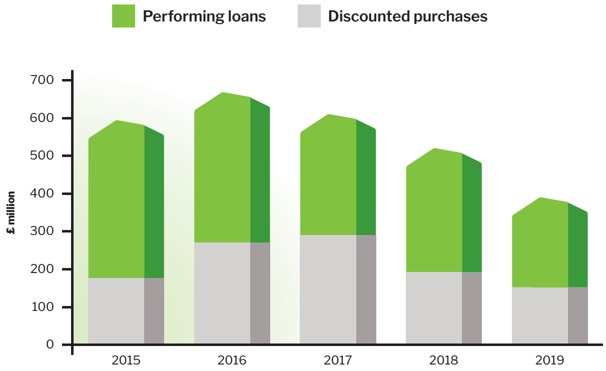
[1]FLA, November 2019 [2]Oxford Economics, October 2019 [3]IHS Markit/CIPS UK Construction Total Activity Index

Idem Capital

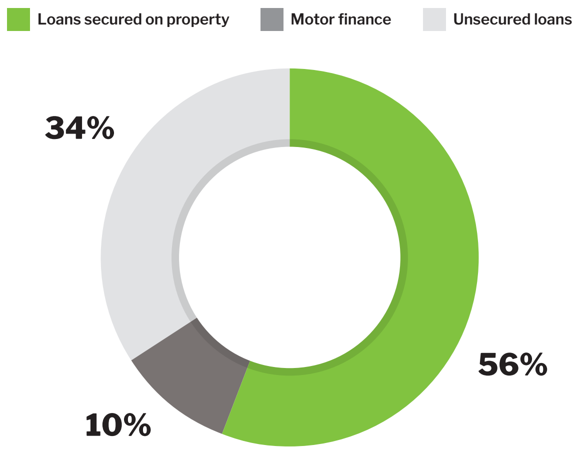
Idem Capital is a leading UK loan purchaser, acquiring and servicing portfolios which include products such as leases, motor finance agreements, mortgages and unsecured loans. In addition, we offer servicing of loan portfolios for clients including banks, private equity houses and specialist lenders.

We acquire loan portfolios from financial institutions that are either restructuring or refocussing their activities and focus on the acquisition and servicing of paying (either fully or semi-performing) accounts. Idem Capital does not actively compete to acquire non-paying portfolios.

Shift towards performing loans



Idem Capital loan portfolio by value



We target those portfolios where the most benefit can be derived from our core credit profiling and administration skills, focussing on disciplined analysis and evaluation of portfolio cash flows on potential acquisitions. We seek to make purchases which will augment the Group's organic loan originations.

Idem Capital has managed more than one million customer accounts and we are proud of the reputation we have established for customer service. We assist our customers in managing their accounts and strive to create fair, affordable and sustainable repayment solutions.

Funding

The Group's principal source of funding for new lending is its range of savings products offered to UK households where the Group seeks to offer simple understandable products at competitive rates. Other funding for lending is derived from the efficient use of Bank of England funding schemes, while securitisation continues to fund much of the back book and is used tactically, including a major transaction in the year. Central funding is provided through corporate and retail bonds.

Savings

Retail deposit balances form the mainstay of the Group's funding, with the capacity to support significant balance sheet growth.

The UK household savings market is £1.2 trillion, so provides a deep and liquid source for the Group's funding. Costs for this funding remain low.

Paragon Bank offers a range of safe, simple and transparent Easy Access, ISA, Notice and Fixed Term savings accounts. Our regular survey of new savings customers demonstrates a high level of satisfaction with our products and our online application process.

The online distribution process has been augmented during the year by the addition of digital banking and wealth management platform relationships.

Central bank funding

The Group uses facilities provided by the Bank of England under the TFS, ILTR and FLS schemes to support lending growth. These schemes provide cost effective funding so long as appropriate targets are met.

Wholesale funding

The Group has a core expertise in securitisation and other debt. Securitisation and other wholesale debt markets are accessed on a tactical basis, when appropriate.

The Group launched its first SONIA referenced mortgage securitisation in the period consolidating its position as one of the main issuers in the market.

£29,000 average deposit

180,000 customers

+65 Net promoter score for savings account opening[1]

£364.3 million raised in the year

[1]Net Promoter Score of +65 for savings account opening process based on online survey of 3,900 savings customers between 1 October 2018 and 30 September 2019.

A2.2 Principal risks

There are a number of potential risks and uncertainties to which the Group is exposed and which could impact significantly on its ability to conduct its business successfully. These are summarised below.

Category	Risk	Description
Business	Economic	The Group could be materially affected by a severe downturn in the UK economy, as its income is wholly derived from activities within the country. The likelihood of this occurring has become more difficult to forecast given the continuing material uncertainties regarding the UK's withdrawal from the European Union ('EU'), and the unstable UK political climate. A material downturn in economic performance 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 material change in the operation 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	Failure to target and underwrite credit decisions effectively could result in customers becoming less able to service debt, exposing the Group to unexpected material losses.
	Counterparty	Failure of an institution holding the Group's cash deposits or providing hedging facilities for risk mitigation could expose the Group to loss or liquidity issues.
Conduct	Fair outcomes	Failure to deliver fair outcomes for its customers could impact on the Group's reputation, its ability to meet its regulatory obligations and its financial performance.
Operational	People	Failure to attract or retain appropriately skilled key employees at all levels could impact upon the Group's ability to deliver its business plans and strategic objectives.
	Systems	The inability of the Group's systems to support its business operations effectively and / or guard against cyber security risks could result in reputational damage and financial loss.
	Regulation	Given the highly regulated sectors in which the Group operates, compliance failures or failures to respond effectively to new and emerging regulatory and legal developments could result in reputational damage and financial loss.
Liquidity and Capital	Funding	If access to funding became restricted, either through market movements or regulatory intervention, this could result in the scaling back or cessation of some business lines.
	Capital	Proposals by the PRA, EBA, and EU to implement changes in the Basel Capital Regime, including changes affecting lending secured on residential property could have adverse financial implications for the Group.
Market	Interest rates	Reduction in margins between market lending and borrowing rates or mismatches in the Group balance sheet could impact profits.
Pension Obligation	Pensions	The obligation to support the Group's defined benefit pension plan might deplete resources.

The Group has considered and responded to all of these risks, mitigating the exposure as far as is practicable to ensure that its risk profile remains within the Board's stated risk appetite. These risks are discussed in more detail in Section B7.5.

A3
Chief Executive's review

A3.1 Strategy review

During the year ended 30 September 2019 the Group has maintained its specialist lending strategy, growing its loan books and improving margins whilst integrating new operations acquired or developed in the previous year.

The Group supports the needs of its consumer and SME customers and seeks to develop its presence in these markets through a combination of specialist product design, distribution and underwriting supported by an efficient operating platform and resilient technology. The Group has an outstanding through-the-cycle record in challenging markets with excellent risk metrics, reflective of the cautious and prudent approach it takes to its risk appetite alongside its highly effective operating model.

Our focus on risk and disciplined underwriting will not change going forward, while our position in the markets we serve will allow us to continue to deliver strong growth. A focus on the delivery of our organic strategy being augmented by the expansion of our proposition, where such developments provide an attractive risk and return profile.

Nigel Terrington, Chief Executive

Strong lending growth was achieved across the Group's businesses, with total new lending of £2,532.4 million, an increase of 8.5% on the previous year...

Lending

Strong lending growth was achieved across the Group's businesses, with total new lending of £2,532.4 million, an increase of 8.5% on the previous year (2018: £2,333.2 million). Combined with the disposal of the Group's residual interest in the PM12 securitisation, these left the loan book 0.5% higher at £12,186.1 million at 30 September 2019 (2018: £12,127.8 million). More than half of this balance is now represented by loans originated since Paragon Bank was formed in 2014.

Volumes within the Mortgages segment remained broadly stable, with £1,564.4 million of advances and a portfolio acquisition of £4.2 million (2018: £1,623.2 million), with the majority of the decrease attributable to first charge owner-occupied business as the Group refocussed its efforts in that area in the light of adverse market conditions. Overall the mortgage segment loan book reduced by 1.2% year-on-year to £10,344.0 million (2018: £10,473.5 million), including the £24.0 million impact of IFRS 9 transition and the disposal of £695.8 million of PM12 assets. The post-2010 buy-to-let portfolio grew by 21.1% to £5,427.7 million (2018: £4,481.8 million).

Within the buy-to-let business the strategic focus remains on specialist landlords who are becoming the core investors in the UK private rented sector. The proportion of completions where the customers were specialist landlords (operating through corporate structures and / or running large portfolios) increased from 79.3% to 88.8% of the total with a corresponding fall in simple completions. This effect is also seen in the pipeline at 30 September 2019, with 91.4% of the £911.7 million total relating to specialist cases (2018: £778.9 million with 87.8% specialist).

Commercial Lending advances increased by 36.3%, to £968.0 million, compared to the previous year (2018: £710.0 million). Within this:

- The Group's development finance operation, incorporating the Titlestone business acquired in July 2018, advanced £362.9 million (2018: £136.8 million, £320.8 million on a proforma basis)
- Structured lending, launched in the second half of 2018 saw £49.7 million of new loans (2018: £40.6 million)
- SME lending, including the Iceberg professions finance operation acquired in December 2017, advanced £406.5 million, 14.6% up on the £354.7 million for 2018, at improved margins
- Motor finance lending reduced from £177.9 million to £148.9 million following a strategic focus on margin improvement

Overall, the Commercial Lending portfolio increased by 28.1% year-on-year to £1,452.1 million (2018: £1,133.2 million).

During 2018 the Group sold a material Idem Capital portfolio, recycling the capital generated to support the Titlestone acquisition which generates attractive, sustainable growth and returns. This process has continued during 2019, where strong cash flow has continued to amortise the Idem Capital balances. In the absence of new Idem Capital deals that generate an acceptable risk / reward combination, capital has again been refocused to support growth in the Commercial Lending division.

Funding

The Group continues to pursue its flexible integrated funding strategy with the increase in lending balances funded principally through an increase in the Group's retail deposit balances to £6,391.9 million, 20.7% higher than the £5,296.6 million balance at the end of 2018. This included increased diversification in the savings operation's route to market, with presences developed on external wealth management and digital banking platforms. Average pricing in the portfolio at 30 September 2019 was 1.81%, slightly higher than the 1.76% reported at 30 September 2018 but in line with the level at 31 March 2019. Retail deposits therefore represent a highly cost-effective and stable funding source.

In wholesale funding, the Group:

- launched its first SONIA referenced securitisation, raising £364.3 million through the Paragon Mortgages (No. 26) transaction
- disposed of its residual interest in the Paragon Mortgages (No. 12) PLC ('PM12') securitisation, releasing £49.8 million of cash resources and generating a profit of £9.7 million
- closed out several other legacy transactions, releasing cash to the Group

Retail deposits represent the Group's primary source of funding for new lending, whilst securitisation or other wholesale channels are used as and when conditions in those markets are attractive, and terms are appropriate.

Results

Underlying profits (before the effect of fair value movements on hedging items and the gain on PM12) increased by 5.0% to £164.4 million, from £156.5 million in 2018. Net interest income was 8.5% higher on an underlying basis at £278.4 million, 9.3% higher on a statutory basis, driven upwards by both a higher net interest margin ('NIM') and year-on-year increases in loan balances.

The Group's new mortgage lending delivers higher margins than its legacy, pre-2010 portfolio. Therefore, the run-off of the legacy assets and their replacement with new loans enhances margins overall. Together with wider margins earned through the businesses within the Commercial Lending segment, the Group's new lending activities create a structurally improving margin. NIM in the period was 2.29%, compared to 2.21% in 2018.

The Group has continued to hold strong levels of liquidity, both actual and contingent, during the period in response to the economic and political uncertainties inherent in the UK's Brexit process. Brexit has had a negative impact on sentiment across the Group's markets during the period and appears set to continue as the economic and political situation develops.

The Group's cost:income ratio in the year on a statutory basis was 40.7%, compared to 37.8% in 2018. On an underlying basis (excluding fair value movements and gains) the cost:income ratio was 42.1%, increased from 40.6% in the previous year. The cost base increased by £13.3 million year-on-year, including a full year of costs from 2018 acquisitions, the increased outsourced costs of the larger savings book and significant project-related costs (including expenses associated with the Group's IRB application). The Group continued to make significant investments in technology, developing systems to provide improved service offerings to its customers and enhance operational resilience, the costs of which contributed to the increase in operational expenses in the period.

Careful cost management remains a key objective of the Group. Investments in new businesses, technologies and our IRB framework mitigate against a near term reduction in the cost:income ratio, as does the amortisation of the Idem Capital portfolio. The Board still expects to achieve significant operational leverage within the business, but now over the longer term.

The Group's loan impairment costs are now reported under IFRS 9. The overall effect of the transition to the new standard was to increase the opening provisions on the Group's loan assets by £27.2 million and reduce equity by £22.2 million, net of tax, although these changes did not impact the Group's results for the period.

IFRS 9, through its focus on expected loss levels rather than the incurred loss approach of IAS 39, accelerates provision for losses, increasing profit and loss charges on growing books, such as many of the Group's portfolios. The forward-looking calculation basis requires estimates to be made of likely future economic conditions. During the year the Group adopted a more pessimistic weighting of the economic scenarios it considers in its calculations, in response to the increased levels of economic uncertainty, which, under IFRS 9, will increase provision charges. Despite these factors, the bad debt charge increased to £8.0 million in the period, compared to £7.4 million, on an IAS 39 basis, in 2018. The bad debt charge was lower in the Mortgage division, but rose in Commercial Lending, reflecting its relative growth rate, and the consequent level of provision on performing new loans required by IFRS 9.

Buy-to-let credit performance remained strong with arrears at 30 September 2019 at 0.18%, significantly less than the market average (2018: 0.11%). Commercial Lending bad debt rates also increased slightly, although still represent a very small number of cases. Overall, our behavioural scoring models, which act as a lead indicator of financial stress in the loan books, were stronger in all significant portfolios across the period.

Throughout the year the UK interest rate outlook and capital markets were affected by Brexit-led macro-economic uncertainties, impacting on fair value exercises carried out for accounting purposes at the year end. This created a charge of £15.1 million in respect of the revaluation of derivatives held for hedging (2018: gain of £1.2 million) in the income statement and an increase in the pension scheme liability in the balance sheet of £15.0 million since 30 September 2018, with, as a consequence, a reduction of capital.

This fair value adjustment, combined with the inclusion of a £28.0 million gain on the disposal of an Idem Capital portfolio in the 2018 result, led to statutory profit before tax decreasing to £159.0 million from £181.5 million in 2018, with profit after tax reducing from £145.8 million to £127.4 million, after provision for tax at a rate of 19.9% (2018: 19.7%).

This result translates to basic earnings per share ('EPS') on an underlying basis of 51.1 pence per share, a year-on-year increase of 6.0% (2018: 48.2 pence per share) (Appendix A). On the statutory basis basic EPS reduced by 11.6% to 49.4 pence per share as a result of the fair value losses in the current period and one-off gains in the prior year (2018: 55.9 pence per share). Underlying return on tangible equity ('RoTE') at 14.6% (2018: 14.0%) continued to make progress towards the Group's long-term target of over 15% (Appendix A).

Capital and distributions

The Group maintains a strong capital position, even after the reductions in equity from IFRS 9 and the revaluation of the pension liability. On an IFRS 9 transitional basis, the Group's CET1 capital ratio was 13.7% and its total capital ratio 15.9% (2018: 13.8% and 16.2%) with the pension deficit reducing the ratio at 30 September 2019 by 20 basis points. The fully loaded CET1 and total capital ratios at 30 September 2019, excluding the IFRS 9 transitional capital relief were 13.4% and 15.7% respectively. The UK leverage ratio remained strong at 6.7% on the transitional basis, 6.6% fully loaded (2018: 6.4%).

The Company's dividend policy is underpinned by the principle of enhancing shareholder returns on a sustainable basis. The Board proposes a dividend for the year of 21.2 pence for 2019, an increase of 9.3% from the 19.4 pence in 2018. This results in a dividend cover ratio of 2.33 times, which is below the normal target of around 2.5 times but which reflects the scale of non-cash, fair value items in the 2019 results.

Following the PM12 residual sale the Company announced a share buy-back programme in July 2019, with £26.5 million (exclusive of costs) having been invested by the year end. The Company will seek the normal shareholder approval at its February 2020 Annual General Meeting ('AGM') to allow such programmes to take place in future if surplus capital becomes available.

The business has successfully pursued the strategy set out to investors, focussing on its specialist markets and maintaining a strong capital and funding base. It is well placed to deliver further progress and provide sustainable returns to shareholders. Its operating model and wide experience mean that 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:

Lending review A3.2	**Funding review A3.3**	**Capital review A3.4**	**Financial review A3.5**	**Operational review A3.6**
Lending, performance and markets	**Retail deposits and wholesale funding**	**Capital management, liquidity and distributions**	**Results for the period, assets and liabilities**	**Governance, people, risk and regulation**

A3.2 Lending review

The Group's operations are organised into three divisions, based on product type, origination and servicing capabilities. This organisational and management structure has been in place throughout the year.

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

	Advances and investments in the year		Net loan balances at the year end	
	2019	2018	**2019**	2018
	£m	£m	**£m**	£m
Mortgages	**1,568.6**	1,623.2	**10,344.1**	10,473.5
Commercial Lending	**968.0**	710.0	**1,452.1**	1,133.2
Idem Capital	**-**	83.4	**389.9**	521.1
	2,536.6	2,416.6	**12,186.1**	12,127.8

The Group's loan book increased by 0.5% in the year, with new lending 8.5% higher than in the previous financial year and total advances and investments 5.0% higher.

A3.2.1 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, proven rating methodology, and robust and informed approach to property risk differentiate it from mass market and other specialist lenders.

Housing and mortgage market

The performance of the UK mortgage and housing markets has remained subdued in the face of economic concerns arising from Brexit and the wider economy. New mortgage approvals, reported by the Bank of England, in the year ended 30 September 2019, at £262.9 billion had increased by only 2.6% from the previous year (2018: £256.3 billion), with remortgaging decreasing by 0.6% and house purchase mortgages increasing by 4.9%. This level of transactions remains some 30.0% below the peak in the market when £375.8 billion of mortgages were advanced in the year ended 30 September 2007. At the same time margins on mainstream mortgage lending have been squeezed as large lenders seek to preserve volumes.

The Nationwide House Price Index reported negligible annual growth of only 0.2%, sharply reduced from the 2.0% seen in 2018, with London and the South Eastern regions of England seeing a decline in prices, although house prices there remain close to their 2017 peak. Across England, Nationwide report house prices only 17%, on average, higher than their level in 2007 with prices outside the South East, having appreciated less. Growth has been at current levels for the past two years, with expectations of future increases remaining modest.

The latest survey data, as at 30 September 2019, from the Royal Institution of Chartered Surveyors ('RICS') UK Residential Market Survey, confirms this subdued position with market confidence drifting downwards, and negative short-term expectations on demand and prices, with some of this attributed to Brexit-related concerns amongst potential buyers. However, RICS expect some improvement in the longer term.

Buy-to-let and the private rented sector

The Group's deep understanding and long-term experience of the buy-to-let mortgage market mean that it is well placed to serve the particular needs of specialist landlord customers. The impact of regulatory and tax changes on landlords in recent years has led to lenders' strategies for buy-to-let polarising, with many large lenders not offering professional buy-to-let loans. This has left the Group amongst a small number of specialist lenders addressing the professional buy-to-let mortgage market. UK Finance ('UKF') has observed that landlords with portfolios of four or more properties comprise over a quarter of the buy-to-let lending market.

The private rented sector ('PRS') lettings market remains robust with RICS reporting both demand and rental levels increasing due to restricted supply, partially as a result of amateur landlords seeking to exit the market in response to fiscal and regulatory changes over recent years. However, the English Housing Survey for 2018, published in January 2019, continues to show the PRS representing around 19-20% of households, as it has for the past five years.

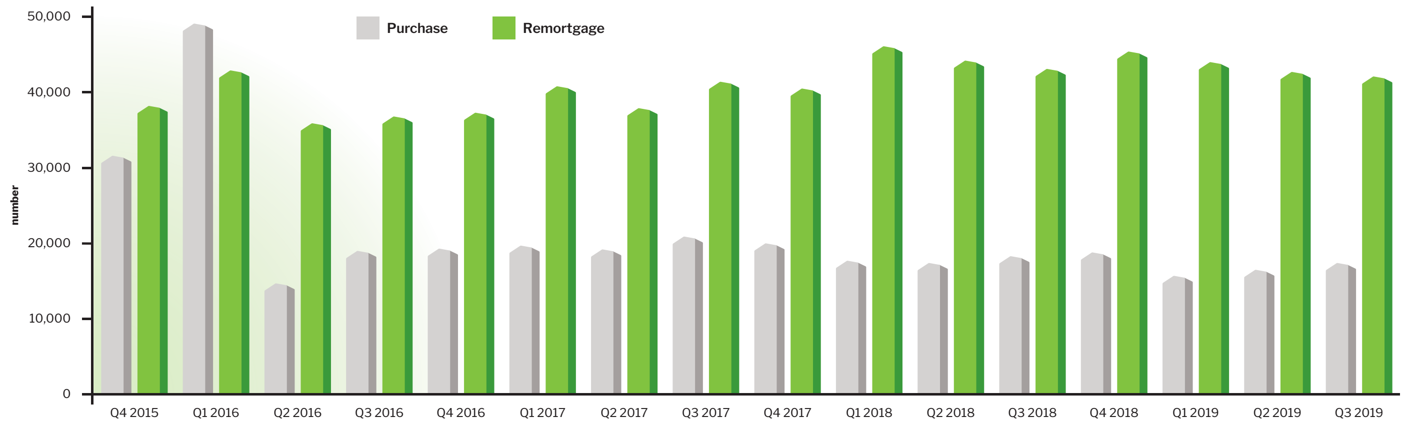
These factors have led to an expectation of increasing rents, with RICS members predicting a 2% increase over the next twelve months, accelerating to 3% per annum up to 2024. This follows average rent increases of 1.3% in the year ended September 2019, reported by the Office of National Statistics (2018: 0.9%), with September data from ARLA Propertymark ('ARLA'), the landlord's trade body, showing 58% of tenants witnessing rent increases in the year (2018: 27%). ARLA data also shows more tenants renting for longer periods. These factors should benefit the Group's customers and the affordability of their loans. However, reduced supply and increased rents may present difficulties for tenants and those seeking rented accommodation.

Buy-to-let lending in the year remained stable with UKF reporting new advances of £39.9 billion, the same value as in the previous year. Much of this activity represents refinancing by landlords, with 71.4% of new advances by value representing remortgages (2018: 70.4%). The trend in favour of longer-term fixed interest rates has also continued, both across the industry and in the Group's own lending, with over half of new lending at rates fixed for five years. This trend is expected to reduce remortgage activity in the short-term as product maturity terms increase.

The numbers of new buy-to-let mortgages reported by UKF over the past four years are set out below.

Number of new buy-to-let mortgages

UKF



These overall movements do, however, conceal a more mixed picture, with smaller landlords less active while activity amongst specialist landlords remains more positive.

The Group considers that its support for the PRS, through the buy-to-let mortgage market, contributes to housing provision for a significant number of families and it seeks to use its position as a lender to drive up standards of housing provision through its interaction with its landlord customers.

Lending activity

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

	2019	2018
	£m	£m
Originated assets		
First charge buy-to-let	**1,480.5**	1,495.5
First charge owner-occupied	**11.9**	56.5
Second charge	**72.0**	71.2
	1,564.4	1,623.2
Acquired assets	**4.2**	-
	1,568.6	1,623.2

Total mortgage originations in the Group reduced by 3.6% in the year. The majority of this decrease arose from owner-occupied lending, where the offering was scaled back in the year. This reflects the Group's focussed approach to balancing acceptable levels of risk and return in lending decisions.

In addition to the loans originated a further portfolio of seasoned, largely performing, buy-to-let loans was purchased from a third party in June 2019 for £4.2 million. This purchase was facilitated by the Idem Capital team but is reported within the Mortgages division as the assets are similar to the segment's other assets and administered by the mortgage servicing team.

Buy-to-let

The Group's buy-to-let lending, at £1,480.5 million, remained largely stable year-on-year, reducing by 1.0% from 2018 levels (2018: £1,495.5 million). The pipeline of buy-to-let loans in process at the year end was £911.7 million, an increase of 17.0% on the position a year earlier (2018: £778.9 million).

In the professional buy-to-let market the Group's strategy of focussing on specialist customers (those operating through corporate structures and those with larger portfolios) has delivered positive results. These are the customers best suited to the Group's service model and this targeting, coupled with a disciplined approach to underwriting and valuation, has enabled margins and retention rates to be increased while providing the customers with a high standard of support for their business needs. The analysis of the Group's new buy-to-let business by customer type is set out below.

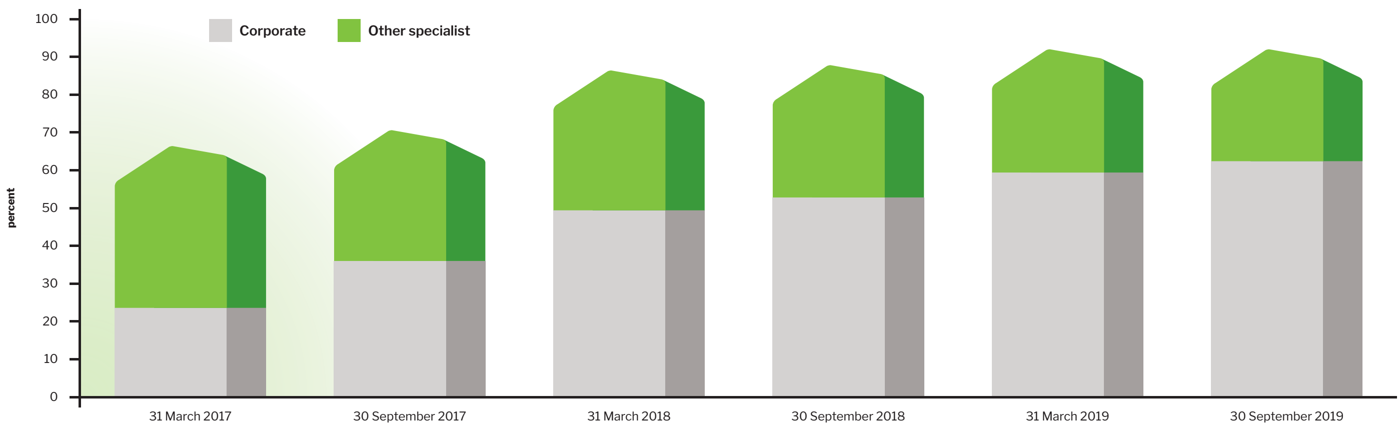
	30 September 2019 £m	**30 September 2019 %**	30 September 2018 £m	30 September 2018 %
Buy-to-let advances				
Corporate customers	**812.4**	**54.9%**	656.7	43.9%
Other specialist customers	**502.7**	**33.9%**	528.8	35.4%
Total specialist	**1,315.1**	**88.8%**	1,185.5	79.3%
Non-specialist	**165.4**	**11.2%**	310.0	20.7%
	1,480.5	**100.0%**	1,495.5	100.0%

These advances show the impact of the concentration of buy-to-let activity among more professional investors, many operating through corporate structures. This trend is set to continue into the next financial year, with 91.4% of pipeline cases relating to specialist landlord customers (2018: 87.8%). Within this, the trend for portfolio landlords to incorporate their businesses, partly as a response to recent changes in the tax regime for buy-to-let, also continued.

This trend can be seen in the analysis of the Group's buy-to-let pipeline numbers over the last three years.

Percentage of specialist pipeline cases

Number outstanding at date



The Group seeks to mitigate exposure to climate change related issues which might impact on security values, through its lending criteria. This includes ensuring that any property proposed as security generally has an Energy Performance Certificate ('EPC') rating of E or better (on a scale of A to G), and considering any property's exposure to flooding risk before it is accepted as security. A detailed review of the buy-to-let loan book in the year indicated that less than 2.5% of security properties for which data was available were situated in postcodes with medium or high flood risk.

The Group sources the majority of its new buy-to-let lending through specialist intermediaries and significant investment has been made to ensure they receive excellent service. It was therefore gratifying that in feedback from intermediaries in the period, 84% were satisfied with the process of arranging a loan offer, delivering a net promoter score at offer stage of +60. Continued improvement is expected in the coming financial year as intermediaries and customers benefit from the Group's investment in its service proposition and the enhanced technology to support it.

Other mortgage lending

The division's other first and second charge mortgage lending has been carefully managed to ensure that only lending with appropriate risks and returns is undertaken.

The Group's second charge mortgage lending has increased marginally by 1.1% during the year, but remains at modest levels. The second charge market is currently not large, with total lending in the financial year reported by the Finance and Leasing Association ('FLA') of £1,207 million (2018: £1,031 million). However, much of the increase has come from sub-prime activity, which falls outside the Group's risk appetite. The Group seeks to target only that population of customers with the strongest credit quality in this area, avoiding any form of sub-prime business, which necessarily limits the addressable market for second charge lending.

In residential mortgage lending, margins have been generally compressed and the Group has maintained credit discipline at acceptable yields, meaning that the amount of new business has fallen. The opportunities for the Group in this area principally relate to highly specialised propositions, where the Group's operational approach can be beneficial, including lending to the existing specialist landlord customer base. In the short-term only small volumes of lending are expected in this area.

Performance

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

	30 September 2019 £m	30 September 2018 £m
Post-2010 assets		
First charge buy-to-let	**5,427.7**	4,481.8
First charge owner-occupied	**68.3**	59.4
Second charge	**171.6**	141.3
	5,667.6	4,682.5
Legacy assets		
First charge buy-to-let	**4,674.2**	5,779.8
First charge owner-occupied	**2.3**	11.2
	10,344.1	10,473.5

At 30 September 2019, the balance on the Group's mortgage portfolio was 1.2% less than a year earlier, with £695.8 million of the reduction being due to the PM12 disposal. Excluding movements in the PM12 portfolio in the year, the mortgage book grew by 6.2%. Within those amounts the post-2010 buy-to-let book grew by 21.1%.

The annualised redemption rate on post-2010 buy-to-let mortgage assets at 10.7% (2018: 16.7%), has reduced from the high level seen in 2018. This higher level of customer retention is a result of the extending profile of product maturities and the changing focus towards specialist landlord customers. The annualised redemption rate on pre-crisis lending, at 6.7%, is similar to that seen in the year ended 30 September 2018 (2018: 6.0%), reflecting the pricing of those loans relative to current market offerings.

Arrears on the buy-to-let book as a whole have marginally increased in the year to 0.18% (2018: 0.11%), with arrears on post-2010 lending standing at 0.03% (2018: 0.01%). These arrears remain very low compared to the national buy-to-let market, with UKF reporting arrears of 0.42% across the buy-to-let sector at 30 September 2019 (2018: 0.42%). This strong 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 arrears increased to 0.38% from 0.21% in the year, as the book continues to season, with performance remaining strong, while the new residential lending has yet to see any arrears, although the loans are still comparatively unseasoned.

The Group's receiver of rent process for buy-to-let assets helps to reduce the level of losses by giving direct access to the rental flows from the underlying properties, while allowing tenants to stay in their homes. At the year end, 683 properties were managed by a receiver on the customer's behalf, a reduction of 11.3% since 2018 (2018: 770 properties) as cases on the old book resolve and post-2010 cases perform well.

Outlook

The Group has established a significant market position in specialist buy-to-let which offers good prospects for future earnings and profitability, though significant expansion of volumes is not anticipated in the year ending 30 September 2020.

Although the general UK economic outlook remains uncertain, the underlying metrics within the PRS are more positive for the Group's landlord customers, with market commentators largely positive. The Group is also confident that its robust approach to valuation and the loan to value coverage in its buy-to-let book, at 67.3% (2018: 65.7%) provide significant security in the event of a downturn.

Looking forward, the Group intends to broaden its offerings to its core professional landlord customers and the intermediaries supporting them to provide both an enhanced service and additional products tailored to their needs. Despite the political uncertainties, professional landlords continue to develop their businesses and expand their portfolios. With the PRS representing a fifth of households, professional landlords are vital to the UK's housing provision and the Group sees significant business opportunities in providing them with the financial support that they require.

A3.2.2 Commercial Lending

The Group's Commercial Lending division's focus is to support UK SMEs and small corporates through the provision of various financing solutions. The division has seen significant levels of investment since 2015 through both acquisition and organic business growth.

The proposition is delivered through four key business lines: SME lending, providing finance leasing for business assets and unsecured cash flow lending to professional services firms amongst other products; development finance, including the operation acquired in 2018; structured lending; and motor finance.

The asset leasing market in the UK is substantial, covering some £79.3 billion of outstanding balances at 30 September 2019 (2018: £75.8 billion) and £33.2 billion of advances in the year then ended (2018: £30.1 billion) according to FLA data. However, a large proportion of this business is commodity lending in the hands of a small number of very large finance houses. It is the Group's strategy to target niches within this market where its particular skill sets can be best applied, and its capital effectively deployed to optimise the relationship between growth, risk and return.

The Group's commercial lending offerings target markets where there has historically been a shortage of credit, such as its development finance business which primarily supports smaller housebuilders, whose difficulties in funding new-builds have been widely reported, and the structured lending business which funds small non-bank lending operations. In each of these markets the Group's competitors are other smaller banks and similar sized lenders. They are markets in which the largest lenders have little presence, creating a credit availability issue for customers and significant opportunities for the Group.

The division's businesses comprise specialist teams, developed internally or sourced externally to provide bespoke focus to their respective markets. This was highlighted in the year when the Group's SME lending business was named as 'Best Commercial Lender' at the 2019 Lending Awards and 'Best Specialist Finance Solutions Provider' in the SME News Magazine's 2019 UK Legal Awards, while being shortlisted in several other categories. Also at the Lending Awards, the structured lending business was named 'Best Specialist Commercial Lender' for 2019.

The common themes of these business lines are a deep understanding of their markets and their customer needs together with expertise in security valuation, collections and asset recovery. 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.

Lending activity

A deceleration in global economic growth and continued political uncertainty in the UK during the year have had an adverse impact on UK business investment, however this has not led to a reduction in the Group's volumes.

The Group's focus across all the Commercial Lending business lines in the year has been on growing the scope of its operations to address a wider range of funding propositions for SME customers, while enhancing service, maintaining credit discipline and improving yields.

The SME leasing operation has strengthened its position in core hard-assets and expanded into soft-asset financing. The Group's development finance and structured lending businesses have also increased their scope.

The UK government retains its target of delivering 300,000 new homes by the mid-2020s, which will require a significant uplift in current construction levels (in 2017/18 222,000 new homes were built), providing opportunities for the Group's customers in the construction and property development fields.

The Group's Commercial Lending exposure has increased overall by 28.1% in the year to £1,452.1 million (2018: £1,133.2 million). The new lending activity in the segment during the year is set out below.

	2019	2018
	£m	£m
Development finance	**362.9**	136.8
SME lending	**406.5**	354.7
Structured lending	**49.7**	40.6
Motor finance	**148.9**	177.9
	968.0	710.0

Development finance

The Group's development finance business was significantly expanded by the acquisition of Titlestone in July 2018. The period since then has been positive with the Group's organically developed activities being integrated with the acquisition to deliver operational efficiencies, and the focus of the combined business refined.

The Group's target customer in this market is a small to medium sized developer of UK residential property. The projects funded have an average size of approximately £5 million and are generally focussed on the more liquid parts of the residential market, avoiding developments with high unit values. While the business has been concentrated in the South-East of England to date, with 51.7% of balances at 30 September 2019 located in London and the South-East, the Group's strategic objective is to lend more widely across the UK. Central London property hot-spots have been largely avoided.

Activity in the Group's target market has held up well in the year, with enquiry levels consistent with previous periods. However, economic uncertainty has led to some developers taking longer to commence projects and there has been additional caution amongst larger scale developers, evidenced in lengthening periods between facility agreement and the first drawdown.

The successful combination of the Group's original Paragon Development Finance business with Titlestone has seen lending volumes increase from £136.8 million in 2018 to £362.9 million in 2019. However, the 2018 figure only includes post-acquisition advances. On a proforma, like-for-like basis, the 2018 volumes were £320.8 million. The underlying £42.1 million (13.1%) increase represents the distribution benefits from the combination and the maintenance of the Group's strong credit standards in this market.

Prospects for the new financial year remain encouraging, with undrawn amounts on live facilities at 30 September 2019 of £294.8 million (2018: £215.2m) and a post-offer pipeline of £160.9 million (2018: £151.5m), a large proportion of which would be expected to flow in to future completions. Market fundamentals remain strong, albeit tempered by short-term economic anxieties, and the Group's extensive property experience can be used to leverage future growth.

SME lending

The SME lending operation has strengthened its position in its core hard-asset leasing market during the period and sought to expand its soft-asset offering. It has maintained its focus on margins and sought to support its business levels through strong customer relationships and service standards.

Business generation has benefitted from an enhanced proposition and operational efficiencies arising from increasing centralisation of operations at the Group's SME lending hub in Southampton. New loan volumes in the leasing business have grown by 11.4% compared to 2018, reaching £288.7 million (2018: £259.2 million). A further £11.6 million of operating lease assets were also acquired in the year (2018: £19.3 million).

The short-term professions finance business, which includes the Iceberg operation acquired in December 2017, grew broadly in line with expectations during the period.

As part of the centralisation process significant investments have been made in technology, while the sales teams have also been strengthened across the various specialist areas of the business. These developments form the first phase of a programme of business enhancements which will sustain growth into the future.

Structured lending

The Group's structured lending business, which made its first loans in the second half of 2018 has made further progress in the year. The structured lending unit provides 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. Transactions are structured using established and robust methodologies and secured on underlying assets, with a substantial amount of over-collateralisation. 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.

The team, which has built a solid reputation in the market, expanded in the year, allowing more prospects to be addressed. The structured lending business generally has a longer pipeline than other operations, with detailed negotiations required before a new loan can be agreed. There are now eight transactions in place, compared to three at the previous year end, with more prospects at various stages of development. The deals currently in progress are expected to provide further lending into the new financial year, while the business as a whole has good prospects for further expansion.

Motor finance

The Group continues to target its motor finance offerings on those specialist propositions which are not addressed by the mass-market lenders who control the majority of the market. This limits the potential to grow market share and the level of advances in 2019 has been below that achieved in 2018, in part due to a continued level of new business pricing discipline. The Group has reviewed its business model for motor finance following the publication of the FCA's review of the sector. It has identified the changes required by the FCA's proposed new rules and considers that is well placed to comply, compared to other market participants.

Across all business lines growth has been carefully controlled with credit quality and margins prioritised over expanding lending volumes and care has been taken to focus effort on those sectors or subsectors of the market most suited to the Group's business model and most likely to provide it with a good return on capital.

Performance

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

	30 September 2019 £m	30 September 2018 £m
Asset leasing	**492.2**	403.4
Professions finance	**46.2**	42.6
Invoice finance	**18.5**	21.8
Unsecured business lending	**19.3**	17.3
Total SME lending	**576.2**	485.1
Development finance	**506.5**	352.8
Structured lending	**88.1**	38.7
Motor finance	**281.3**	256.6
	1,452.1	1,133.2

Margins in the segment have remained strong and have reflected both the changing business mix and strategic initiatives to improve yields across the main product lines.

Credit quality in the development finance book has been good, and the overall performance of the projects has been in line with expectations. These accounts are monitored on a case-by-case basis by the Credit Risk function. At 30 September 2019 very few cases had been classified by the monitoring process as being likely to result in a loss, beyond a small number of Titlestone accounts identified on acquisition and allowed for in the purchase price and where refinements in fair values at the acquisition date have been reflected in the goodwill valuation during the year.

The average loan to gross development value for the portfolio at the year end, a measure of security cover, was 64.8% (2018: 63.2%).

Credit performance on the division's finance leasing portfolios remains stable, with arrears in asset leasing at 0.43% and motor finance at 1.27% (2018: 0.78% and 0.93% respectively). These compare favourably to those in the wider sector, with the FLA reporting average arrears for business leasing at 1.10% and car finance at 2.70% at 30 September 2019 (2018: 0.70% and 2.50%).

Performance in the structured lending operation has been in line with expectations, with satisfactory pricing and no serious concerns with the operation of any of the deals.

Outlook

The Commercial Lending segment has seen the greatest level of investment by the Group in the recent past, most notably through its acquisition activity in the SME lending and development finance markets. The Group has demonstrated its ability to support the needs of underserved customers in these important parts of the UK economy.

Whilst further bolt-on acquisitions to enhance existing operations remain a possibility, the Group's focus, having integrated and embedded the acquired elements into its core risk, operational and systems processes, is now to invest in technological, distribution and servicing enhancements for its commercial lending activities, optimising its proposition to customers.

The division seeks to be responsive and flexible in addressing the SME market, but its UK focus means that it is exposed to a downturn in business investment nationally. Overall, the Group has a good platform for continuing growth and increasing scale and diversity will enable a better return to be generated from its resources, control framework and investments in systems.

A3.2.3 Idem Capital

The Group's Idem Capital division includes its acquired loan portfolios, together with its pre-2010 legacy consumer accounts. Its strategic focus is on the acquisition of more specialist loan portfolios where it can enhance value through leveraging the Group's origination and collections expertise and access to funding, and which will augment the organic origination activities of the Group. It uses its analytical skills base, which it sees as a core differentiator, to identify and evaluate portfolios brought to market.

The division's profitability relies on providing a high quality service to customers when collecting on acquired assets. Many of these borrowers may have historically experienced financial difficulties, and its focus in collections activity is to generate fair outcomes for these customers, while being mindful of potential vulnerabilities.

As part of the banking group it is able to deploy expertise in a wide variety of asset classes and access the systems development resource and support functions of the wider business, enabling more complex portfolios to be addressed. It also has significant experience in working in partnership, either as an investor or administrator, giving it access to transactions which may be unattractive on a standalone basis.

As part of a wider Group, Idem Capital evaluates investments on the potential return which can be achieved on Group capital compared to alternative opportunities in other divisions, imposing a bidding discipline on potential purchases, but is also not constrained to pursue volumes in order to retain critical mass, as a monoline asset purchaser might be.

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

New Business

The UK loan portfolio purchase market has remained active throughout the year despite the current levels of economic uncertainty, and the Group has accessed all the significant tender processes in the period. However, conditions in the market are difficult, with levels of demand and pricing remaining high, and several very large investors being prepared to accept returns on capital below those required by the Group.

In the face of these conditions the Group has maintained its disciplined approach to pricing and quality. It continues to target only those deals where its wider capabilities in administration and funding can provide a real benefit to the project and where the projected return is attractive in comparison to the other opportunities for the deployment of its capital.

During the period no new deals were completed which were subsequently included on the division's balance sheet (2018: one deal) although the Idem Capital team was active in facilitating the £4.2 million asset purchase undertaken by the Mortgages division in the year, as noted above. In addition, the division undertook a limited number of reviews of opportunities that were ultimately not progressed.

Aside from these, the main focus of the business was on monitoring the performance of the extant portfolio and the integration of the £83.4 million motor finance portfolio purchased towards the end of the previous financial year.

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 principal UK vendors.

Performance

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

	30 September 2019 £m	30 September 2018 £m
Second charge mortgage loans	**217.7**	274.6
Unsecured consumer loans	**134.7**	173.7
Motor finance	**37.6**	72.8
	389.9	521.1

The reduction in balances is a result of the scale of collections from the brought forward loan portfolios, particularly the unsecured and motor finance balances, together with some minor asset disposals. 120 month Estimated Remaining Collections ('ERC') on acquired consumer assets reduced from £489.6 million at 30 September 2018 to £366.4 million at the year end, for the same reasons.

Overall collections from customers have held up well in the year, despite the generally negative economic forecasts for the UK. Whilst the division's second charge assets are over 10 years seasoned, offering resilience to any potential downturn, the unsecured assets are less seasoned, and their performance will continue to be carefully monitored over the coming year.

Arrears on the segment's secured lending business have risen slightly to 17.2% (2018: 15.8%), the increase arising from redemptions amongst the better performing accounts in the year. These arrears levels remain higher than the average for the sector, but this reflects the seasoning of the balances, and the inclusion of accounts which are currently making full monthly payments but had missed payments at some point in the past. Average arrears for secured lending of 8.7% at 30 September 2019 were reported by the FLA (2018: 9.4%).

None of the division's remaining 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 30 September 2019 such collections were 109.8% of those forecast to that point (2018: 109.7%).

The motor finance book acquired at the end of the previous financial year has been bedded in successfully, with collections currently ahead of plan, resulting in a reduction of 48.4% in the carrying balance, year-on-year, and only 12.1% of remaining cases in arrears at the year end. The success of this acquisition reflects the Group's strategy of targeting more specialist portfolios.

Operational improvements have continued to be made in systems, processes and employment patterns which are expected to generate operational efficiencies and improve both customer service and customer experience in future periods.

Outlook

The loan purchase market continues to offer opportunities for Idem Capital to invest in portfolios, either by itself or with partners, where its ability to leverage the skill base of the wider group can generate good returns. These deals are likely to be larger, more idiosyncratic and less frequently available than the average, which leads to an irregular flow of new accounts to the division.

The Group regards such investments as essentially opportunistic, and its firm belief is that the maintenance of strict discipline in this area is the best route to delivering an appropriate return on its investments. The division is well placed to continue the effective management of its asset base and to address appropriate business opportunities as they arise, however, in the absence of an acceptable return on investment, the Group expects to focus its capital allocation on its other operating divisions in the near term.

A3.3 Funding review

The Group's strategic funding objective is to maintain a diversified and sustainable funding base. It accesses differing mixes of funding options from time to time to ensure that pricing and availability issues in any particular funding market can be mitigated, while maintaining the flexibility to fund new business opportunities when required.

During the year the Group has continued to emphasise the central role of retail deposits within its funding mix. This has resulted in savings deposits accounting for almost half the Group's funding by the year end.

In the wholesale markets the Group issued its first SONIA referenced securitisation transaction, Paragon Mortgages (No. 26) PLC during the year. It also disposed of its residual interests in the Paragon Mortgages (No. 12) PLC securitisation and repaid several other securitisation deals, financing them on balance sheet.

In the uncertain economic climate, which has continued throughout the year, the Group maintained its policy of holding strong levels of contingent liquidity and of holding larger cash balances than might otherwise be the case, with £872.1 million of cash available for liquidity and other purposes at 30 September 2019 (2018: £962.9 million). Further contingent liquidity was provided by undrawn warehouse facilities of £200.0 million (2018: nil) and assets pre-positioned to access Bank of England facilities. The contingent liquidity policy will be kept under review in the light of the emerging economic and political environment.

The Group has also explored new routes to the savings market in the period in order to broaden its distribution, increase the market addressed and create the capacity for more flexibility in its funding.

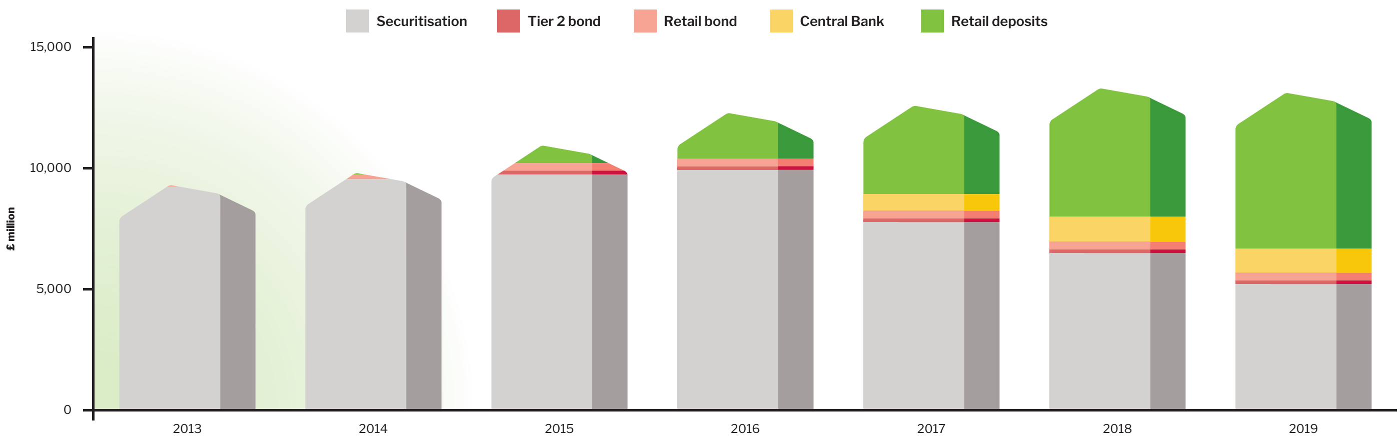
The Group's funding at 30 September 2019 is summarised as follows:

	2019	2018	2017
	£m	£m	£m
Retail deposit balances	**6,391.9**	5,296.6	3,615.4
Securitised and warehouse funding	**5,206.9**	6,490.3	7,781.8
Central bank facilities	**994.4**	1,024.4	700.0
Tier 2 and retail bonds	**446.1**	445.4	444.8
Total on balance sheet funding	**13,039.3**	13,256.7	12,542.0
Off balance sheet central bank facilities	**109.0**	108.7	109.0
	13,148.3	13,365.4	12,651.0

The Group's funding has become increasingly diversified in the years following the authorisation of Paragon Bank in 2014. This is illustrated by the chart below which shows, for each of the year ends since 2013, the outstanding funding balance by type.

Funding by type (£m)

30 September 2013 – 2019



The Group continues to hold both assets and liabilities where the interest rate is set by reference to LIBOR, which will be withdrawn in 2021. A working group is in place to oversee a transition plan managing impacts on both sides of the balance sheet.

It is likely that a market consensus solution for LIBOR-linked instruments will emerge, which will then need to be implemented on a case-by-case basis. The position with regard to LIBOR linked assets, where the Group has a substantial position relating to legacy mortgage lending is likely to be more complex, with regulatory expectations playing a significant role. No new LIBOR-linked lending is undertaken without specific contractual terms addressing replacement benchmarks. The Group continues to carefully monitor emerging regulatory and market developments so that it minimises, as far as possible, any disruption on LIBOR withdrawal.

A3.3.1 Retail funding

Paragon Bank's savings business 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'). While the business currently sources the majority of deposits through its own website, it also has an increasing presence on wealth management platforms and is expanding to offer postal accounts.

Retail deposits continue to represent a reliable, cost-effective and scalable source of finance for the Group. The volume of retail deposits has continued to grow significantly during the period, in line with the Group's funding strategy, with balances at 30 September 2019, at £6,391.9 million, having increased by 20.7% over the year (2018: £5,296.6 million).

The Group's share of the overall UK savings market remains small, with opportunities identified to expand the franchise. Household savings balances reported by the Bank of England increased by 3.7% in the year ended 30 September 2019 to £1,220.9 billion (2018: £1,177.3 billion), although these deposits remain overwhelmingly with clearing banks and building societies. While this market position enhances the Group's funding flexibility, it does mean that rates may be influenced by the funding needs of other, larger, participants in the market, which are beyond the Group's control.

New entrants in the banking market have sought to access similar segments of the savings market as the Group, and therefore competition for internet-sourced deposits has increased. However, the Group's competitive position on pricing, products and service, has meant that it has been able to achieve its required funding levels at attractive prices.

Savings balances at the year end are analysed below.

	Average interest rate		**Average initial balance**		**Proportion of deposits**	
	2019	2018	**2019**	2018	**2019**	2018
	%	%	**£000**	£000	**%**	%
Fixed rate deposits	**2.02%**	1.94%	**16**	19	**65.0%**	68.8%
Variable rate deposits	**1.43%**	1.36%	**16**	16	**35.0%**	31.2%
All balances	**1.81%**	1.76%	**16**	18	**100.0%**	100.0%

The average initial term of fixed rate deposits was 28 months (2018: 27 months).

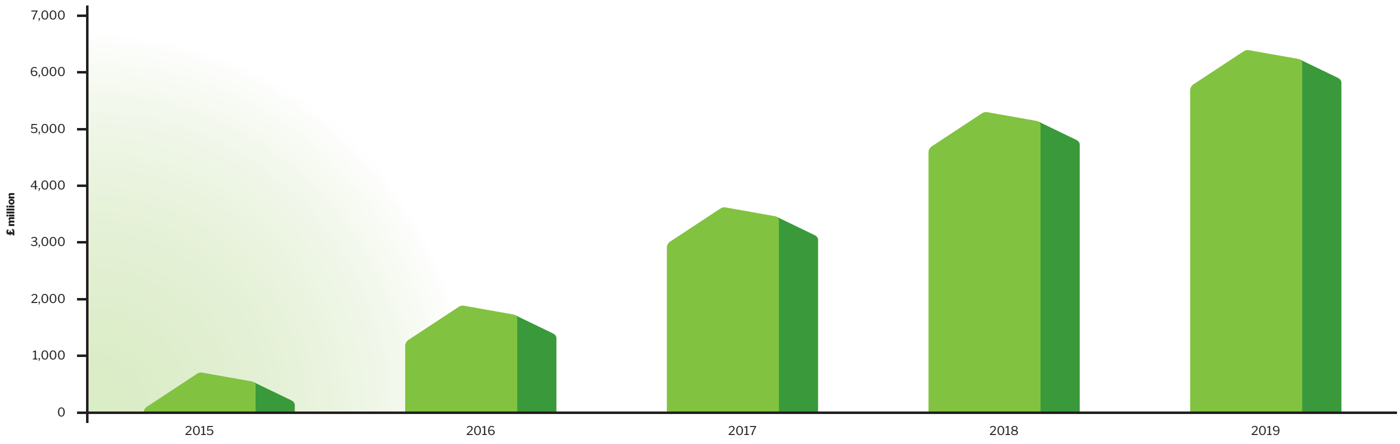
Market rates for new easy access accounts and one year deposits reported by the Bank of England have increased year-on-year, with rates on longer dated products falling, which is consistent with the picture shown above.

At 30 September 2019 the proportion of easy access deposits, which are repayable on demand, at 27.8% was a little higher than its level at the beginning of the year (30 September 2018: 25.5%), and represented £1,778.0 million of the balance (2018: £1,349.2 million). This percentage can be expected to rise going forward as the Group generates richer behavioural data to support its liquidity requirement assumptions for easy access business.

The growth of the retail funding balance since the authorisation of Paragon Bank as a deposit taker in 2014 is shown below.

Retail deposits (£m)

At 30 September 2015-2019



The core route to market for the deposit proposition is through its online presence, with traffic driven by strong repeat business flows, organic searches, a presence on price comparison websites and recommendations from industry savings experts. This has been enhanced in the period by the launch of alternative deposit sources, such as investment platforms outside the main business flow.

The first of these alternative sources, the Hargreaves Lansdown Active Savings platform came on stream in November 2018, with further relationships with Flagstone, a wealth management solution and Monzo, the digital bank, launched later in the year. These arrangements allow the Group to access an additional customer base, as the platforms target different demographics to its online direct savings channel. The Group will seek to develop such relationships further in future periods.

The Group's products, process and approach have been recognised in the industry and by customers winning the 'Best Monthly Interest Provider' award in the 2019 Moneynet awards, its second consecutive victory in this category. It was also named as 'Best Online Cash ISA Provider' in the 2019 YourMoney.com Awards and 'Best Savings Provider for Existing Customers' in the 2019 Savings Champion awards.

In customer feedback 89% of those opening a savings account with the Group in the year who provided data, stated that they would 'probably' or 'definitely' take a second product (2018: 90%). The net promoter score in the same survey was +65, up from +61 for the 2018 financial year.

When customers with maturing savings balances in the year were surveyed 91% stated that they would 'probably' or 'definitely' consider taking out a replacement product with the Group (2018: 90%) with a net promoter score at maturity of +53, up from +50 for the 2018 financial year. This performance is particularly valuable to the Group, given the benefits of customer and deposit retention.

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. The Group has a close relationship with the service provider through which it seeks to enhance both its offerings and its customer service levels.

The size and diversity of the Group's deposit base is expected to continue to expand, forming the principal funding source for new lending activities. This will be driven through expanding distribution and developing the product range to serve additional customer groups. The guarantee provided by the FSCS scheme is likely to reduce the potential for an economic downturn to impact liquidity and the profile of the Group's target customers suggests that they are likely to be more resilient than average in such circumstances.

Overall, the savings proposition provides the Group with 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, giving the funding channel flexibility and manageability. The additional routes to market enhance this flexibility.

A3.3.2 Wholesale funding

The Group's wholesale funding comprises securitisation funding, warehouse debt and retail and corporate bonds. It has been one of the principal issuers of residential mortgage backed securities ('RMBS') in the UK over many years. Its Long-Term Issuer Default Rating was affirmed at BBB by Fitch in the period, albeit with a negative outlook which was applied to all the major UK banks as a result of the uncertainty surrounding the Brexit process. Fitch have stated that, all other things being equal, this would be removed in the event of a resolution.

The capital markets were largely quiet in the first six months of the period with rates less appealing than in previous periods. This was attributable to two factors, the general economic environment in the UK and the impending withdrawal of the LIBOR reference rate, which has formed the basis for interest charging on the majority of asset backed securities since the inception of that market. LIBOR is due to be withdrawn in 2021, within the lifetime of a newly issued four-year security, and UK regulators have mandated the Bank of England Sterling Overnight Index Average ('SONIA') to replace it.

No significant SONIA-linked bonds were issued before April 2019, with much of the market waiting for a standard approach to emerge. However, the first issuers came to market after that point and the levels of pricing and liquidity returned to a more normal level for the rest of the year, despite the general economic pressures.

The Group issued its first SONIA linked transaction, Paragon Mortgages (No. 26) PLC ('PM26') in June 2019. PM26, backed by seasoned buy-to-let mortgage assets, raised £364.3 million of external funding in sterling Mortgage Backed Floating Rate Notes. The senior notes, the only notes issued externally, were rated AAA by Fitch and Aaa by Moodys and bear interest at compounded SONIA plus a margin of 1.05%. It should be noted that margins above SONIA are typically larger than those above LIBOR, reflecting the risk-free nature of the SONIA rate. The deal also generated internally held rated notes which may either be sold later or used as collateral for Bank of England or other repo facilities, giving the Group enhanced funding and liquidity options.

On 27 June 2019 the Group sold its remaining investments and residual interest in the Paragon Mortgages (No. 12) PLC securitisation. While the transaction remains in place and the Group continues to manage the assets, it has no further interest in their performance and both the assets and the associated funding have been derecognised from the Group's balance sheet, realising a net profit of £9.7 million as well as crystallising its loan participation in cash. This removed £695.8 million of low yielding securitised assets from the Group's balance sheet and, consequently, reduced its encumbrance ratio, while improving yields.

During the year the Group paid down five further securitisation transactions. These included two funding legacy mortgages and the Group's remaining consumer finance transaction. These transactions between them had £95.8 million of notes outstanding at 30 September 2018 and had some of the highest funding costs among the legacy arrangements. Additionally, two transactions funding post-2010 mortgages were paid down, having reached their optional call dates. After the year end, notice was given on a further post-2010 mortgage transaction. Further such refinancing transactions should be expected over the coming years.

A further funding option is provided by wholesale warehouse funding, which provides standby capability, particularly in the event of market disruption elsewhere, where funds need to be deployed rapidly or as an alternative to retail deposit funding for liquidity purposes or in the process of building a portfolio of loan assets for securitisation. During the period a new £200.0 million facility was agreed with Bank of America Merrill Lynch, carrying an interest rate of LIBOR plus 0.95%.

A3.3.3 Central bank facilities

The Group has continued to make use of facilities offered by the Bank of England to support its lending to households and businesses. Its drawings under the Term Funding Scheme ('TFS') remain in place and provide £944.4 million of the Group's funding (2018: £944.4 million), with all drawings remaining in place until at least 2021. The Group also utilised the Indexed Long-Term Repo scheme ('ILTR') for six-month borrowings, with £50.0 million outstanding at the period end (2018: £80.0 million).

The Group's liquidity drawdown under the Funding for Lending Scheme ('FLS'), which provides liquidity of £109.0 million (2018: £108.7 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, providing access to liquidity of up to £1,095.0 million. It can also use the retained notes in recent securitisation transactions, which are externally rated, for this purpose.

The Group will continue to utilise central bank facilities in future, subject to availability, as part of its integrated funding framework.

A3.3.4 Summary

The Group's diversified funding position, with strong wholesale and retail franchises gives it a strong position in the face of economic uncertainties. This reduces its exposure to issues affecting any particular funding source and allows it the flexibility to raise funds in accordance with its own market assessments, rather than being forced into sub-optimal transactions for short term reasons. This base delivers a robust and adaptable position going forward, supporting the Group's overall business strategy and aspirations.

Further information on all the above borrowings is given in notes 32 to 36.

A3.4 Capital review

The Group's capital policy aims to provide appropriate returns to shareholders, whilst maintaining prudent levels of capital to support its strategic objectives going forward. The maintenance of strong regulatory capital and liquidity positions to safeguard its depositors is also a principal strategic objective.

For regulatory purposes the Group's capital comprises shareholders' equity and tier 2 bonds. It has no outstanding AT1 issuance, but has the capacity to issue such securities, if considered appropriate, under an authority granted by shareholders at the 2019 AGM, which will be proposed for renewal at the forthcoming meeting.

A3.4.1 Dividends and distribution policy

The Company's previously announced dividend policy of paying out approximately 40% of consolidated earnings to shareholders remains in place, achieving a dividend cover ratio of around 2.5 times, in ordinary circumstances. During July 2019 an interim dividend of 7.0 pence per share was paid, determined, in accordance with the Group's stated policy, as 50% of the previous year's final dividend.

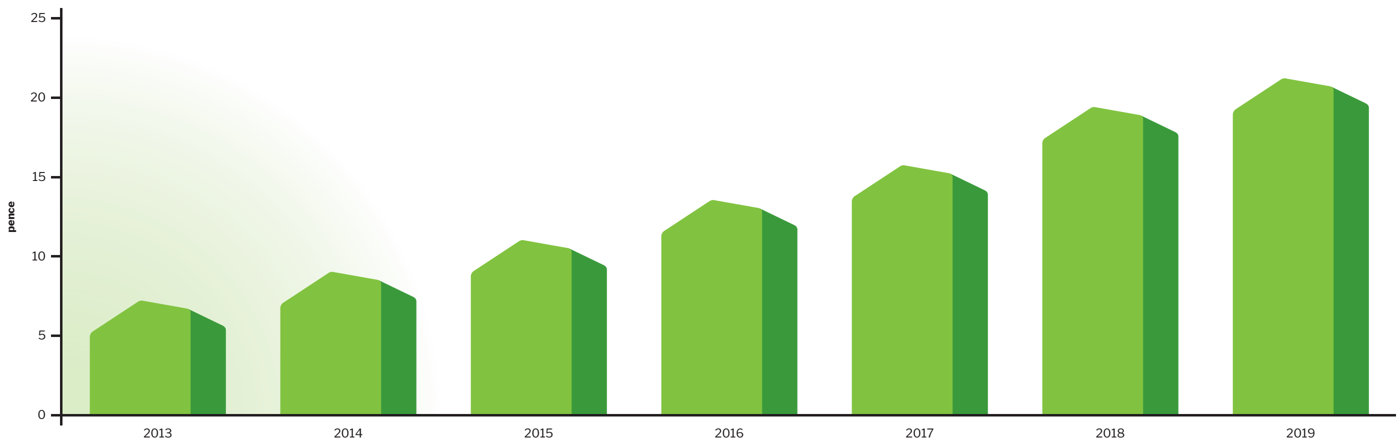
Following the completion of the PM12 residual sale on 27 June 2019 the Board considered the profit generated and the capital released by that transaction and determined that it was appropriate to return a portion of this capital to shareholders by way of a share buy-back programme. During the year the Group bought back 6.0 million of its ordinary shares at a cost of £26.7 million, including stamp duty and transaction expenses (note 44); £26.5 million excluding costs, these shares being held in treasury. Treasury shares may subsequently be cancelled.

In determining the level of dividend for the year, the Board has considered the dividend policy, and has also taken into account the impact of the buy-back programme, together with 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. The dividend policy is underpinned by the principle of enhancing shareholder returns on a sustainable basis and the Board is proposing, subject to approval at the Annual General Meeting on 13 February 2020, a dividend for the year of 21.2 pence for 2019, an increase of 9.3% from the 19.4 pence in 2018. This results in a dividend cover ratio of 2.33 times, which is below the normal target of around 2.5 times but which reflects the scale of non-cash, fair value items in the 2019 results.

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

Dividend for the year (pence)

In respect of the years 2013 - 2019



The directors have considered the distributable reserves of the Company and concluded that such a dividend is appropriate.

A3.4.2 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 an individual capital requirement 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 total risk exposure in order to safeguard depositors in the event of severe losses being incurred by the Group.

The Group maintains strong capital and leverage ratios, with a total capital ratio of 15.9% at 30 September 2019 (2018: 16.2%) and a UK leverage ratio at 6.7% (2018: 6.4%) (note 55(c)). The CET1 ratio, 13.7% at 30 September 2019, marginally reduced during the period (2018: 13.8%), reflecting primarily the growth in the balance sheet, offset by the impact of distributions to shareholders through buy-backs and dividends.

The Group's principal capital measures are set out below. It has been granted transitional relief on the adoption of IFRS 9, with the impact on capital being phased in over a five-year period, with only 5% of the effect being recognised in the first year. However, firms are also required to disclose capital measures as if the relief had not been given (referred to as the 'fully loaded' basis).

		2019	2018	2018
		IFRS 9	IFRS 9	IAS 39
		£m	£m	£m
CET1 capital	Basic	**922.0**	888.7	889.9
	Fully loaded	**900.8**	867.5	889.9
Total Regulatory Capital ('TRC')	Basic	**1,072.0**	1,038.7	1,044.8
	Fully loaded	**1,050.8**	1,017.5	1,044.8

The Group's CET1 capital comprises its equity shareholders' funds, adjusted as required by the CRD IV rules. TRC, in addition, includes tier 2 capital representing the Tier 2 Bonds. Additional tier 2 capital arising from credit loss allowances is no longer included in regulatory capital following the introduction of IFRS 9.

The Group's capital requirements include the Pillar 1 + 2a amount which is specific to the Group and is set by the regulator. This may include both variable and fixed components. At 30 September 2019 this requirement was £742.9 million on the transitional basis and £741.8 million on the fully loaded basis (2018 (IAS 39): £727.7 million), with the increased requirement principally driven by the growth in the Group's asset base.

The Group's capital must also cover the CRD IV buffers, the Counter-Cyclical ('CCyB') and Capital Conservation ('CCoB') buffers. These apply to all firms and are based on a percentage of total risk exposure. These buffers were both increased in the period, with the CCoB increasing from 1.875% to 2.500%, its long-term rate, from January 2019 and the CCyB increasing from 0.5% to 1.0%, from November 2018. These increases in standard CRD IV buffers have added over £75.0 million to the Group's capital requirement. Further buffers may be set by the PRA on a firm-by-firm basis but may not be disclosed.

The Group continues to maintain a healthy capital surplus, although this has been eroded by the 1.125 percentage point increase in the CRD IV buffers in the period, the introduction of IFRS 9 and the increase in the deficit on the Group's defined benefit pension plan.

The Group's capital ratios are set out below.

		2019	2018	2018
		IFRS 9	IFRS 9	IAS 39
		£m	£m	£m
CET1 capital	Basic	**13.7%**	13.8%	13.8%
	Fully loaded	**13.4%**	13.5%	13.8%
Total capital ratio	Basic	**15.9%**	16.2%	16.2%
	Fully loaded	**15.7%**	15.8%	16.2%
UK leverage ratio	Basic	**6.7%**	6.4%	6.4%
	Fully loaded	**6.6%**	6.3%	6.4%

Capital ratios remain largely in line with previous performance, with IFRS 9 transition not having a major impact.

During the year the Group has undertaken a thorough review of the risk weightings applied to its assets for capital purposes, partly in response to market concerns across the sector. This exercise confirmed the weightings being applied under the Standardised Approach for credit risk ('SA') and the appropriateness of the Group's risk weighted asset values and hence its capital measures.

The regulatory authorities in the UK and EU have also continued their work to put in place the December 2017 amendments to the Basel III capital adequacy regime, published in the BCBS document 'Basel III: Finalising post-crisis reforms'. This addresses both the SA for credit risk, presently used by the Group, and the Internal Ratings Based ('IRB') approach, which is based on firms' own internal calculations and subject to supervisory approval.

These proposals are expected to increase capital requirements under the SA for a number of asset classes, including buy-to-let lending, and introduce stricter parameters within which IRB approaches must operate. The Group has monitored developments during the year and revised its capital strategy where necessary.

The Group's project to develop an IRB approach to credit risk for capital adequacy purposes has continued throughout the year. A considerable amount of work has been completed, using both internal and external resources, generating system enhancements as well as progressing the application process. However, in September 2019, the PRA published a consultation paper (CP 21/19) which would enact significant new EBA regulations governing IRB techniques in the UK. At the same time the CP highlighted a need for firms applying for IRB accreditation to comply with certain future regulatory requirements where the authorisation process is expected to extend beyond 2020.

The Group's models already reflect the most material requirements arising from the CP, however, whilst only a consultation at this stage, the Board has decided to ensure its IRB models are fully compliant with the requirements of the CP before delivering the first part of its the application to the PRA.

A3.4.3 Liquidity

The Group's operational capital and funding requirements are also influenced by the Group's policy to hold sufficient liquidity in the business to meet its cash requirements in the short and long-term, as well as to provide a buffer under stress. There is also a regulatory requirement to hold liquidity in Paragon Bank. The Board regularly reviews liquidity risk appetite and closely monitors a number of key internal and external measures. The most significant of these, which are calculated for the Paragon Bank regulatory group on a basis which is standardised across the banking industry are set out below.

	2019	2018	Regulatory minimum
LCR – Liquidity coverage ratio	**138%**	144%	100%
NSFR – Net stable funding requirement	**115%**	113%	100%*

*Not yet a binding requirement

This shows the available liquidity at the year end to be well in excess of regulatory minimums.

A3.4.4 Capital outlook

The Board keeps the appropriate level and form of capital required by the Group under review to ensure that, in the light of the Group's strategic objectives and the economic environment in which it operates, and more specifically where there are changes in the business or in regulatory expectations, the capital position remains prudent and sustainable, for the benefit of all stakeholders.

A3.5 Financial review

The underlying economic uncertainty in the UK over the past year has been reflected in significant shifts in the interest rate yield curve which have affected the Group's results, generating fair value volatility in the profit and loss account and increasing the deficit in the Group's pension plan. However, the underlying position remained positive as the Group's long term strategy continued to bear fruit.

The Group's underlying profit in the financial year ended 30 September 2019 (appendix A) increased by 5.0% to £164.4 million (30 September 2018: £156.5 million) while on the statutory basis, including the effect of fair value losses, profit before tax decreased by 12.4% to £159.0 million (30 September 2018: £181.5 million). The underlying result also excludes a gain of £9.7 million resulting from the disposal of the Group's residual interest in the PM12 securitisation in June 2019 (the 'PM12 disposal') (2018: £28.0 million gains on asset disposals).

Earnings per share on the statutory basis reduced to 49.4 pence (30 September 2018: 55.9 pence) while increasing by 6.0% to 51.1 pence on an underlying basis (30 September 2018: 48.2 pence).

A3.5.1 Results for the year

CONSOLIDATED RESULTS

For the year ended 30 September 2019

	2019	2018
	IFRS 9	IAS 39
	£m	£m
Interest receivable	**505.7**	451.9
Interest payable and similar charges	**(227.3)**	(197.3)
Net interest income	**278.4**	254.6
Net leasing income	**3.8**	3.8
Gain on derecognition of financial assets	**9.7**	28.0
Other income	**15.4**	15.5
Total operating income	**307.3**	301.9
Operating expenses	**(125.2)**	(114.2)
Provisions for losses	**(8.0)**	(7.4)
	174.1	180.3
Fair value net (losses) / gains	**(15.1)**	1.2
Operating profit being profit on ordinary activities before taxation	**159.0**	181.5
Tax charge on profit on ordinary activities	**(31.6)**	(35.7)
Profit on ordinary activities after taxation	**127.4**	145.8

	2019	2018
Dividend – rate per share for the year	**21.2p**	19.4p
Basic earnings per share	**49.4p**	55.9p
Diluted earnings per share	**48.2p**	54.2p

Income

Underlying net interest income increased by 8.5% to £278.4 million from the £256.5 million for the year ended 30 September 2018 (2018 statutory basis: £254.6 million). The growth reflects improved yields in the loan book, together with the size of the average loan book, which rose by 4.5% to £12,143.4 million over the year (2018: £11,626.0 million) (appendix B).

Underlying net interest margin ('NIM') in the year ended 30 September 2019 increased to 2.29% compared to the 2.21% in the previous year (appendix B). This increase reflects the changes in product mix in the Group's balance sheet, with new buy-to-let margins exceeding those achieved on the legacy book and the growing Commercial Lending division operating on still wider margins (appendix B).

During the year the Group disposed of its residual interest in the legacy PM12 securitisation (note 7), generating a cash inflow of £49.8 million. As a result, the assets and liabilities of PM12 were derecognised from the Group's balance sheet, resulting in a net gain of £9.7 million.

Excluding the gain on disposal, other operating income was little changed at £19.2 million for the year, compared with £19.3 million in 2018.

Total underlying operating income increased by 7.9% to £297.6 million (2018: £275.8 million). Total operating income on the statutory basis, at £307.3 million (2018: £301.9 million) also included the gain on the PM12 disposal, whereas the 2018 result included a £28.0 million one-off gain on Idem Capital asset disposals arising during that year.

Costs

Underlying operating expenses increased by 11.9% to £125.2 million from £111.9 million reported in the previous year. These costs include a full year's costs relating to both the Titlestone business, acquired in the second half of the last financial year and the Iceberg business, acquired in December 2017. During the year the Group's average number of employees increased 1.2% to 1,365 (2018: 1,349) and with the Group's strategic initiatives seeing a significant level of higher-paid individuals joining the payroll in the year, employment costs increased by 8.2% year-on-year (note 10). The increase in the Group's savings balance in the period (20.7% year-on-year) also impacts operating costs, with the outsourced servicing fee set by reference to the balance outstanding, rather than simply rising in line with inflation.

The delivery of the Group's strategy depends heavily on its IT infrastructure, and during the year it made substantial investments in developments both to improve efficiency and to provide an enhanced experience to its customers, particularly in the SME market. These initiatives were ongoing at the year end and will be rolled out in the future. Further systems effort was deployed to enhance cyber-security and operational resilience. The period's costs also include expenditure of around £2.4 million on the development of the Group's IRB approach, both in internal resources and external advice, which should generate future benefits to the Group's capital position. Overall the Group estimates that these project costs comprise over £3.5 million of the cost base for the period.

This investment for the future increased the Group's underlying cost:income ratio in the period to 42.1% (appendix C) from the 40.6% recorded in 2018, although without the additional project costs and the impact of the acquisitions, this would have reduced. The control of operating costs remains a principal strategic priority of the Group and it applies a rigorous budgeting and monitoring process.

Strategic disposals, such as the PM12 disposal and the Idem Capital sale in 2018, will have improved earnings per share and RoTE, however their impact has increased the cost:income ratio as a consequence. Over the medium term, the Group targets improvements in the cost:income ratio, from scale and efficiency gains, but increases in regulatory requirements, IT investments and the impact of new operations means that progress to a lower ratio is unlikely to be linear.

Total operating expenses, which in 2018 included the costs of the Iceberg and Titlestone acquisition transactions, increased by 9.6% to £125.2 million (2018: £114.2 million), giving a cost:income ratio on a statutory basis of 40.7% (2018: 37.8%) (appendix C), with the 2018 figure deflated due to the size of the gains on derecognition in that period.

Impairment provisions

The Group has applied IFRS 9 in calculating its provisions for impairment for the first time in the year. As prior year charges are not required to be restated, the 2019 charge is not strictly comparable to that for 2018. However, the charge of £8.0 million for loan impairment has remained broadly similar to that for the previous year under IAS 39 (2018: £7.4 million). The cost of risk (the impairment charge as a percentage of average loans to customers) (appendix B) remains stable at 0.07% compared to 0.06% in 2018.

Under IFRS 9, interest is only recognised on the net value of a credit impaired (Stage 3) loan, reducing both interest receivable and impairment charges. The value of this adjustment in the year was approximately £1.0 million, reducing NIM and cost of risk by approximately 1 basis point.

Careful management of all the Group's loan books continues to be a strategic priority, for both retention and credit purposes. The credit performance of the books continues to be pleasing, with that of the buy-to-let book particularly strong, compared to market averages, with improvements in performance on acquired consumer portfolios year-on-year and credit metrics on the Group's newer portfolios also strong and in line with expectations.

Fair value movements

Yield curve movements during the period resulted in hedging instrument fair value net losses of £15.1 million (2018: £1.2 million net gains), which do not affect cash flow. The size of the movement in the period is mostly a result of market turbulence throughout the year, with the yield curve showing large fluctuations, primarily downwards, especially at month ends. Commentators have ascribed some of this to heightened political uncertainties in the UK over Brexit during the period, with these uncertainties carrying on into the new financial year.

This impacted particularly on the carrying values of swaps held for the purpose of hedging pipeline loan commitments, which cannot be included in a hedge for accounting purposes.

The fair value movements of hedged assets or liabilities are expected to be profit neutral over time, as these instruments will be held to maturity. As such, this item represents a timing difference. The Group remains economically and appropriately hedged.

Tax

Corporation tax has been charged at the rate of 19.9%, increased from 19.6% for the previous year. Materially all of the Group's operations fall within the scope of UK taxation and the standard rate of corporation tax applying to the Group in both years was 19.0%. The Group pays tax at a higher rate on profits arising within its banking subsidiary.

Profits after taxation of £127.4 million (2018: £145.8 million) have been transferred to consolidated equity, which totalled £1,108.4 million at the year end (2018: £1,095.9 million), representing a tangible net asset value of £3.71 per share (2018: £3.59 per share) and an unadjusted net asset value of £4.39 per share (2018: £4.25 per share) (appendix D).

A3.5.2 Segmental results

The Group 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 lending and related activities
- Commercial Lending, including the Group's asset leasing and motor finance activities, together with development finance, structured lending and 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. Items excluded from underlying profit have also been included in unallocated costs, as these are not included in divisional results internally.

The underlying operating profits of these business segments are detailed fully in note 2 to the accounts and are summarised below.

	2019	2018
	£m	£m
Segmental profit		
Mortgages	**167.9**	144.8
Commercial Lending	**43.8**	19.9
Idem Capital	**48.0**	78.2
	259.7	242.9
Gains on disposals	**9.7**	28.0
Unallocated central costs and other one-off items	**(95.3)**	(90.6)
	174.1	180.3

Mortgages

The Mortgages division continues to maintain a strong market position in its core specialist buy-to-let loan market. Strategically targeted operational initiatives have improved retention and enhanced NIM, while provisions remain low. As a result, the segmental profit increased 16.0% to £167.9 million (2018: £144.8 million). Net interest income increased by 12.8% to £177.8 million (2018: £157.6 million), although growth in the average loan book was only 1.8%, a result of the PM12 disposal in the year. The Group's legacy mortgage assets are lower yielding than newer business therefore asset turnover will be beneficial to margins. These effects combined to deliver a 17 basis point improvement in segmental NIM in the period.

The PM12 disposal also provided an additional one-off gain of £9.7 million, included in unallocated items above.

The costs of the division increased as a result of higher activity levels while other income reduced marginally during the period. The overall result was also affected by a reduction of the impairment charge to £1.0 million (2018 (IAS 39): £5.5 million), following the transition to IFRS 9, where an additional write down of £24.0 million was posted against reserves.

Commercial Lending

In the Commercial Lending segment, the level of new advances generated a substantial increase in loan assets, with the segment's loans to customers at 30 September 2019, at £1,452.1 million, increasing 28.4% from the position twelve months earlier (2018 (IFRS 9): £1,131.3 million). Growth was seen across all the major product lines with the development finance portfolio increasing 43.2% year-on-year, asset leasing 21.3% and structured lending 127.6%.

NIM in the division rose by 124 basis points compared with the year ended 30 September 2018, driven by the additional high-yielding development finance assets and a focus on enhancing yields elsewhere.

Segmental profit in Commercial Lending increased 120.1% in the year to £43.8 million (2018: £19.9 million). This is attributable to the contribution of operations acquired in the previous year and maturing new business lines, together with growth and enhanced focus in the ongoing sectors.

Idem Capital

The Idem Capital division's portfolios continued to generate strong operational cash flows in the year ended 30 September 2019. No new deals were completed and hence the average outstanding loan balance reduced through run-off in the period, falling by 25.0% in the last twelve months to £389.9 million (2018 (IFRS 9): £519.8 million). NIM reduced in the segment, a result of the recent strategic focus on acquiring performing books, which may have lower yields; the impact of the portfolio sale of higher yielding assets in September 2018; and strong natural portfolio amortisation. This impacted on segmental profit, which fell by 38.6% to £48.0 million (2018: £78.2 million).

A3.5.3 Assets and liabilities

The Group's assets and liabilities at the year end are summarised in the balance sheet below.

SUMMARY BALANCE SHEET

30 September 2019

	2019	2018	2018
	IFRS 9	IFRS 9	IAS 39
	£m	£m	£m
Intangible assets	**171.1**	169.3	169.3
Investment in customer loans	**12,186.1**	12,100.6	12,127.8
Derivative financial assets	**592.4**	855.7	855.7
Free cash	**225.7**	238.0	238.0
Other cash	**999.7**	1,072.6	1,072.6
Other assets	**220.5**	51.7	51.7
Total assets	**14,395.5**	14,487.9	14,515.1
Equity	**1,108.4**	1,073.5	1,095.9
Retail deposits	**6,391.9**	5,296.6	5,296.6
Borrowings	**6,648.4**	7,961.2	7,961.2
Pension deficit	**34.5**	19.5	19.5
Other liabilities	**212.3**	137.1	141.9
Total equity and liabilities	**14,395.5**	14,487.9	14,515.1

The size of the Group's balance sheet has remained broadly similar through the year although the underlying balances evidence the continuing reshaping of its operations, with increased diversity of assets and growth in the retail deposit franchise.

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 leasing and motor finance loans in the Commercial Lending segment, with similar purchased accounts in the Idem Capital segment
- Professions finance, invoice finance and other finance for SME businesses in the Commercial Lending segment
- Development finance loans in the Commercial Lending segment
- Structured lending loans in the Commercial Lending segment

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

	2019	2018	2018
	IFRS 9	IFRS 9	IAS 39
	£m	£m	£m
Mortgages	**10,344.1**	10,449.5	10,473.5
Commercial Lending	**1,452.1**	1,131.3	1,133.2
Idem Capital	**389.9**	519.8	521.1
	12,186.1	12,100.6	12,127.8

During the year the mix of the Group's assets has been altered by the PM12 disposal, increased volumes in development finance and structured lending and the continuing run-off of Idem Capital assets. Movements in the Group's loan asset balances are discussed in the lending review section (Section A3.2) while an analysis of the Group's financial assets by type is shown in note 20.

Derivatives

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

The interest rate movements mentioned above have also driven significant changes in the valuation of derivatives held for hedging fixed rate loan assets or deposit liabilities, with the net carrying value switching from a £21.3 million asset at 30 September 2018 to a £70.8 million liability at the period end. For those derivatives forming part of a hedge for accounting purposes this movement is offset by the movement in the fair value adjustments against loans to customer and retail deposits.

Funding

Movements in the Group's funding, including retail deposit balances and wholesale borrowings, are discussed in the funding review section (Section A3.3), with retail deposits now forming almost half of the Group's total funding. The Group has pursued a conservative liquidity policy in the period, resulting in a focus on contingent liquidity arrangements and strong levels of liquid assets being held throughout the period.

Pension obligations

The accounting value of the deficit in the Group's defined benefit pension plan (the 'Plan') has increased over the year ended 30 September 2019. Gilt yields fell sharply over the year, resulting in a discount rate of 1.85%, 110 basis points less than at 30 September 2018. This effect was mitigated, to some extent, by the adoption of more recent market mortality assumptions and a strong performance by the Plan's investments. Together these resulted in the deficit under International Accounting Standard ('IAS') 19 increasing to £34.5 million (2018: £19.5 million). These movements also generated an actuarial loss of £16.5 million before tax which was recognised in other comprehensive income (2018: gain of £8.9 million).

While the valuation under IAS 19 is that which is required to be disclosed in the accounts, pension trustees generally use the technical provisions basis as provided in the Pensions Act 2004 to measure scheme liabilities. On this basis, the deficit at the triennial valuation date (31 March 2016) was £18.0 million and this had increased to £29.2 million at 30 September 2019 (30 September 2018: £15.2 million), representing an 80% funding level (30 September 2018: 87%).

Other assets and liabilities

Sundry assets have increased as a result of the Group's deferred tax balance becoming an asset (a result of IFRS 9 transition adjustments and the movement in the pension plan liability), together with the inclusion of £72.2 million of collateral which was required to be placed with banks as security for the Group's swap liabilities (30 September 2018: £3.8 million).

Within sundry liabilities the largest movement has been the increase in derivative liabilities to £80.5 million from £4.7 million at 30 September 2018, principally as a result of interest rate movements.

A3.5.4 Accounting changes

On 1 October 2018 the Group adopted IFRS 9 in place of IAS 39. The new standard changes the basis of provision from incurred loss to expected loss, which means that although a broadly similar bad debt charge will be posted over the life of a credit impaired account, it will be recognised earlier. The consequence of this is that a growing portfolio, such as most of the Group's loan books, will attract a higher provision charge than it would have done under the previous methodology. This has required the development of models and methodologies over a period of years, utilising the Group's historic data and its experience in modelling and analytics.

The Group published a report on its transition to IFRS 9 on 20 March 2019 which is available from the investor section of the Group's website at www.paragonbankinggroup.co.uk.

The change impacted on loan asset values on the Group's balance sheet on transition but has not had a significant impact on the profit and loss charge in the year. This was anticipated, as the accounting change is principally an acceleration of the impairment charge and is therefore a timing difference, rather than an additional loss. Within the charge, however, amounts which would have been provided in the year under IAS 39 were included in provision brought forward under the new standard, while additional provisions, particularly for new originations, were required where no provision under IAS 39 would have been booked.

The other new requirements of IFRS 9 have not had a significant impact on the Group's accounting but have required the presentation of significant additional or expanded disclosures. At the same time the Group adopted IFRS 15 – 'Revenue', but this did not have a significant impact.

The total effect of these changes was an increase in the Group's impairment provisions at 1 October 2018 of £27.2 million and a reduction in equity of £22.4 million after tax (note 62).

For regulatory capital purposes the CRR allows the impact of the transition to be phased in over a five year period, so that the initial impact on capital ratios was negligible. On a fully loaded basis the transition to IFRS 9 resulted in the Group's CET1 ratio at 1 October 2018 reducing from 13.8% to 13.5%.

The Group will continue to develop, test and validate its IFRS 9 approach as more data becomes available and market practice continues to develop.

The Group has adopted IFRS 16 – 'Leases' with effect from 1 October 2019. However, this change will have minimal impact on the Group's results and balance sheet, increasing both assets and liabilities by around £9.0 million and not impacting on reserves or capital (note 61).

A3.6 Operational review

A3.6.1 Management and people

The Group's people are its most significant cost, whilst also key to its future growth and development and the medium through which its culture is manifested. Over 1,300 people worked for the Group throughout the period, at its Solihull headquarters and other locations across the UK. Training and development, together with a rigorous recruitment and selection process are a key part of the Group's organic growth strategy, underpinning the strong progress made to date, and the Group's Investors in People Champion status.

Governance and management

During the period the Company continued to comply with the principles of the UK Corporate Governance Code (the 'Code'). On 31 December 2018, Alan Fletcher and Patrick Newberry stepped down from the Board. Alan served as a director from 2009, including a lengthy term as Chair of the Remuneration Committee. Pat served first as an independent director of Paragon Bank PLC from its earliest months of operation in 2014, serving as chair of its audit committee, and joined the Board of Paragon Banking Group in 2017. Both left with the thanks of the Group and the Board for their support and dedication.

Peter Hartill, a non-executive director since 2011, and Chair of the Audit Committee and Senior Independent Director, will be retiring at the 2020 Annual General Meeting having served on the Board for nine years. The Group has progressed its search for a new Audit Committee Chair and, at the date of signing this report, hopes to be in a position to announce a new appointment, after the AGM in February 2020, subject to regulatory and Board approval.

John Heron, Director of Mortgages, has also signalled his intention to retire and will be leaving in early 2020. John joined the Group in 1986 and, as well as being the Group's longest-serving employee, he has been instrumental in establishing and building our buy-to-let mortgage offering. A robust and extensive recruitment process has completed, and the Group looks forward to welcoming Richard Rowntree to run the Mortgages division during the first quarter of 2020, subject to regulatory approval.

During the period the Group has continued its review of the requirements of the new edition of the Code, which came into force for the Company from 1 October 2019. At the same time the Group has considered the forthcoming changes in UK rules for the disclosure of Chief Executive remuneration and the director's consideration of wider stakeholder interests ('section 172') and new requirements for corporate governance and other new disclosures in subsidiary entities. No significant implementation issues were identified and appropriate measures to comply with the new rules have been put in place.

The Board has also considered the governance and committee structures in preparation for the Group's IRB application, as well as providing oversight to that development more generally.

The Group's third annual statement under the Modern Slavery Act 2015 was published on its website in March 2019. 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.

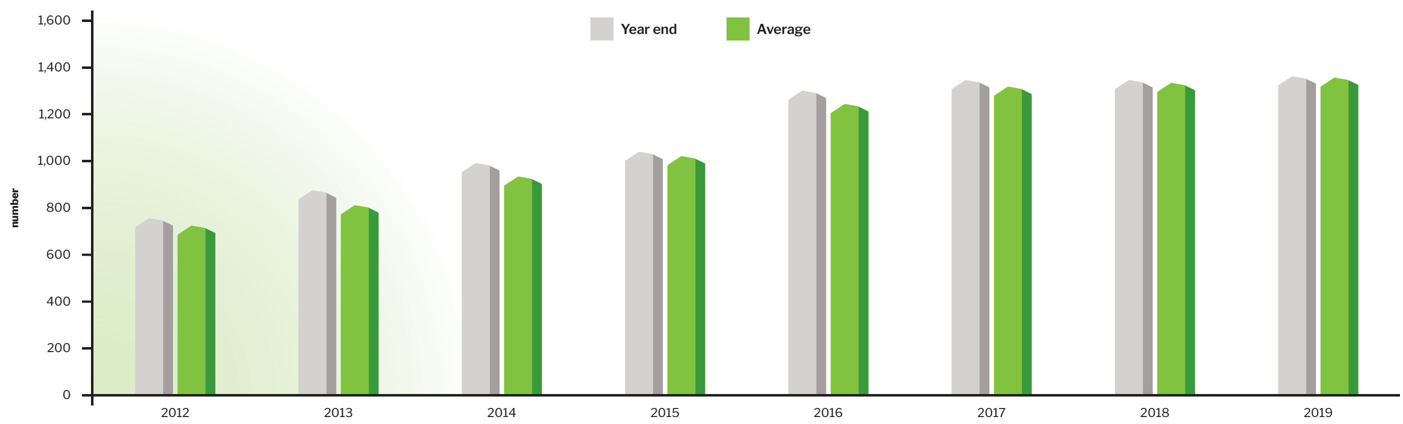
People, diversity and development

The Group continues to focus on maintaining an efficient and effective workforce, increasing employee numbers by 1.3% over the year. The Group maintains its accreditation from the UK Living Wage Foundation and minimum pay continues to meet the levels set by the Foundation.

The Group prides itself on its high levels of employee retention and long service. Its annual employee attrition rate of 11.5% is below the national average and 27.3% of its people have over ten years' service, with 11.5% having achieved over 20 years with the Group. We believe this is due to providing quality development opportunities and creating a place where people want to work, which has meant that knowledge and experience have been retained in each of our specialist areas. We believe our people are well positioned to support the Group's future growth strategy.

Employee numbers

At 30 September and average for the year



The Group has been a signatory of the Women in Finance Charter, sponsored by HM Treasury, since 2016. The Charter's objectives reflect the Group's own aspirations for gender diversity and the Group published its first set of internal targets under the Charter in January 2017.

The Group submitted its latest progress report at 30 September 2019 confirming that the Group is making excellent progress towards its targets. In particular:

- 42.7% of employees receiving management career development/leadership training are female (target 50%)
- 35.8% of the workforce are on flexible working contracts (target 10%)
- 65.9% of the flexible working available is on a part-time basis (target 50%)

Activities under the Women in Finance initiative in the year have included participating in cross-company mentoring programmes to nurture female talent and diversity training for all employees. Initiatives are also in hand to reduce the scope for unconscious bias in recruitment processes.

The Hampton-Alexander ('HA') Review published its latest report on gender diversity in the leadership of FTSE 350 entities in November 2019. The Group believes that its Women in Finance primary objective is consistent with the review's recommendation and notes that its proportion of female senior managers at the year end, as defined by HA, was 35.9% (2018: 29.1%). The Group is delighted to achieve its target of 35% well ahead of the original target date of 31 January 2022.

The Group has calculated its gender pay gap at April 2019. This calculation shows that median female pay in the Group was 31.0% less than the median male pay (2018: 30.7%). This is broadly in line with the results reported by other financial services companies and narrower than the 39.1% gap for the sector reported by the Office of National Statistics in their Annual Survey of Hours and Earnings published in October 2019. Analysis of the gender pay gap data indicates that the Group's gap arose principally as a result of the distribution of roles between the genders, highlighting the importance of the Women in Finance initiative in addressing these issues.

The Nomination Committee, as the board committee with responsibility for diversity under the new Code, has identified action on the diversity agenda as an important objective and during the year has taken a detailed interest in progress in these areas.

The Group's succession planning strategy has also been an important area of focus during the year, with all Board and executive management roles, together with their direct reports, assessed from a leadership and specialist perspective. Immediate successors are in place for these roles for the short term to provide business continuity and longer-term succession plans are being developed for those with career aspirations and strong potential.

In addition, the Group has introduced a specific senior leadership development programme focussed on those identified with high potential for future roles, to strengthen the succession plan and increase the overall talent pool required to deliver the Group's medium to long term strategy. This area will remain a priority for the Board, with the assistance of the Nomination Committee, during the forthcoming year.

The Group was proud to be reaccredited with the Investors in People Gold Standard in February 2019 for a further three years. It was particularly pleasing to note the improvement noted by the external assessors in the areas of building capability, empowering and involving people and recognising and rewarding performance, as well as maintaining overall strengths in living the organisation's values and behaviours, delivering continuous improvement and creating sustainable success. It retains its status as an Investors in People Champion, providing advice and support to other organisations.

During the year, the Group's long-standing People Forum has had its membership and terms of reference refreshed to reflect the current organisational structure. This will also provide a renewed focus on the Forum's objectives of giving all employees a voice, nurturing good employment relations, driving employee engagement and improving overall employee communications. In addition, the Forum's role is being enhanced in the light of the new Code requirements on workforce engagement and will have direct access to the Board. Regular meetings with non-executive directors will commence from November 2019, with specific outcomes from the engagement activities being reported from next year.

A3.6.2 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.

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

- The development of advanced models to enhance credit risk management and support the Group's IRB application process
- Enhancement of stress testing procedures to ensure the robustness of capital and liquidity positions
- The continuing evolution and embedding of its risk appetite framework
- The enhancement of its operational risk capabilities, including the assessment of critical business services and tolerances and the embedding of its operational risk management system in business areas for use on a day-to-day basis
- The maintenance and further development of effective cyber-security controls
- The integration of the businesses acquired in the previous year to ensure they are fully captured by the risk management framework
- Continuing the embedding of robust data protection processes and controls to ensure compliance with the Data Protection Act 2018

During the year the Group has continued to review its exposure to emerging developments in the Brexit process, and the political uncertainties surrounding it, both in terms of impacts on its own activities and on the potential effect on its businesses from wider economic consequences. While the Group does not have operations outside the UK, this analysis addressed, in detail, the capital, liquidity and operational implications of the stresses which might be caused by the process. The Board assessed the output of this analysis throughout the year as the position and potential outcomes developed. The Group considers itself well placed to address the challenges arising, but the position remains uncertain and will continue to be subject to detailed monitoring going forward.

The principal challenges in the risk environment faced by the Group during the year and moving forward into 2020 include:

- The level of change in products, funding and operations which will be required in preparation for the withdrawal of LIBOR in 2021
- 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 increased focus on the impact of climate change on managing financial risks

Further details regarding the governance model, together with the principal risks and uncertainties faced by the Group, the ways in which they are managed and mitigated and the extent to which these have changed in the year are detailed within Section B7 of this annual report.

A3.6.3 Regulation

The Bank is authorised by the PRA and regulated by the PRA and the FCA. The Group is subject to consolidated supervision by the PRA and a number of its subsidiaries are authorised and regulated by the FCA. As a result, current and projected regulatory changes continue to pose a significant risk for the Group.

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

- The Senior Managers and Certification Regime ('SMCR') will be extended to cover a wider section of persons employed in the financial services sector in December 2019, with the establishment from March 2020 of a Directory of Certified Regime (CR) staff. 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 been delivered across the Group
- SONIA (the Sterling Overnight Index Average) administered by the Bank of England is to be established as the primary sterling interest rate benchmark by the end of 2021, in place of LIBOR. The Bank of England and the FCA are leading efforts to develop proposals to establish and transition to the new regime. Appropriate steps are being considered and will be taken to manage the transition from LIBOR where it impacts the Group's business, particularly regarding LIBOR linked lending products and borrowings
- The Bank of England, PRA and FCA published a discussion paper in July 2018 emphasising the importance of a firm understanding and ensuring its operational resilience across critical business services and processes. The Group has implemented a formal programme to both address the specificities of the paper and to align existing workstreams and activities to support wider resilience activities already being undertaken. The appointment of a dedicated Operational Resilience manager has enabled a coordinated approach to improving resilience capability
- Vulnerable customers continue to be a strong focus for the FCA, and the Group takes its responsibilities in this regard seriously. The Group welcomes the recently issued improved FCA guidance and is reviewing its current arrangements against that guidance
- In March 2019 the FCA published the results of its review of the motor finance industry, identifying concerns about some commission models used and lenders' assessments of affordability. This was followed in October 2019 by the publishing of new regulations addressing these issues. The Group has reviewed the FCA's findings and identified the required changes in its motor finance lending models. The Group believes it is well placed to accommodate these changes

- The FCA has proposed changes to its responsible lending and affordability rules to enable 'mortgage prisoners' to more easily switch mortgages, and to require inactive lenders, and administrators acting for unregulated entities, to write to certain customers highlighting the rule change, directing them to relevant sources of information. The Group has a number of accounts likely to fall into these categories and, when the FCA final rules are available, will take the appropriate action

- The PRA published policy and supervisory statements in April 2019, addressing climate change and its associated impact on the management of financial risks within firms. These will require firms to proactively identify such risks and establish appropriate systems to ensure these exposures are managed and governed. The Group is currently in the process of establishing its strategy in respect of climate change, using the PRA's suggested approach, to ensure it is well-positioned to address the challenges as they become better understood

- In December 2017 the BCBS published its 'Basel III: Finalising post-crisis reforms' document. This has clarified the proposed increase to the capital risk weights for buy-to-let lending under the revised standardised approach and the introduction of a capital output floor for IRB based on the revised standardised approach. During the period the EU, PRA and EBA have continued the process to embed the Basel III revisions into the UK regulatory framework and determine how their respective discretions should be applied. The proposed changes had been anticipated within the Group's IRB project

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

The Group, along with the rest of the UK corporate sector, continues to lack clear visibility on potential regulatory changes that may be introduced following the UK's exit from the EU, if and when that occurs. However, given the nature and scope of its operations, it does not have any EU passporting issues that need to be considered.

The governance and risk management framework within the Group continues to be developed to ensure that the impacts of all new regulatory requirements are clearly understood and mitigated as far as possible. Regular reports on key regulatory developments are received at both executive and board risk committees.

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

A3.7 Conclusion

We are delighted to report another excellent financial and operational performance, underpinned by our effective diversification strategy and focus on specialist lending. Volumes, profits and dividends are up strongly, and we are moving closer to our medium-term target of over 15% return on tangible equity.

The Group's transformation to a broadly based specialist banking group has continued over the last year. Our customers have increasingly complex needs which are supported by ongoing technology investments and the deep experience of our employees. This approach, alongside a disciplined and prudent risk appetite, has enabled us to achieve strong lending growth at improving margins, whilst maintaining an exemplary credit performance.

Whilst there is uncertainty in the environment we have prepared well and look forward with optimism to the opportunities ahead.

Nigel Terrington

Chief Executive

26 November 2019

A4
Future prospects

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

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

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

The business activities of the Group, its current operations and those factors likely to affect its future results and development, together with a description of its financial position and funding position, are described in the Chairman's Statement in Section A1 and Chief Executive's review in Section A3. The principal risks and uncertainties affecting the Group, and the steps taken to mitigate these risks are described in Section B7.5.

Section B7 of this annual report describes the Group's risk management system and the three lines of defence model which it is based upon.

Note 55 to the accounts includes an analysis of the Group's working and regulatory capital position and policies, while notes 56 to 59 include a detailed description of its funding structures, its use of financial instruments, its financial risk management objectives and policies and its exposure to credit, interest rate and liquidity risk. Critical accounting estimates affecting the results and financial position disclosed in this annual report are discussed in note 65.

Financial forecasts

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

The plans for the period commencing on 1 October 2019 have been approved by the Board and have been compiled taking into consideration the Group's cash flow, dividend cover, encumbrance, liquidity and capital requirements as well as other key financial ratios throughout the period.

Current economic and market conditions are reflected at the start of the plan with consideration given to how these will evolve over the plan period and affect the business model. The plan is compiled by consolidating separate income forecasts for each business segment and securitisation vehicle to form the top-level projection for the Group. This allows full visibility of the basis of compilation and enables detailed variance analysis to identify anomalies or unrealistic movements. Cost forecasts and new business volumes are agreed with the heads of the various business areas to ensure that targets are realistic and operationally viable.

During this process, sensitivity analysis is also carried out on a number of key assumptions that underpin the forecast to evaluate the impacts of the Group's principal risks on profit, capital, liquidity, cash flow and other key metrics. This is further stress tested as part of the Group's Internal Capital Adequacy Assessment Process ('ICAAP'), using a number of severe downside scenarios.

Risk assessment

During the year, the directors, as members or attendees of the Risk and Compliance Committee undertook reviews on a quarterly basis which included:

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

During the year, directors held focussed in-depth sessions to review risk and risk management as part of the annual strategy day. The results of this exercise were fed back into the Group's risk management process.

Throughout the year, the directors received and discussed analyses of the potential impacts of the Brexit process on the Group. This included consideration of regulatory impacts, impacts on the Group's markets and customers, and impacts on the Group from general economic effects. The results of these considerations fed into the Group's forecasting and risk assessment.

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

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

The directors concluded that those activities, taken together, constituted a robust assessment of all of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity. These principal risks are set out in Section B7.5 of the Risk Management Report.

Availability of funding and liquidity

The Group's retail deposits of £6,391.9 million (note 31), accepted through Paragon Bank, are repayable within five years, with 67.8% of this balance (£4,333.0 million) payable within twelve months of the balance sheet date. The liquidity exposure represented by these deposits is closely monitored; a process supervised by the Asset and Liability Committee. The Group is required to hold liquid assets in Paragon Bank to mitigate this liquidity risk. At 30 September 2019 Paragon Bank held £646.4 million of balance sheet assets for liquidity purposes, in the form of central bank deposits (note 19). A further £109.0 million of liquidity was provided by the Bank of England FLS, bringing the total to £755.4 million.

Paragon Bank manages its liquidity in line with the Board's risk appetite and the requirements of the PRA, which are formally documented in the Board's approved ILAAP. The Bank maintains a liquidity framework that includes a short to medium term cash flow requirement analysis, a longer-term funding plan and access to the Bank of England's liquidity insurance facilities, where pre-positioned assets would support drawings of £1,095.0 million. Holdings of the Group's own mortgage backed loan notes can also be used to access the Bank of England's liquidity facilities.

The Group's securitisation funding structures, described in note 58, ensure that a substantial proportion of its originated loan portfolio is match-funded. This proportion was reduced by the PM12 disposal in June 2019, and increased by the issue of the PM26 securitisation in July 2019. Repayment of the securitisation borrowings is restricted to funds generated by the underlying assets and there is limited recourse to the Group's general funds. Recent and current loan originations are financed through retail deposits and may be refinanced through securitisation where this is appropriate and cost-effective.

The earliest maturity of any of the Group's working capital debt is in December 2020, when the first of the Group's retail bond issues matures.

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

In addition to its expertise in the securitisation market, evidenced by the PM26 and new warehouse transactions in the year, 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. The Group's access to debt is also enhanced by its corporate BBB rating, affirmed by Fitch Ratings in March 2019, and its status as an issuer is evidenced by the BBB- rating of its £150.0 million Tier 2 bond.

As described in note 55 the Group's capital base is subject to consolidated supervision by the PRA. Its capital at 30 September 2019 was in excess of regulatory requirements and its forecasts indicate this will continue to be the case.

Viability statement

In considering making the viability statement the directors considered the three-year period commencing on 1 October 2019. This aligns with the horizons used in the Group's analysis of risk and includes the two years covered by the detailed group forecast, together with one year of the less detailed forecasting period.

The directors considered:

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

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

On this basis, the directors have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the three-year period commencing on 1 October 2019.

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

Going concern statement

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

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

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

A5
Corporate responsibility

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

A5.1 Non-Financial Information Statement

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

In addition to the description of the Group's business model, discussed in section A2, the Group's remaining disclosures are included in this section A5. This includes a discussion of the Group's risk, policies, outcomes and key performance indicators with respect to each of the areas set out in the Act, as follows:

	Area	Reference
(a)	Environmental matters	Section A5.3
(b)	Employees	Section A5.2
(c)	Social matters	Section A5.4
(d)	Respect for human rights	Section A5.5
(e)	Anti-corruption and anti-bribery matters	Section A5.6

A5.2 People

The welfare, development and engagement of the Group's employees are central to developing a strong culture, with employee capability and motivation acknowledged as being central to the delivery of the Group's strategy.

Engagement levels are monitored through external assessments, such as Investors in People ('IIP') and other external employee surveys. The most recent survey was via the IIP assessment in February 2019 which noted that across the 27 themes assessed, 100 out of 108 indicators were met with notable strengths including; a strong values-based culture, a clear people strategy that is built upon high levels of empowerment and devolved accountability, and a universal and strong sense of pride for delivering quality and high standards of customer service. The Group was reaccredited with the IIP Gold Standard which was first achieved in 2013 and it maintains its IIP Champion Status; a recognised best practice status awarded to less than 1% of financial services companies in the UK. The next employee engagement survey is planned to take place in June 2020.

Employment conditions

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

At 30 September 2019, employees on temporary or short-term contracts accounted for 2.1% of the workforce (2018: 0.9%) and no use was made of zero-hours contracts. The Group's annual employee turnover for the year was 11.5% (2018: 16.1%), returning to the Group's longer-term normal level.

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

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

Remuneration packages across the business are compliant with the UK's national minimum wage rates. In addition, the Group has been accredited as a Living Wage employer since June 2016, by the Living Wage Foundation. The independent Living Wage Foundation sets an hourly rate calculated according to the cost of living in the UK which is updated annually. This is a higher rate than the government's National Living Wage. Accredited employers such as the Group must not only pay this rate to their own employees, but ensure that any contractors used also undertake to do so.

When responding to changes in its business, the Group always seeks to minimise the requirement for compulsory redundancy, retraining and redeploying employees wherever possible.

The Human Resources department actively works alongside the Group's management to recruit, develop and retain capable people.

Equality and diversity

The Group is committed to providing a working environment in which employees feel valued and respected and are able to contribute to the success of the business, and to employing a workforce that recognises the diversity of its customers. The Group has invested not only in management training to ensure managers are equipped to support fair working practices, but also in educating all employees to ensure the policy is fully embedded.

The Group's aim is that its employees should be able to work in an environment free from discrimination, harassment and bullying, and that employees, job applicants, customers, retailers, business introducers and suppliers should be treated fairly regardless of:

- Race, colour, nationality (including citizenship), ethnic or national origins
- Gender, sexual orientation, marital or family status
- Religious or political beliefs or affiliations
- Disability, impairment or age
- Real or suspected infection with HIV/AIDS
- Membership of a trade union

and that they should not be disadvantaged by unjust or unfair conditions or requirements.

The Group aims to ensure that applications for employment from people with disabilities and other under-represented groups are given full and fair consideration and that all employees have access to the same training, development and job opportunities. Every effort is also made to retrain and support employees who suffer from disabilities during their employment, including the provision of flexible working to assist their return to work.

During this year, an automated recruitment system was introduced which automatically anonymises applicants at the first stage of selection. This intervention was an intended action to minimise any unconscious bias and support the Group's equality, diversity and inclusion strategy.

The Nomination Committee, as the board committee responsible for diversity issues across the Group, oversees policies and performance on diversity. 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.

Women in Finance

The Group understands the significance and value of building strong and diverse teams, with leaders from all backgrounds. Gender diversity is an important element of the Group's people strategy and the Women in Finance Charter was signed in 2016.

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

In January 2017 the Group's first set of internal targets under the charter was published on its website. They include a target of 35% female representation in senior management roles by January 2022, increasing from 26% at the time the targets were set. All of the Group's diversity targets are published on the 'Corporate Responsibility' section of the Group's website, together with annual progress updates.

The definition of senior management used in the Group's 'Women in Finance' targets is the same as that used by the Hampton-Alexander Review. The Group is pleased to confirm the proportion of female senior managers on this basis at 30 September 2019 was 35.9% (2018: 29.1%), reaching its objective significantly ahead of the target date.

Gender Pay

As required by legislation, the Group has calculated its gender pay gap as at April 2019. The results will be published on the government website and on the Group's own website and are summarised below.

	April 2019	April 2018
Median gender pay gap	**33.9%**	30.8%
Mean gender pay gap	**41.3%**	36.8%
Median bonus pay gap	**1.2%**	1.2%
Mean bonus pay gap	**76.9%**	84.6%

The median and mean pay gaps are broadly in line with the 39.1% median pay gap and 35.5% mean pay gap in the financial services sector reported by the Office of National Statistics in their Annual Survey of Hours and Earnings published in October 2019. They are also broadly in line with those for other businesses in the sector. While the gender pay gap has increased year-on-year, the Group's initial analysis of the most recent figures indicates that this is principally driven by the Titlestone acquisition undertaken between the two snapshot dates, and other changes in the staffing mix. The Group is committed to increasing the representation of women in its senior roles, which will reduce the gender pay gap in the longer term.

88.0% of male employees and 90.1% of female employees received a bonus (2018: 83.4% and 87.9%), as defined by legislation, which includes payments under the Group's profit related pay scheme. The difference between the mean and median bonuses reflects the impact of a very small number of bonus payments to executive directors and other very senior staff.

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

The Group welcomes the interest in this issue generated by the public reporting of gender pay but would favour a review of the detail of the legislation in the light of experience to date to ensure all disclosures required are comparable and understandable.

Composition of the workforce

During the year the workforce has grown by 1.3% to 1,362 people (2018: 1,345). Information on the composition of the workforce at the year end is summarised below:

	2019 Females	**2019 Males**	2018 Females	2018 Males
Employees				
Number	**711**	**651**	711	634
Percentage	**52.2%**	**47.8%**	52.9%	47.1%
Management grade employees				
Number	**115**	**210**	98	187
Percentage	**35.4%**	**64.6%**	34.4%	65.6%
Senior managers				
Number	**7**	**30**	5	22
Percentage	**18.9%**	**81.1%**	18.5%	81.5%
Directors				
Number	**2**	**7**	2	9
Percentage	**22.2%**	**77.8%**	18.2%	81.8%

Of these employees, ethnic minority employees comprised 13.4% of the workforce (2018: 11.6%) and 1.8% of management grade employees (2018: 1.2%). The definition of 'senior manager' used in the table above is that required by the Companies Act 2006 (Strategic Report and Directors Report) Regulations 2013 which differs from that used by the Hampton-Alexander Review.

Composition of the workforce is reviewed on an annual basis and employee satisfaction with equality of opportunity is monitored as part of the regular employee surveys. Human Resources policies are reviewed regularly to ensure that they are non-discriminatory and promote equality of opportunity. In particular, recruitment, selection, promotion, training and development policies and practices are monitored to ensure that all employees have the opportunity to learn and develop according to their abilities.

In June 2019 the Group conducted its third annual diversity survey to obtain anonymous feedback from employees on their age, gender, ethnicity, sexual orientation, religious beliefs and disability. A positive response rate of 67% was received (2018: 72%) and, as expected, the survey illustrated our workforce is diverse. The results were reviewed at executive level and the action plan, agreed in line with the Group's commitment to the Women in Finance Charter, was amended where appropriate. This plan includes requiring improved diversity from external recruitment partners, providing more flexible working opportunities and the provision of mentoring support for individuals.

Health and wellbeing

The health and wellbeing of the Group's employees is an important element of its people strategy. It offers a cycle-to-work scheme, provides fruit in offices and other health benefits through employee schemes.

An internal team of emotional wellbeing volunteers, identified and trained with the support of the charity, Mind, during 2018, is now embedded and provides support to individuals experiencing issues within their personal life or at work, which may impact on their emotional, psychological or social wellbeing. Mental health awareness training was also provided to managers across the Group during the year, and a mobile app focused on developing and maintaining positive mental health strategies is provided to all Group employees.

Training and development

The Group has been accredited under the 'Investors in People' scheme since 1997 and its Gold status was confirmed again in February 2019. This demonstrates the Group's commitment to the training and development of all its employees.

In addition, the Group has held Investors in People Champion status for the last six years. This is given to organisations who are seen as pioneers in people management practices and role models in strategic leadership and is currently held by only 1% of financial services companies in the UK. It involves the Group in active networking with other organisations and offering mentoring support to smaller organisations that are working towards gaining Investors in People status.

All employees receive an appraisal at least annually. These reviews are designed to assist employees in developing their careers and to identify and provide appropriate training opportunities. Appraisals also provide a method to track individual's progress and identify opportunities to develop them into further roles, thereby supporting the Group's overall succession planning objectives.

During the year the Group joined the Women Ahead 30% Club cross-company mentoring scheme, providing 10 trained mentors to support female mentees from other companies, whilst nominating 10 female mentees to receive external mentoring support at the same time. Feedback from the first cohort was very positive and the Group will be continuing with an additional 10-person cohort for the forthcoming year.

The Group has continued to draw down on Apprenticeship Levy funds to support its development objectives and the internal Management Academy was certified with the Chartered Management Institute ('CMI') to facilitate this. There are typically over 100 people completing professional qualifications at any one time across the Group. The Group currently has 41 apprentices (3% of employees) registered under the levy scheme, utilising 47% of its levy pot in the past 12 months. These apprenticeships cover a range of specialist and operational roles including IT, finance, underwriting, and first line management. 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.

The Group provides financial support for professional development and approximately 7.7% of employees are undertaking professional qualifications at any one time. 40% of the employees achieving professional qualifications in the year were female.

During the period work has continued to embed the internal mentoring programme, accredited by the CMI, which helps to support succession planning strategy and develop future leaders. Management development has been a core focus to support the Group's wider succession planning strategy, as well as developing more female employees to increase the pool of available internal candidates. The Group held a senior leadership conference in January 2019 and two senior leadership development centres have been held during the period.

The corporate training and development strategy focusses on providing opportunities to develop all employees and is central to the achievement of the Group's business objectives. On average, employees received 6.9 days training in the year (2018: 7.5 days), which is significantly higher than the average figure quoted by the Chartered Institute of Personnel and Development ('CIPD') of between 2.8 and 3.3 days for the private sector. This included online training undertaken by all employees on various matters including regulatory requirements.

Recruitment

The Group remains committed to employing individuals from the communities in which it is based. We engage with local schools and colleges in the Solihull area, where the Group has its headquarters, through careers fairs to offer 'employability workshops' and to promote ourselves as a local employer. In addition, we have offered 11 work experience placements to local students this year.

We also run a successful 'refer a friend' scheme whereby employees receive a referral fee if an individual they refer for a role passes probation. This year 29 individuals were successfully recruited through this scheme (2018: 55).

Employees' involvement

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

The purpose of the Forum is to encourage and develop an employee voice to support effective decision making and continual business improvement, to protect the Group's strong culture and to deliver good customer outcomes. During the year, the Forum has been restructured to reflect the current organisational structure. In addition, the People Forum has been designated as the channel through which employee views will be communicated to the Group's Board as required by the 2018 Code. The Forum will have direct contact with the Board, with regular meetings with the non-executive directors commencing from November 2019. Specific outcomes from the engagement activities will be reported in the Annual Report from 2020.

Employees at all locations are provided with regular information on the performance and plans of the Group, and the financial and economic factors affecting it, through electronic information and presentations.

The Company operates a Sharesave share option scheme and a profit sharing scheme, both of which enable eligible employees to benefit from the performance of the business.

The directors encourage employee involvement at all levels through the appraisal process and communication between directors, managers, teams and individual employees.

Involvement in industry initiatives on employment standards

This year the business has provided support to external working groups focussing on employment standards organised by industry bodies such as UKF and the FLA.

The Group's membership of the Investors in People Gold Club involves sharing best practice with other Gold Standard employers and it hosts one networking event each year.

Health and Safety

The Group is committed to providing a healthy and safe working environment for all employees, contractors and visitors to its premises, and those impacted by its operations in public areas.

The Group's principal source of health and safety related risk is in the vehicle maintenance operation of Specialist Fleet Services Limited ('SFS') undertaken at either directly controlled premises or any contracted sites. The Group aims to be compliant with all applicable health and safety legal requirements, and to ensure that best practice management standards are implemented and maintained across all operations.

Employees and contractors, are provided with appropriate levels of information, instruction, training and supervision, to empower them to take ownership of their responsibility for a healthy and safe environment and are encouraged to report any concerns in line with health and safety objectives.

The Group's occupational health and safety management system ('OHSMS') includes a health and safety policy, risk assessments, performance evaluation and regular health and safety management meetings monitoring performance, objectives and targets.

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

In April 2019, the Group (excluding SFS) migrated to the new standard for OHSMS and is now certified to ISO45001:2018. Compliance is audited bi-annually by a UKAS accredited auditor.

SFS has its own health and safety manager and OHSMS. Incidents are investigated locally with access to Group resources as required. The operation is currently certificated to BS:18001 and intends to migrate to ISO45001:2018 during its next compliance audit cycle.

The number of fire marshals, first aiders and other qualified personnel is monitored, and continues to be sufficient with training and adequate cover provided in all offices. Defibrillator machines are available at all sites.

Health and safety performance continues to be good with the number of accidents and incidents remaining at a low level. During the financial year ended 30 September 2019, there were no prosecutions or any enforcement action from visits by the authorities for non-compliance in respect of health and safety matters.

During the year, only 19 incidents were reported (2018: 14), all of a minor nature with 1 lost time incident reported under the Reporting of Incidents, Disease and Dangerous Occurences Regulations 2013 ('RIDDOR') (2018: 1).

A5.3 Environmental issues

The Group's environmental impacts can be considered under two headings, its operational impacts and the impact of its lending products. Until recent periods the focus of the Group's environmental policies has been on its own activities, which are described further below, but it is clearly true that the use to which customers put the funds which are advanced to them will also have an impact. This gives rise to two related issues:

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

The Group already considers these types of issue in its underwriting and credit risk processes to some extent. Examples of how the Mortgage business manages its exposure to climate effects and seeks to promote environmentally positive behaviour by customers are given in section A3.2.1.

During April 2019 the PRA published a Policy Statement noting that climate change, and society's response to it, present financial risks which are relevant to its objectives. In its view, while the financial risks from climate change may crystallise in full over longer time horizons, they are also becoming apparent now. The Statement sets out the regulator's expectations of the type of strategic approach it expects firms to adopt in managing such financial risks.

In response to the PRA's intervention and more widespread societal concerns, the Group is developing an enhanced approach to identifying the potential impacts of climate change on its business and developing a system to managing the financial risks involved.

This process is still in its early stages and the Group will report on progress in future annual reports.

Operational Impact

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

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

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

Policy

The Group complies with all applicable laws and regulations relating to the environment. Its environmental commitments are expressed in its Green Charter which is approved by the CEO and kept under regular review.

The Green Charter aims to:

- Ensure all buildings occupied by the Group are managed efficiently
- Encourage employees to conserve energy
- Promote recycling by negotiating contracts and providing facilities to enable employees to recycle office waste and other used products
- Control business travel by promoting video conferencing between sites when appropriate and provide opportunities for employees to travel to work in various ways; such as providing cycle racks
- Ensure liaison with the local community through our Responsible Business initiatives
- Ensure that redundant equipment is disposed of in accordance with the Waste Electrical and Electronic Equipment Regulations ('WEEE')
- Ensure that all fluorescent light tubes are disposed of in a safe manner, compliant with appropriate regulation
- Arrange for paper waste products to be recycled, securely, by third parties

Groupwide recycling and awareness campaigns are also run to reduce various forms of waste such as food, consumables or energy.

Risk management

The Group's environmental commitment is included within the Health, Safety and Environmental policy that is approved by the CEO and the People Director and which is publicly displayed in its buildings. Energy data is collated by Group Property, the division responsible for managing the Group's premises. Consumption figures for all locations occupied, whether directly owned or tenanted, are actively monitored. This is reported upwards to Board level.

SFS operates from several workshops around the UK and has exposure to several waste streams (oils, vehicle parts etc) that come from its workshop activities. These are effectively managed under an environmental management system that is certificated to an International Standard – ISO14001:2015. A dedicated health and safety manager has direct responsibility for environmental issues at all SFS sites.

The environmental risk inherent in the Group's operations is managed by the Group Property function, and is within the remit of the Chief Operating Officer. It is monitored within the Group's operational risk management framework and is monitored by the second line Operational Risk function and the ORC.

The Group complies with the Energy Savings and Opportunities Scheme ('ESOS'). This is a UK Government initiative, under an EU Directive, and requires the Group to identify and reduce its energy consumption. The Group is actively engaged in the data collection phase for the next Environment Agency compliance submission under ESOS due in December 2019.

Supply chain and procurement

The principal suppliers of the Group comprise its outsourced savings administrator, legal and professional services providers, building lessors and IT service providers. They therefore are exposed to similar operational environmental risks to those of the Group.

The Group remains committed to identifying, targeting and addressing inefficiencies within its supply chain. The procurement function is currently working with key suppliers to identify solutions to continue to reduce the environmental impacts of our business activities whether direct or indirectly.

All pre-printed stationery items used by the Group are from renewable sources certified by FSC. 80.3% of the purchased electricity in the year was obtained from sources certified as renewable by the Office of Gas and Electricity Markets ('OFGEM').

Environmental initiatives

The Group's environmental initiatives in the period include:

- Sourcing electricity for the Group's largest sites from 100% renewable energy sources
- Increasing the proportion of sustainably sourced paper in printers and photocopiers. This now covers approximately 93% of the Group's operations
- Notifying shareholders than half-year financial reports will only be available via our website from 2020, to reduce the environmental impact from shareholder communications

The financial year ending 30 September 2020 will see objectives being established against current energy performance to further reduce consumption through energy initiatives, new plant and technology.

Performance indicators

The environmental key performance indicators for the Group, determined having regard to the Reporting Guidelines published by the Department of Business, Energy and Industrial Strategy ('BEIS') and the Department for Environment, Food and Rural Affairs ('DEFRA') in March 2019, are set out below.

The Group does not consider it has significant environmental impacts under the headings 'Resource Efficiency and Materials', 'Emissions to Land, Air and Water' or 'Biodiversity and Ecosystem Services' set out in the Guidelines, due to the nature of its business activities.

This information is presented for the twelve months ended 30 September in each year and includes all entities included in the Group's financial statements. Information for acquired entities is included from the acquisition date. Normalised data is based on adjusted total operating income of £297.6 million (excluding the £9.7 million gain on derecognition) (2018: £273.9 million, excluding the £28.0 million gain on financial asset sales).

Greenhouse gas ('GHG') emissions

	2019 Tonnes CO_2	2018 Tonnes CO_2
Scope 1 (Direct emissions)		
Combustion of fuel:		
Operation of gas heating boilers	**519**	653
Petrol and diesel used by company cars	**679**	641
Operation of facilities:		
Air conditioning systems	**24**	20
	1,222	1,314
Scope 2 (Energy indirect emissions)		
Directly purchased electricity	**995**	1,163
Total scope 1 and 2	**2,217**	2,477
Normalised tonnes - scope 1 and 2 CO_2 per £m income	**7.5**	9.0
Scope 3 (Other indirect emissions)		
Fuel and energy related activities not included in scope 1 or 2	**542**	637
Water consumption	**14**	11
Waste generated in operations	**21**	20
Total scope 3	**577**	668
Total scopes 1, 2 and 3	**2,794**	3,145
Normalised tonnes scope 1, 2 and 3 CO_2 per £m income	**9.4**	11.5

CO^2 values above are calculated based on the DEFRA / BEIS guidelines published in August 2019. CO^2 values for the year ended 30 September 2018 have been restated for the revised conversion factors published by DEFRA / BEIS.

The amounts shown above for total scope 1 and scope 2 emissions are those required to be reported under the Companies Act (Strategic Report and Directors Reports) Regulations 2013. Other scope 3 emissions not reported above are not considered to be significant.

The Group continues to manage its consumption levels carefully and, in the period, continued to optimise its use of its resources. It also benefits from the reduction in GHG conversion factors applying to UK purchased electricity as the profile of generation activities in the country changes towards renewables. These factors combined to reduce the normalised emissions figure.

The Group has not been involved in any prosecutions, accidents or similar non-compliances in respect of environmental matters, nor incurred any fines in respect of such matters.

Power usage

The Group uses mains electricity and natural gas from the UK grid to provide heat, light and power to its office buildings. It also uses fuel in company vehicles and through business travel of employees. The amount of power used in the year ended 30 September 2019 is shown below.

	2019 MWh	2018 MWh	2017 MWh
Renewable electricity	**3,123.5**		
Other electricity	**768.1**		
Electricity	**3,891.6**	4,107.5	4,040.1
Natural gas	**2,817.1**	3,547.6	3,192.4
Motor fuel	**3,099.9**	2,913.9	3,675.9
Total	**9,808.6**	10,569.0	10,908.4
Normalised MWh per £m income	**33.0**	38.6	43.2

Consumption levels have remained broadly stable over the year. However, the normalised usage has continued to improve with more efficient utilisation of the Group's facilities.

Gas and electricity usage are based on consumption recorded on purchase invoices. Vehicle fuel usage is based upon expense claims and recorded mileage.

For the first time, in the year ended 30 September 2019, the Group has been able to report that a proportion of the electricity is sourced from renewable energy sources, as accredited by OFGEM.

The 2019 DEFRA / BEIS guidelines also require that the Group report on power usage including the impact of fuel used by company vehicles. This figure was not reported prior to this year, and additional comparative figures have been provided above.

Water usage

The Group's water usage is limited to the consumption of piped water in the UK and no water is extracted directly. Water usage in the year ended 30 September 2019 was 13,010m^3 (2018: 10,155 m^3), based upon consumption recorded on purchase invoices, a normalised amount of 43.7m^3 per £m income (2018: 37.1m^3 per £m income). A water saving initiative is in place which is intended to reduce year on year water usage across the sites where the Group has full responsibility for the premises occupied.

Waste

SFS are the Group's primary waste producers. Their vehicle servicing activities generate a variety of different waste steams – including various grades of oil, and a range of metals and plastics. These wastes are managed responsibly in accordance with an ISO14001:2015 certificated management system. Waste streams generated by SFS are disposed of in accordance with the waste hierarchy before being consigned to approved waste transfer stations under contract and Waste Transfer Notes obtained.

The Group's waste output outside SFS consists of a mixture of general office waste types which includes principally paper and cardboard with some wood, plastic and metals. The Group provides facilities in its offices for recycling paper, cardboard, newspapers, glass, plastics and aluminium and steel cans. Batteries and printer and photocopier cartridges are collected and sent for recycling.

All the Group's waste is either recycled or sent to landfill.

Amounts of waste generated in the year ended 30 September 2019 together with the methods of disposal are shown below.

	2019	2018	2017
	Tonnes	Tonnes	Tonnes
Recycled	**122**	202	282
Landfill	**187**	154	169
Total	**309**	356	451
Normalised tonnes per £m income	**1.04**	1.30	1.78

Waste generation data is based upon volumes reported on disposal invoices.

A5.4 Social and community matters

The Group's activities are based wholly within the United Kingdom. It operates within the legal and regulatory framework of the UK, acknowledging the importance of corporate responsibility and citizenship in its relationships with its customers, the wider community and other stakeholders.

Where possible, it uses its lending relationships to promote good practice. In particular, its buy-to-let mortgage division demands minimum standards from landlords in the properties it funds. This form of intervention should drive up standards in the private rented sector.

Commitment to our customers

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

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

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

The desire to achieve positive outcomes for our customers is an important commercial differentiator which has helped the Group build strong relationships over many years. This is supported by a focus in employee training programmes on areas which impact on customer outcomes, such as the correct approach to working with vulnerable customers. This pro-active approach accords with the FCA's Principles for Business, particularly with regard to treating customers fairly and ensuring that all communications are clear, fair and not misleading. We ensure that we know how well we are performing in respect of these requirements, regularly adjusting what we do to deliver better customer solutions.

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

Complaint handling

We do not always get things right and take customer complaints very seriously. Each complaint is acknowledged promptly, and the Group works with customers to understand their feedback, investigating these fully and responding swiftly in a fair and open manner.

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

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

Every complaint is viewed as an opportunity to improve our business, an opportunity to identify where complaint handling is going wrong, and most importantly, an opportunity to put things right for our customers. Root cause analysis is completed on complaints to ensure appropriate corrective actions are taken to address the issue and minimise the risk of re-occurrence for other customers.

Information on the number and nature of complaints and on their resolution is reported regularly through the Conduct and Compliance Committee to the board level Risk and Compliance Committee for monitoring and, if appropriate, for action to be taken.

Supporting the community

The Group contributes to registered charities relating to financial services or serving the local communities in which it operates. Contributions of £1,522,000 (2018: £1,950,000) were made by the Group during the year to the work of the Foundation for Credit Counselling which operates the StepChange Debt Charity. The Group also contributed to charities throughout the year by way of single donations.

Other charitable contributions made in the year totalled £24,200 (2018: £25,300). The Group's main objective is to support children's and local charities, although no charity request is overlooked. During the last year the Group has helped many and varied charities and causes including: Kids Cancer Charity, 3H Fund - Helping Hands for Holidays, Lupus UK, Multiple Sclerosis Society, Chicks, Soroptimist International Solihull and District, Kids in Action and Super Hero Sport Foundation, amongst others.

Employees have also been making a difference to the local community in many ways. A volunteering programme was launched in January 2019 and to date employees have delivered 47 volunteering days (3.4% engagement), targeting issues linked to poverty. Activities have included:

- Volunteering at SIFA Fireside, a specialist centre in the centre of Birmingham dedicated to supporting the homeless people of Birmingham
- Supporting a local primary school to renovate their playground
- Volunteering at a "Ready for Work" initiative run by Business in the Community that supports getting homeless people back into the workplace

Employees also took part in education initiatives, supporting 'Life Ready' days, which provide an opportunity to talk to school students about managing finances, budgeting and implications of debt, and attending Careers Conventions at local schools.

In addition, the Group's External Relations team arranged 'the Great Mortgage Sleep Out' in November 2018 to raise awareness of homelessness, which raised £15,000 for youth homelessness charities, with 34 individuals participating.

At Christmas 2018, food parcels were collected for Christians Against Poverty, with 134 food parcels delivered to 80 families.

The Group also supports Paragon's Charity Committee, consisting of volunteer employees, which organises a variety of fundraising activities throughout the year. In the calendar year 2018, £15,772 was raised for Solihull Mind and Birmingham Children's Hospital, while in the first nine months of 2019, £15,532 has been raised for Dementia UK. All employees are given the opportunity to nominate a charity each year and a vote is carried out amongst the employees to select the charity or charities to benefit from the following year's fundraising activities.

Taxation policy and payments

Materially all of the Group's taxable income arises in the UK and therefore it has no presence in jurisdictions considered to enable tax base erosion and profit shifting.

The Group's tax strategy is to comply with all relevant tax obligations whilst cooperating fully with the tax authorities. The Group recognises that in generating profits which can be distributed to shareholders it benefits from resources provided by government and the payment of tax is a contribution towards the cost of those resources. The Group will only undertake tax planning that supports commercial activities and, in the UK context, is not contrary to the intention of Parliament.

As a group containing a bank, the Group is subject to The Code of Practice on Taxation for Banks (the 'Bank Tax Code') published by Her Majesty's Revenue and Customs ('HMRC') in March 2013. The Group has previously confirmed to HMRC that it was unconditionally committed to complying with the Bank Tax Code, and formally re-approved the Group's tax governance policies and the tax strategy outlined above.

During each financial year the Group publishes a tax strategy document for that year on its website, in accordance with the Finance Act 2016. This document addresses the following matters:

- The approach of the Group to risk management and governance arrangements in relation to UK taxation
- The attitude of the Group towards tax planning (so far as affecting UK taxation)
- The level of risk in relation to UK taxation that the Group is prepared to accept
- The approach of the Group towards its dealings with HMRC

The third such statement was published during the year and can be found in the investor relations section of the Group's website.

The published strategy is owned by the Board collectively in accordance with HMRC's published expectations. The Chief Financial Officer has been designated as the Senior Accounting Officer for tax purposes and, as such, reviews compliance with the Group's policies each year.

The Group has an open and positive relationship with HMRC, meeting with their representatives on a regular basis, and is committed to full disclosure and transparency in all matters.

The Group is resident and operates in the UK and its tax payments to the UK authorities include not only corporation tax but also substantial payroll taxes. The amounts of the Group's cash payments to UK national and local tax authorities in the year, including Pay As You Earn ('PAYE') and National Insurance ('NI') contributions deducted from employee wages and salaries were as follows:

	2019	2018
	£m	£m
Corporation tax	**39.4**	32.0
PAYE and NI	**27.3**	28.0
VAT	**2.1**	1.6
Stamp duty	**0.1**	0.2
Total national taxation	**68.9**	61.8
Business rates	**1.4**	1.1
	70.3	62.9

A5.5 Human rights

The Group respects all human rights and in conducting its business regards those rights relating to non-discrimination, fair treatment and respect for privacy to be the most relevant and to have the greatest potential impact on its key stakeholder groups of customers, employees and suppliers.

The Group's commitment to supporting its people's employment rights is described in section A5.2.

The Group operates exclusively in the UK and, as such, is subject to the European Convention on Human Rights and the UK Human Rights Act 1998.

The Board and the CEO have overall responsibility for ensuring that all areas within the Group uphold and promote respect for human rights. The Group seeks to anticipate, prevent and mitigate any potential negative human rights impacts as well as enhance positive impacts through its policies and procedures and, in particular, through its policies regarding employment, equality and diversity, treating customers fairly and information security.

The Group's policies seek to ensure that employees comply with the relevant legislation and regulations in place in the UK and to promote good practice. The Group's policies are formulated and kept up to date by the relevant business areas, authorised in accordance with the Group's governance procedures and are communicated to all employees and included in the Human Resources Policies Manual.

The Group's compliance with human rights regulation falls within its overall compliance regime, and any breaches or potential breaches would be investigated and addressed through the Group's risk management framework.

The Group supports the objective of the Modern Slavery Act 2015, in raising awareness of modern slavery and human trafficking. The Group's annual Modern Slavery Statement is published on its website and also reflected in relevant policies.

The Group is committed to ensuring that there is no modern slavery or human trafficking in its supply chains or in any part of the business and to acting ethically and with integrity in all business relationships. It actively engages with suppliers to ensure that compliance with Modern Slavery legislation is achieved.

The statement describing the Group's policies for achieving this can be found on the Group's website: www.paragonbankinggroup.co.uk.

The Group undertakes extensive monitoring of the implementation of all of its policies and has not been made aware of any incident in which the organisation's activities have resulted in an abuse of human rights or a breach of Modern Slavery legislation. No fines or prosecutions in respect of non-compliance have been incurred.

A5.6 Business practices

The Group carries out its business fairly, honestly and openly. It has a comprehensive anti-bribery and corruption policy, endorsed by the directors, covering all employees and operated throughout the Group. It will not make bribes, nor will it condone the offering of bribes on its behalf. It is the Group's policy that it will not accept bribes, nor will it agree to them being accepted on its behalf and will avoid doing business with those who do not accept its values and who may harm its reputation.

The Group carries out an annual risk assessment as required by the Bribery Act 2010 and concluded that it is not a company with a high risk of bribery. The Group conducts all of its business within the UK and its only significant outsourcing arrangement relates to the administration of its savings operations by the outsourcing arm of a major UK building society. The UK is not considered a jurisdiction with a high incidence of corrupt practices, ranking joint 11th in the Corruption Perceptions Index for 2018, out of 180 countries. However, the Group takes its responsibilities seriously and will not tolerate bribery in any form on any scale and, as such, its policies and procedures are kept under regular review. The Group will self-report any serious incidence of bribery or corruption that is identified.

The Group's policies cover the conduct of its business, the Group's interaction with suppliers and contractors and the giving or receiving of gifts and corporate hospitality. It prohibits facilitation payments. Before new suppliers are approved, the Group's procedure requires that they must be assessed against the requirements of the anti-bribery and corruption policy. The policy is updated and a risk assessment conducted on an annual basis.

All employees are required to read the Group's anti-bribery and corruption policy and undertake annual on-line training to assess their understanding. The anti-bribery culture forms part of the induction course for all new employees and is reinforced at subsequent training sessions. Any employee found to be in breach of these policies will be subject to disciplinary action. No such disciplinary action has taken place in the year ended 30 September 2019.

The CRO, in conjunction with the Head of Financial Crime, who are both part of the 'second line' Risk and Compliance function, are responsible for ensuring the Bribery Act risk assessment and resulting policies and procedures are in place and reviewed on a regular basis. They are also responsible for ensuring any changes in the law are noted and applied to the Group's policies and procedures, where appropriate.

As a financial services entity, the Group also has procedures in place to ensure it cannot be used to facilitate money laundering, sanctions abuse or other forms of financial crime. Employees receive regular annual training in these areas, with their understanding being tested and levels of completion reported to regulators. The Group's money laundering reporting officer is the Deputy CRO, who is part of the second line Risk and Compliance function.

All business heads are responsible for having the appropriate controls in place to ensure that employees adhere to the anti-bribery and corruption policies and procedures and other policies relating to business practices at all times. This is monitored as part of the Group's risk management process and reviewed, as appropriate by the Internal Audit function.

A whistleblowing hotline, run by an independent third party, is available to staff who have concerns over any aspects of the Group's business practices. This is described further in section B5.7.

The Group has not been involved in any incidents resulting in prosecutions, fines, or penalties or in similar incidents of non-compliance in respect of bribery, corruption or other illegal business practices (2018: none).

A6
Approval of Strategic Report

Section A of this Annual Report comprises a Strategic Report for the Group which has been drawn up and presented in accordance with, and in reliance upon, applicable English company law, in particular Chapter 4A of the Companies Act 2006, and the liabilities of the directors in connection with this report shall be subject to the limitations and restrictions provided by such law.

It should be noted that the Strategic Report has been prepared for the Group as a whole, and therefore gives greater emphasis to those matters which are significant to the Company and its subsidiaries when viewed as a whole.

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

Pandora Sharp
Company Secretary

26 November 2019