

# Paragon Banking Group PLC

2017 Annual Report and Accounts

paragon



**CAUTIONARY STATEMENT**

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

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# FINANCIAL HIGHLIGHTS

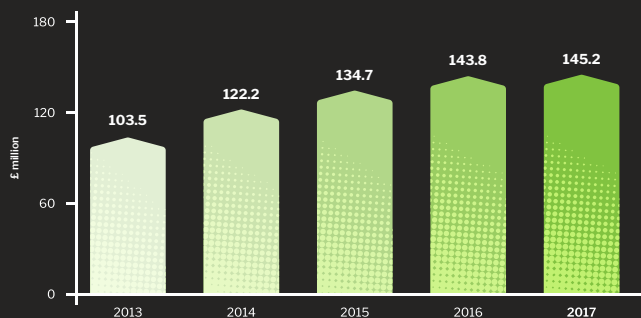
Results in brief

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# FINANCIAL HIGHLIGHTS

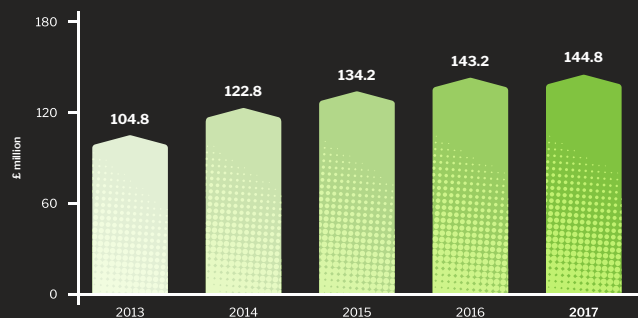
## UNDERLYING PROFIT BEFORE TAX **£145.2 million**

1.0% higher (2016: £143.8 million)



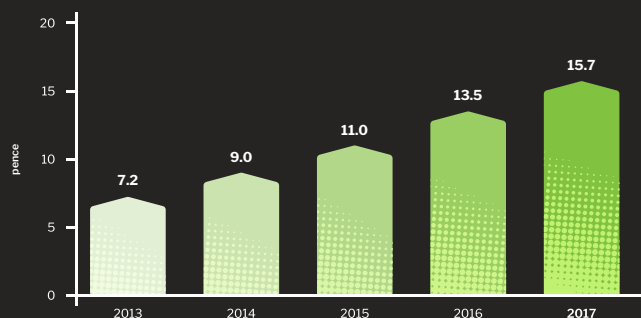
## PROFIT BEFORE TAX **£144.8 million**

1.1% higher (2016: £143.2 million)



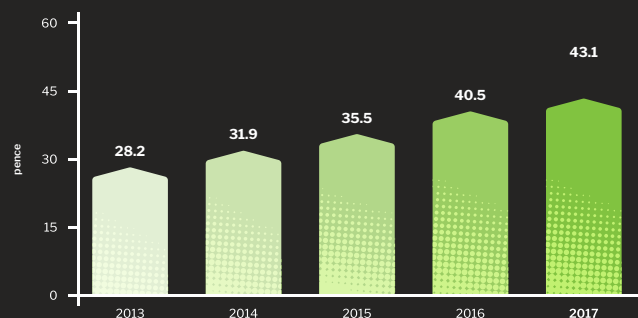
## DIVIDEND PER SHARE **15.7 pence**

16.3% higher (2016: 13.5 pence)



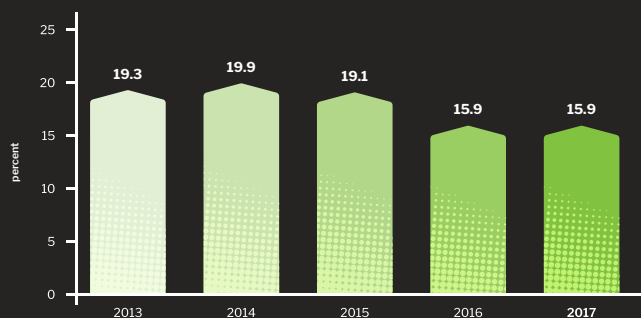
## BASIC EARNINGS PER SHARE **43.1 pence**

6.4% higher (2016: 40.5 pence)



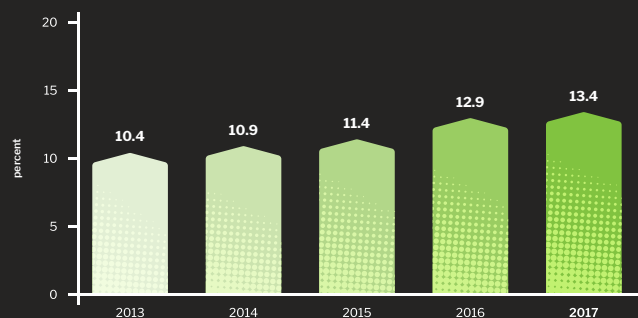
## CAPITAL - CET 1 ratio **15.9%**

Remains strong (2016: 15.9%)



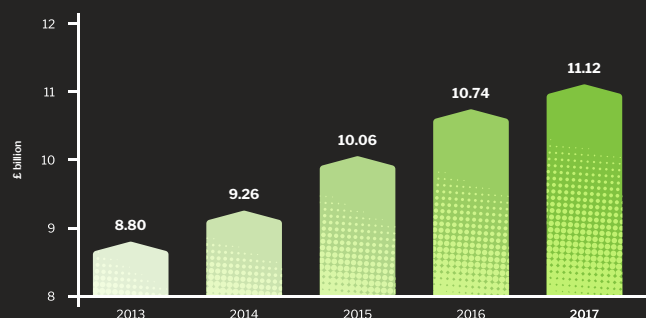
## RETURN ON TANGIBLE EQUITY **13.4%**

(2016: 12.9%)



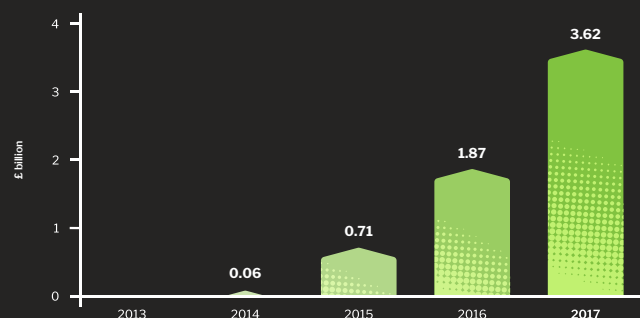
## TOTAL LOANS TO CUSTOMERS £11.1 billion

3.6% higher (2016: £10.7 billion)



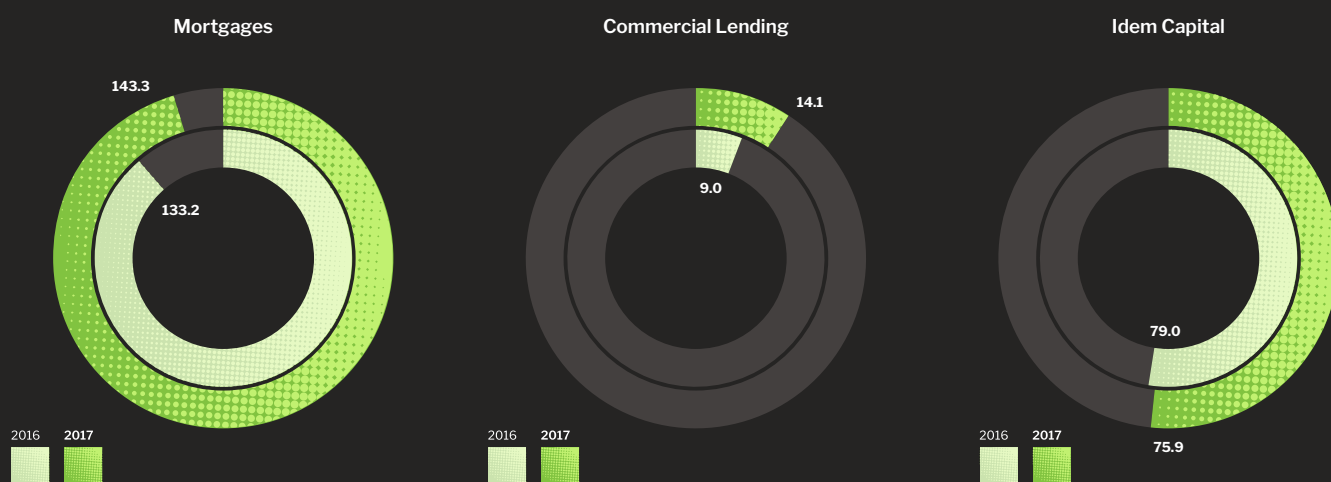
## RETAIL DEPOSITS £3.6 billion

92.9% higher (2016: £1.9 billion)



## SEGMENTAL PROFIT BY DIVISION\*

2016 and 2017 (£ million)



## Five year performance summary

	2013	2014	2015	2016	2017
	£m	£m	£m	£m	£m
Underlying profit before taxation	103.5	122.2	134.7	143.8	<b>145.2</b>
Profit before taxation	104.8	122.8	132.2	143.2	<b>144.8</b>
Profit after taxation	84.7	97.2	107.1	116.0	<b>117.2</b>
Total loans to customers	8,801.5	9,255.9	10,062.4	10,737.5	<b>11,124.1</b>
Shareholders' funds	873.3	947.1	969.5	969.5	<b>1,009.4</b>
	2013	2014	2015	2016	<b>2017</b>
Return on tangible equity	10.4%	10.9%	11.4%	12.9%	<b>13.4%</b>
Earnings per share					
- basic	28.2p	31.9p	35.5p	40.5p	<b>43.1p</b>
- diluted	27.3p	31.1p	34.8p	39.7p	<b>41.9p</b>
Dividend per ordinary share	7.2p	9.0p	11.0p	13.5p	<b>15.7p</b>

The derivation of underlying profit before taxation is described in Appendix C. The calculation of return on tangible equity is shown in note 7.

\* Segmental profit for divisions is stated before central funding and overhead costs (note 14).

A.



# STRATEGIC REPORT

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

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# A1

## CHAIRMAN'S STATEMENT



**Robert G Dench**  
Chairman

### Dear Shareholder

I have the pleasure of introducing our first Annual Report and Accounts as Paragon Banking Group PLC, following a year which has seen a major restructuring of the Group's businesses and governance structure as well as a significant change in its regulatory profile.

This represents a major milestone in the Group's strategic development, transitioning to a banking group deriving significant funding from retail deposits, while providing new finance options for underserved UK customers.

The Group has also made progress in its asset diversification strategy, which will support its medium-term objective of improving net interest margin and cost efficiency, with increasing business volumes capable of being supported by the investments in operations, infrastructure and start-up costs already being put in place.

As a result of the reorganisation, you will see significant changes in these accounts, both to better reflect the new structure of the Group and to enhance comparability with other businesses in the sector. I hope you will find these changes helpful.

### The business

The business is now managed in three lending divisions, Mortgages, including buy-to-let, Commercial Lending and Idem Capital, giving greater clarity of focus on product lines and a more streamlined administrative structure.

During the year, the asset finance business acquired in 2015 and the development finance business launched organically continued to develop, while the Mortgages division launched its first pilot offerings in the specialist owner-occupied mortgage market.

The new financial year will see the first loans in structured lending and aviation finance, as the Group's diversification continues.

Significant cost investment has been made in developing these newer business lines during 2017 and further investments are anticipated in the coming year.

**The Group's business is described more fully in section A2**

### Results

The growth in the Group's loan books, up 3.6% to £11,124.1 million, contributed to an increase in underlying profit by 1.0% to £145.2 million after absorbing £10.9 million of interest cost in respect of the Group's £150.0 million Tier 2 Bond (2016: £143.8 million). Profit before tax on the statutory basis grew by 1.1% to £144.8 million. This led to earnings per share increasing by 6.4% to 43.1 pence (2016: 40.5 pence) and return on tangible equity reaching 13.4% (2016: 12.9%).

Funding was enhanced with the growth of the Group's savings deposit base to £3,615.4 million from £1,873.9 million a year earlier and the utilisation of the Bank of England's Term Funding Scheme ('TFS'), where drawings had reached £700.0 million by the year end.

The Group's capital position remains strong, with regulatory Core Equity Tier 1 ('CET1') capital of £876.1 million (2016: £838.6 million). The CET1 ratio at 30 September 2017 remained stable at 15.9% (2016: 15.9%).

**The financial results and operational performance are reviewed in section A3**

## Stakeholders

The year has seen major developments in the diversity landscape both for corporates generally and within the Group. The Group is supportive of the aims of the Women in Finance initiative and committed to its charter in the year. We have published our targets for increasing diversity, and will be publishing our first progress report in January 2018. We have also submitted data to the Hampton-Alexander review team and calculated our gender pay gap under government rules for the first time. The year also saw an increase in female representation on the Board.

We recognise the importance of the contribution of the Group's people to its 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

The Group is committed to good corporate governance and complied with the new 2016 version of the UK Corporate Governance Code (the 'Code') in the year. As part of the Group's restructuring, I have been delighted to welcome four new non-executive directors to the Board, Pat Newberry, Barbara Ridpath, Finlay Williamson and Graeme Yorston, significantly adding to the Board's regulatory and retail banking experience. I look forward to working with all of them.

In addition to our normal duties, the entire Board has been much involved with the development and implementation of the strategic review, as well as the continuing integration and strategic direction of the businesses acquired last year.

**Corporate governance is discussed in section B3**

## Risk

The group restructuring has enabled us to bring together all of the Group's risk monitoring activities into one function, increasing depth of coverage and resilience. As part of the process all risk appetites were reviewed and the system to manage them enhanced. Additional resource has been added on prudential, liquidity and capital risk matters, meaning the Group is better placed to manage the new risks it encounters as it grows.

**The Risk Management report is set out in section B6**

## Shareholder returns

The group restructuring, together with the positive results have enabled the Board to increase its dividend payout policy. As a result, we have declared a final dividend for the year of 11.0 pence per share, bringing the dividend for the year to 15.7 pence per share, up 16.3%, subject to shareholder approval. £65.0 million (excluding costs) has also been spent on the share buy-back programme which will be continued into the new financial year, with the purchase of further shares up to a value of £50.0 million. Each of these actions enhances returns for shareholders.

## Conclusion

The impact of the group restructuring in the year has made this an interesting and exciting time for the Board. Despite economic uncertainties and the potential for more regulatory change, I remain confident that our new structure and new product ranges, coupled with the strength of our existing businesses, position us well to deliver strong growth and sustainable returns into the future.

**Robert G Dench**

Chairman

**23 November 2017**

# A2

## BUSINESS MODEL AND STRATEGY

### A2.1 PARAGON OVERVIEW

Paragon is a specialist financial services business operating in the UK. In September 2017 the Group carried out a strategic reorganisation, transitioning to a banking group. The scope of the regulated bank was increased, while focussing the Group's business around product lines and streamlining governance. This gives the Group enhanced access to retail funding and opens up new business opportunities, and forms a natural step in our development, supporting further diversification of our funding and income.

#### Growing

Best-known as one of the country's leading, independent buy-to-let lenders, the Group is growing its business by expanding into broader mortgage, consumer and Small or Medium-sized Enterprise ('SME') markets through its banking subsidiary.

Paragon is also one of the UK's largest portfolio purchasers through its Idem Capital division, where it purchases, co-manages and services secured and unsecured consumer loan portfolios.

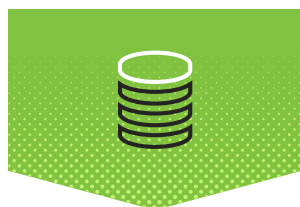
#### Specialist

Through its underwriting and account management experience over many years, the Group has developed a deep expertise in broader data analytics, together with advanced risk and credit management capabilities. These strengths are complemented by a highly developed loan servicing platform and through the cycle experience in its senior management team.

It is this expertise that enables it to tailor lending products for specialist target markets and effectively manage complex consumer loan portfolios.

#### Simple

The Group has a simple business model, underpinned by a focus on people and a commitment to a single set of values.



#### Income

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



#### Assets

To grow its income, the Group focuses on building its asset base by originating new loans, developing new products and acquiring loan portfolios.



#### Funding

The Group funds its assets using a variety of sources, including savings 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.



#### Profitability

Profitability is a key measure of success and the Group manages all aspects of its business closely to deliver sustainable and growing returns to its shareholders.

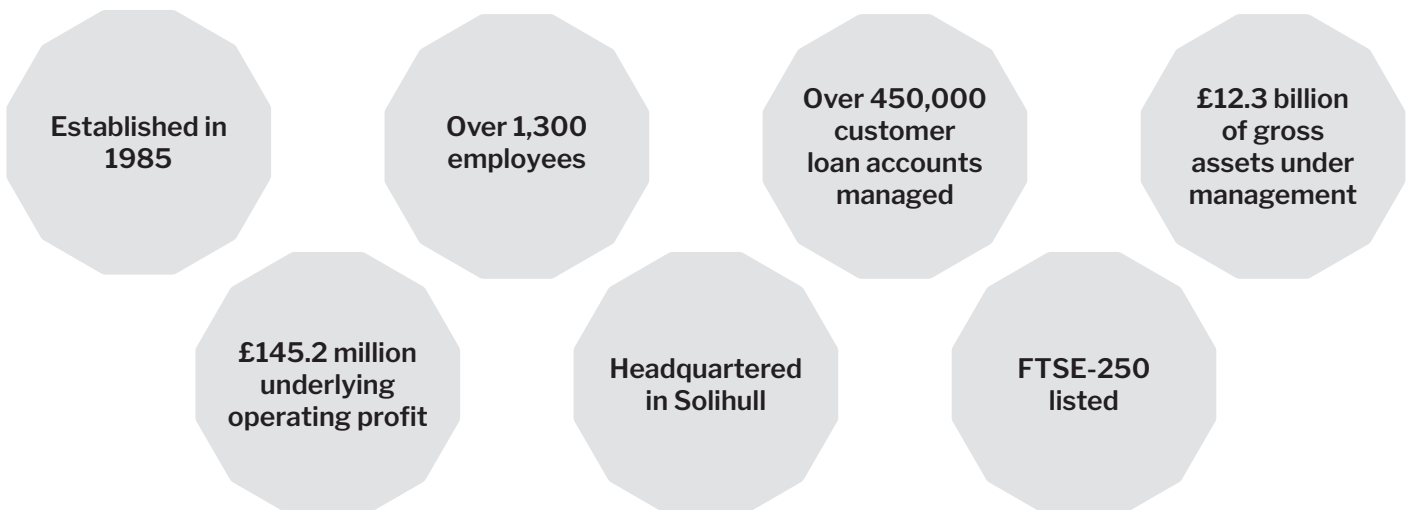
## Operations

Paragon's operations are organised into three divisions, each with responsibility for achieving asset and profit growth, with new lending funded principally through an online personal savings operation. The three divisions 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. The Group's central funding is provided by a mix of equity and corporate and retail bonds.



Segment profits are before central costs of £88.1m. Figures at 30 September 2017.

### Paragon Banking Group Fast Facts



# SUCCESS FACTORS

Key factors affecting the Group's ability to maintain and grow profits and enhance shareholder returns:

# 1.

## CREDIT QUALITY

Paragon is a conservative lender. When underwriting any new loan or portfolio purchase, the Group makes a detailed credit assessment of the customer and the strength of the underlying loan collateral to help minimise the risk of non-payment and portfolio losses.

Buy-to-let 3 months+ arrears

Paragon

**0.08%**

Buy-to-let industry average

**0.45%**

# 2.

## LOAN PRICING

Paragon prices all new advances and portfolio purchases to be competitive and achieve an appropriate margin over funding costs.

Net interest margin

**2.13%**

# 3.

## FUNDING

The Group ensures that its loan assets are financed using appropriately dated and priced funding. It seeks to build a broad and diversified funding mix to underpin the business.

Retail deposit growth

**92.9%**

TFS drawings

**£700.0 million**

Rating retained

**BBB-**

# 4.

## STRONG FINANCIAL FOUNDATIONS

Strong cash generation helps to support new investment and growth in each of the Group's three operating divisions. The Group's conservative capital and debt positions, which rank among the strongest in the UK, give the Group material balance sheet capacity for further development.

Total regulatory capital ratio

**18.7%**

UK Leverage ratio

**6.6%**

# 5

## EFFICIENT UTILISATION OF THE GROUP'S CAPITAL BASE

Returns increasing whilst maintaining prudent capital ratios.

RoTE

**13.4%**

CET1

**15.9%**

# 6

## LOAN SERVICING

Each loan is serviced to optimise retention and minimise the risk of non-payment. We also operate a specialist receiver of rent operation for buy-to-let cases.

**385 million**

pieces of customer data collected and analysed each month

Behavioural scoring models applied

# 7

## COST CONTROL

The Group has a low cost:income ratio and controls costs carefully to maintain this advantage. It operates mainly from a centralised location, maximising the potential for operating leverage. Loan products are distributed principally via third party brokers and savings deposits are collected online.

Cost:income ratio

**40.5%**

# 8

## A CUSTOMER-FOCUSED CULTURE

All the Group's employees share a common culture with a single set of core values. These values – fairness, integrity, respect, professionalism, teamwork, commitment, humour and creativity – inform the way that we interact with our customers, our colleagues and our wider stakeholders. Importantly, Paragon's employees agree that customers are at the heart of our business and recognise the value of treating customers fairly.

**93%**

of employees feel the service we give to customers is improving

**93%**

of employees feel there are a clear and consistent set of values and behaviours that support the way we do business

**85%**

of employees feel the customer is at the heart of everything we do

Source : 2016 employee survey.

Amounts above at 30 September 2017.

# MORTGAGES

## WHAT WE DO

The Group offers first and second charge mortgage products with buy-to-let mortgage finance for landlords operating in the UK's Private Rented Sector ('PRS') its largest market. Paragon was one of the first lenders to develop buy-to-let finance and, since 1996 the Group has originated or acquired just over £20.0 billion of buy-to-let accounts. It now provides 3.9% of all new buy-to-let mortgages in the UK.

The Group seeks to serve niche markets where its customer focussed approach to lending and its expertise in property valuation and risk assessment can differentiate it from its competitors.

## MARKET DYNAMICS

Renting in the PRS is the second most common housing tenure in the UK today, after owner-occupation. Economic, social and demographic changes, together with the flexibility that renting provides, have all combined to make renting in the PRS an increasingly popular choice. Against a UK backdrop of limited house building, low investment in social housing and mortgage affordability constraints, tenant demand is expected to remain strong.

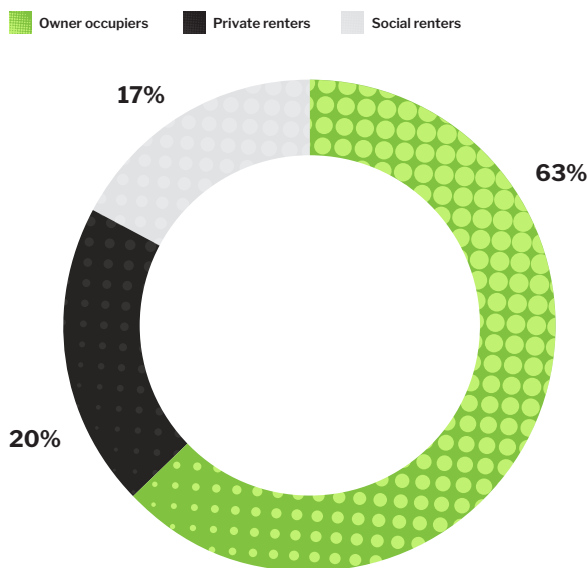
The owner-occupied mortgage market has become increasingly commoditised, leaving significant customer groups badly underserved.

## MARKET OUTLOOK

Whilst UK buy-to-let lending contracted sharply following the financial crisis, the market began its recovery in 2009 and had grown to £40.6 billion by 2016 – still 11% below its peak. Government changes to the tax treatment of buy-to-let property and finance, combined with the Prudential Regulation Authority's ('PRA') introduction of minimum underwriting standards for buy-to-let mortgages are expected to moderate the rate of market growth going forward. As an established buy-to-let specialist, Paragon is well-aligned with the PRA approach and has the opportunity to grow its market share under the new regime.

### Housing tenure

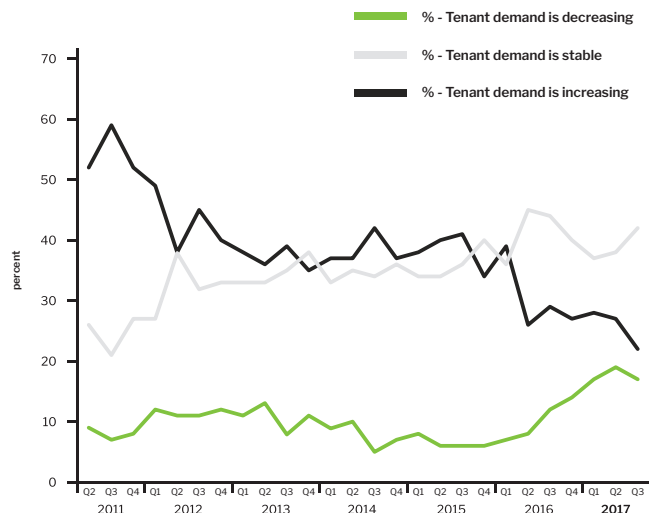
The PRS makes up 20% of the English housing market



Source: English Housing Survey 2015-16

### Strong demand for PRS property

Tenant demand - landlord perceptions



Source: BDRG Continental



# COMMERCIAL LENDING

## WHAT WE DO

Building on the asset finance business acquired in 2015, the division offers motor and asset lease products to consumer, SME and smaller corporate customers, focussing on specialist assets and underserved markets.

It also funds small scale property developments and has recently launched in the structured lending market, offering senior debt facilities to non-bank lenders.

## MARKET DYNAMICS

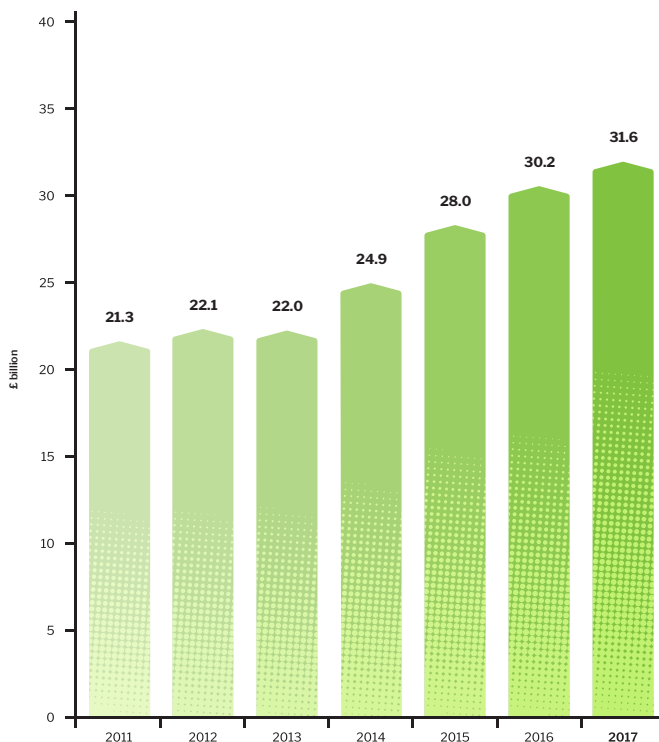
The Group aims to bring new competition and choice to UK consumers and SMEs. While the asset finance market is broad, most participants are focussed on specific asset classes or markets, providing the Group with opportunities to increase its presence through either organic growth or acquisition.

Access to finance for smaller UK corporates has been seen as constrained in recent years and the Group will continue to develop new offerings to address underserved markets.

## MARKET OUTLOOK

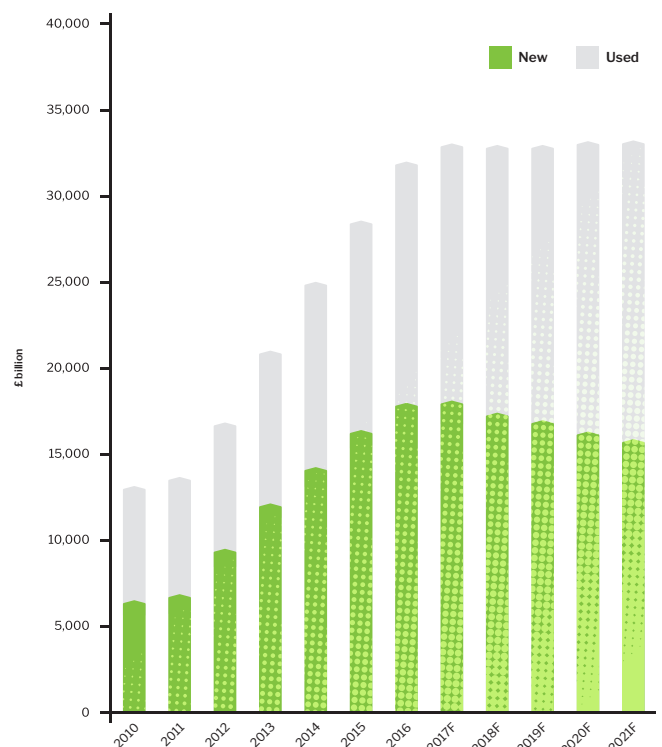
UK SME asset finance market is forecast to continue growing strongly while the motor finance market is expected to remain stable.

### UK asset finance origins



Source: Finance and Leasing Association

### Forecast gross advances for UK motor finance



Source: Verdict Financial - UK Consumer Credit 2016 - Forecasts and Future Opportunities

## WHAT WE DO

Idem Capital is a leading UK consumer loan purchaser, acquiring and servicing loan portfolios, including first and second mortgages as well as unsecured loan assets. In addition, it offers servicing of loan portfolios for clients including banks, private equity houses and specialist lenders.

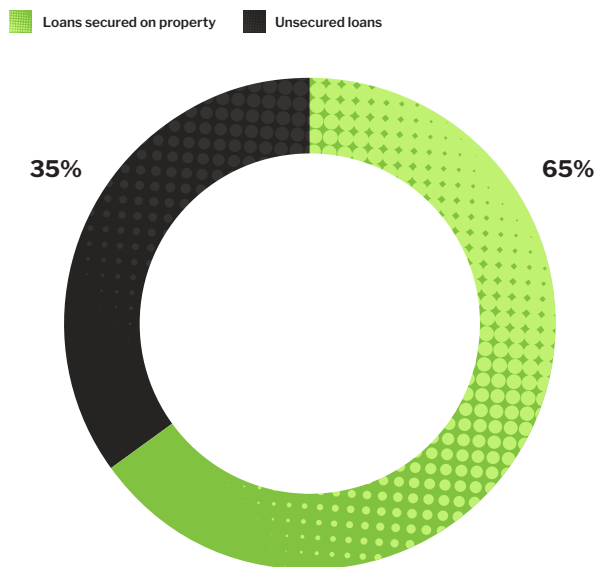
## MARKET DYNAMICS

Idem Capital acquires loan portfolios from banks that are either restructuring or refocusing their activities. It focuses on the acquisition and servicing of paying and semi-performing debt. Idem Capital does not actively compete to acquire non-paying debt.

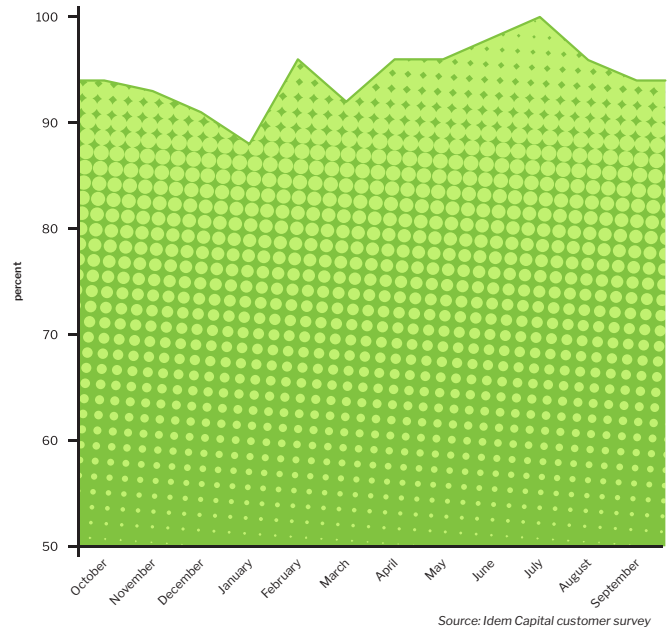
## TREATING CUSTOMERS FAIRLY

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 and affordable repayment solutions should they encounter financial difficulties.

Idem Capital's loan portfolio by value



Idem Capital customer satisfaction 2016 / 17



## MARKET OUTLOOK

The UK's well-established debt purchase market is worth over £10 billion annually, with further growth forecast as banks continue to de-leverage and focus on core lending markets and secondary sales come to market. Market consolidation amongst debt purchasers combined with improved availability of funding has led to greater competition for individual portfolios.

Idem Capital targets those portfolios where it can derive the most benefit from its core credit profiling and administration skills and focuses on disciplined analysis and evaluation of portfolio cash flows on potential acquisitions.

# FUNDING

## WHAT WE DO

The Group's principal source of funding for new lending is its range of savings products offered to UK households. All balances are sourced from the internet and 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 may be used tactically in the future.

Central funding is provided through corporate and retail bonds.

## MARKET DYNAMICS

The UK household savings market is £1.1 trillion, so provides a deep and liquid source for the Group's funding.

Costs for this funding remain low.

## CUSTOMER SATISFACTION

Paragon Bank funds its lending through a range of safe, simple and transparent Easy Access, Notice and Fixed Term savings accounts. In May 2016, ISAs were added to the range.

Our regular survey of new savings customers demonstrates a high level of satisfaction with our products and our online application process.

**87%**

of customers opening a savings account would probably or definitely consider taking out another account.

Net promoter score for account opening

**+59**

## 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 raising. While no wholesale funding was raised in the year, such transactions are a strategically important option.

## OUTLOOK

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

Use of Bank of England facilities will be optimised, for as long as they are available.

Securitisation and other wholesale debt markets will be accessed on an tactical basis, when appropriate.

## 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 given its income is wholly derived from activities within the UK. This is more difficult to forecast given current uncertainties on the terms on which the UK will leave the EU in March 2019.  This could reduce demand for the Group's loan products, increase the number of customers that default on their loans and cause security asset values to fall.
	Concentration	The Group's business plans could be particularly affected by any downturn in the performance of the UK private rented sector and/or further regulatory intervention to control buy-to-let lending.
	Transition	Failure to manage major internal reorganisations or integrate acquired businesses safely and effectively could adversely affect the Group's business plans and damage its reputation.
Credit	Customer	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 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 might result in the scaling back or cessation of some business lines.
	Capital	Proposals by the BCBS to change capital requirements for lending secured on residential property could have adverse financial implications for the Group.
Market	Interest rates	Reduction in margins between market lending and borrowing rates or mismatches in the Group balance sheet could impact profits.
Pension Obligation	Pensions	The obligation to support the Group's defined benefit 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 B6.5.

# A3

## CHIEF EXECUTIVE'S REVIEW

### A3.1 Strategy review

The last few years have been a period of transition for the Group from a monoline centralised lender to an increasingly diversified banking group. Over the last twelve months, a significant component of this transition was completed with the reorganisation of the Group's operating structure, resulting in the bulk of its activities moving under its banking subsidiary, Paragon Bank, following authorisation from the Prudential Regulation Authority ('PRA') and Financial Conduct Authority ('FCA').

Recognising the focus on a retail deposit led banking strategy, the Group changed its name to Paragon Banking Group in September 2017 and has subsequently re-branded its operating units.

The reorganisation has created a simplified operating model, enhanced governance processes with a streamlined and unified board and management structure, and greater transparency. This has been reflected in the way the Group now reports its results, as three operating units – Mortgages, Commercial Lending and Idem Capital, as well as its centralised operations.

The restructure will deliver significant liquidity benefits, together with a notable reduction in the need for the Company to issue debt over the medium term, thereby reducing the Group's funding costs over time and, in turn, giving the Group far greater access to the retail deposit market to support its lending activities.

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

Alongside its transition to a banking model, the Group has made good progress in delivering improved profits and strong organic new business generation. Underlying profits (Appendix C) rose by 1.0% to £145.2 million during the year (2016: £143.8 million) having absorbed the costs of the Group's £150.0 million Tier 2 Bond, the start-up costs of new lending lines, incurred as part of the diversification strategy and the impact of the restructuring. Profits on the statutory basis increased by 1.1% to £144.8 million (2016: £143.2 million). Basic earnings per share ('EPS') increased by 6.4% to 43.1 pence (2016: 40.5 pence) (note 29) and return on tangible equity ('RoTE') improved to 13.4% (2016: 12.9%) (note 7).



**Nigel S Terrington**  
Chief Executive

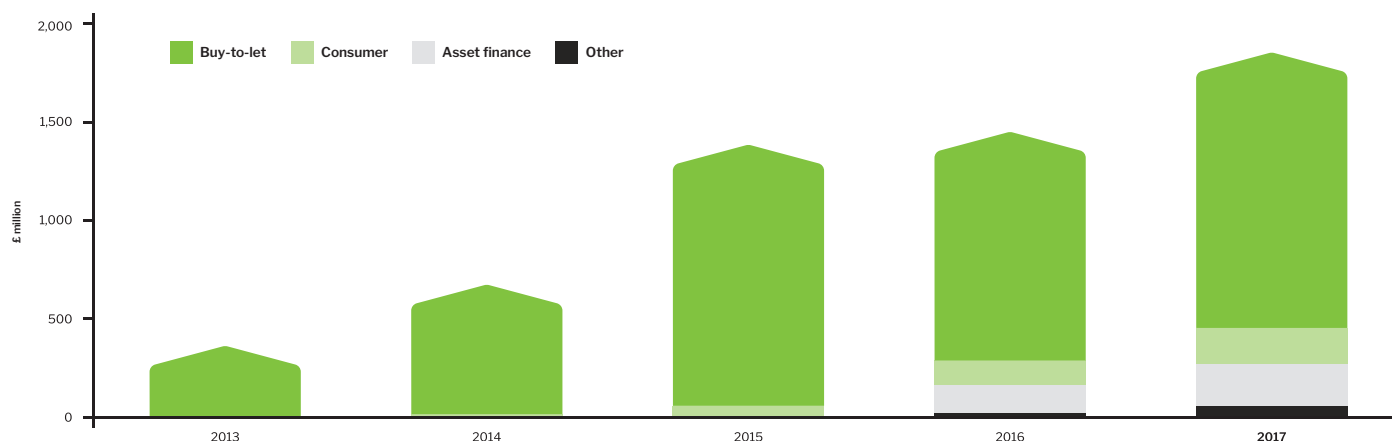
## Lending

The year has seen continued strong growth levels in organic business generation and further debt purchase activity, albeit the level of portfolio acquisitions, at £98.0 million, was at a lower level than the £208.8 million achieved in 2016. Group wide organic originations rose 28.8% to £1,853.4 million compared to £1,439.1 million last year. The combination of portfolio purchases and organic growth contributed to net loan growth of 3.6% to £11,124.1 million over the last twelve months (2016: £10,737.5 million).

The growth and diversification of organic business flows over the past five years is shown in the table below, demonstrating the progress made in the Group's core buy-to-let market and the growing influence of the newer, diversified product streams.

### Annual lending volumes by asset class (£m)

Year ended 30 September 2013-2017



The Group's core business remains its buy-to-let franchise. The UK private rented sector continues to see strong levels of demand from tenants which is expected to continue for the foreseeable future. The buy-to-let market has experienced a period of disruption following a series of fiscal and regulatory changes aimed at both landlords and lenders. These changes disrupted the level of market activity during the year, dampening demand in the sector at an aggregate level. Against this backdrop the Group's performance has been strong, with its twenty-year experience of servicing the complex needs of professional landlords differentiating it from other lenders and allowing the business to make market share gains during the year. New buy-to-let origination levels increased by 20.6% from the previous year's level to £1,399.9 million in the year to September 2017 (2016: £1,161.0 million), with the Group's market share, as measured by the figures reported by UK Finance, increasing from 2.74% to 3.93%.

The most recent regulatory changes in the buy-to-let market require lenders to collect and analyse more information about the landlord's property portfolio and wider business than has previously been common in the market. The Group considers that this will lead to further disruption with some lenders restricting their buy-to-let activity as a result of the increased demands of a complex underwriting process. The Group's expertise in this particular market segment positions the business well to benefit from these changes and further increase its market share.

The Group's other mortgage businesses comprise its second mortgage activities, where new origination levels rose 35.2% to £60.7 million during the year (2016: £44.9 million) and a specialist residential lending operation, which remains in its pilot phase with distribution limited to a small fraction of the Group's broker panel pending final systems and process enhancements. New specialist residential volumes totalled £3.9 million during the year (2016: £nil).

Further asset and income diversification is generated by the Group's Commercial Lending division. The principal activity of the division is asset finance, where strong progress has been made following the acquisitions made in the previous year. The Group's asset finance activities are transforming to service a broader mid-market range of SME customers, as opposed to the more limited niches originally serviced. This strategy has resulted in higher new business volumes (up 52.5% on the eleven month performance in 2016 to £220.0 million in 2017). Customer credit profiles are generally stronger in this larger sector, with yields commensurately lower. The Group's motor finance business also saw strong growth in 2017. Operating in the hire and lease purchase segments of the market (with no exposure to personal contract purchase products), new business origination grew by 50.4% to £120.0 million during the year (2016: £79.8 million). The final established sector is the division's development finance operation, providing funding to smaller property developers, where new drawings totalled £48.9 million in the first full operating year of the business (2016: £9.1 million).

The Group has also established a team to provide structured lending solutions to non-bank financial institutions, with the first lending scheduled for the second quarter of the Group's 2018 financial year.

The Group's portfolio purchase business, Idem Capital, is an established purchaser of secured and unsecured portfolios. Gross purchases in 2017 were £98.0 million (2016: £208.8 million). The sector has proved increasingly popular for both specialist purchasers and credit funds in recent years, with yields reducing as a consequence. Idem Capital has retained its credit and pricing discipline across the past year, but as a consequence investment levels have reduced year-on-year.

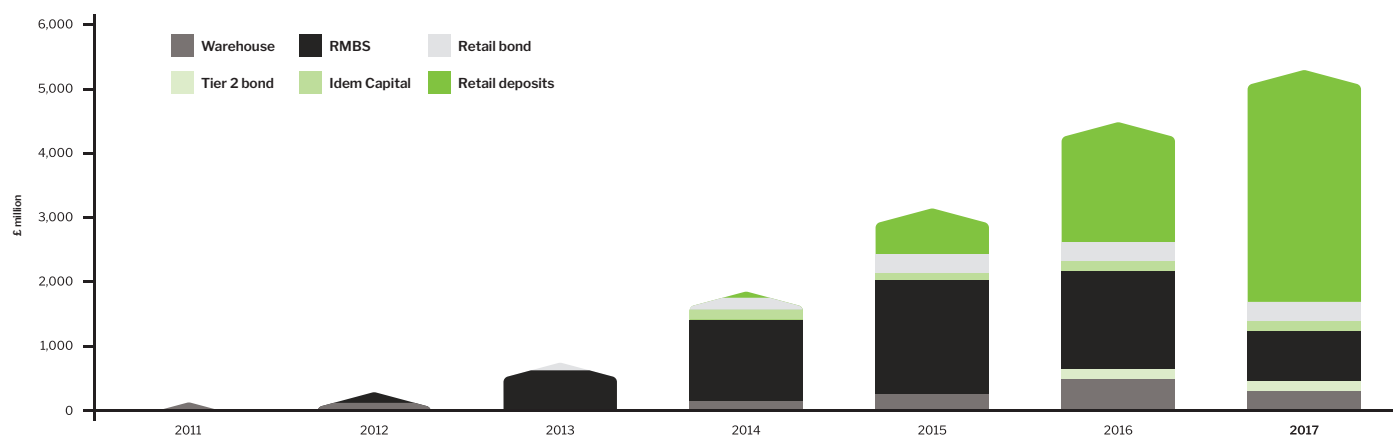
## Funding

The increased banking focus of the Group is evidenced by the pace of development of its retail deposit funding base, together with Paragon Bank's increased access to Bank of England facilities. At 30 September 2017, retail savings balances were £3.6 billion and Term Funding Scheme ('TFS') drawings totalled £0.7 billion, compared with savings deposits of £1.9 billion and £nil TFS drawings a year earlier. In addition to funding new advances, the Group has also refinanced a number of previously securitised or warehoused portfolios using retail deposit funding during the year, with similar refinancing activity expected over the coming years.

The Group's funding has become increasingly diversified in the years following the financial crisis. This is illustrated by the chart below which shows, for each of the year ends since the Group re-entered the funding markets, the outstanding balance on post 2010 funding lines. Funding for pre-2010 balances is still primarily provided by securitisation funding arranged around the time of advance.

### Post 2010 funding by type (£m)

30 September 2011 – 2017



Retail deposits represent the Group's primary source of funding for new lending, with its historical securitisation approach taking a more tactical role as and when conditions in that market are attractive, maintaining a diversified approach to the Group's funding.

## Capital

The Group's core equity tier 1 ratio ('CET1') remained unchanged in 2017 at 15.9% (2016: 15.9%), despite balance sheet growth and higher distributions to shareholders through buy-backs and enhanced dividend levels. The Group's total capital ratio was 18.7% at September 2017 (2016: 19.0%). Free cash resources totalled £305.5 million at the end of the period (2016: £383.1 million). During the year, the Group repaid its £110.0 million subordinated bond which matured in April 2017.

Enhancing shareholder returns on a sustainable basis is a key objective for the Group and during the year basic EPS increased by 6.4%. The reorganisation of the Group in 2017 confers a number of benefits but the impact on Group-level liquidity requirements is particularly pronounced. Most notably, the Company no longer needs to inject capital into Paragon Bank at the start of each year and the requirement to fund the credit enhancement needs of the former warehouse-to-securitisation financing model has been removed. Given the increased efficiency of the new financing model, the Board has reviewed the Group's earnings retention requirements and concluded that it would be appropriate to reduce its dividend cover ratio from the current 3.00 times on a stepped basis. The cover ratio for 2017 will therefore be 2.75 times, and this is expected to fall to 2.50 times for the 2018 financial year, subject to the requirements of the business.

The increase in the Group's EPS and annual dividend rate over the past five years, together with their compound annual growth rates ('CAGR') is set out below.

	2017	2012	Increase	CAGR
	p	p	p	%
EPS	43.10	24.20	18.9	12.3
Dividend	15.70	6.00	9.7	21.2
<b>Dividend cover (times)</b>	<b>2.75</b>	<b>4.03</b>		

The Group will also adopt a formulaic approach to its interim dividend levels going forward, with the interim dividend per share for any given year being one half of the final dividend declared in the preceding period in normal circumstances.

The Group's share buy-back programme has progressed well, with £165.0 million having been invested to date. The £150.0 million cumulative target announced with the 2016 preliminary results was extended to £165.0 million during 2017 given the strong cash flow. The programme will be extended by an additional £50.0 million in the current financial year, further enhancing shareholder returns.



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

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

BUSINESS REVIEW	FUNDING REVIEW	FINANCIAL REVIEW	OPERATIONAL REVIEW
Lending, performance and markets	Retail deposits, wholesale funding and capital management	Results for the year	People, risk and regulation

## A3.2 Lending review

Following the Group's reorganisation in September, its operations are organised into three divisions, based on product types and origination and servicing capabilities.

This review is based on the new organisational structure, and amounts from previous periods have been reanalysed on the basis of the new segments.

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

	Advances and investments in the year		Investments in loans at the year end	
	2017 £m	2016 £m	2017 £m	2016 £m
Mortgages	1,464.5	1,205.9	9,953.9	9,694.7
Commercial Lending	388.9	233.2	558.8	375.0
Idem Capital	98.0	208.8	611.4	667.8
	1,951.4	1,647.9	11,124.1	10,737.5

The Group's loan investments increased by 3.6% in the year, with new advances and investments 18.4% higher than in the previous financial year.

### 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 and its robust and informed approach to property risk differentiate it from mass market lenders.

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

#### *Housing and mortgage market*

The UK mortgage market is currently finely balanced and there is the potential for considerable volatility. However, the data would indicate that the market has been more robust than some media reports would suggest. Housing transactions, the key measure of market activity, have been improving through the year and monthly house purchase numbers are running at post-crisis highs. Mortgage transactions have also been on the increase, with advances increasing at a sharper rate than housing transactions.

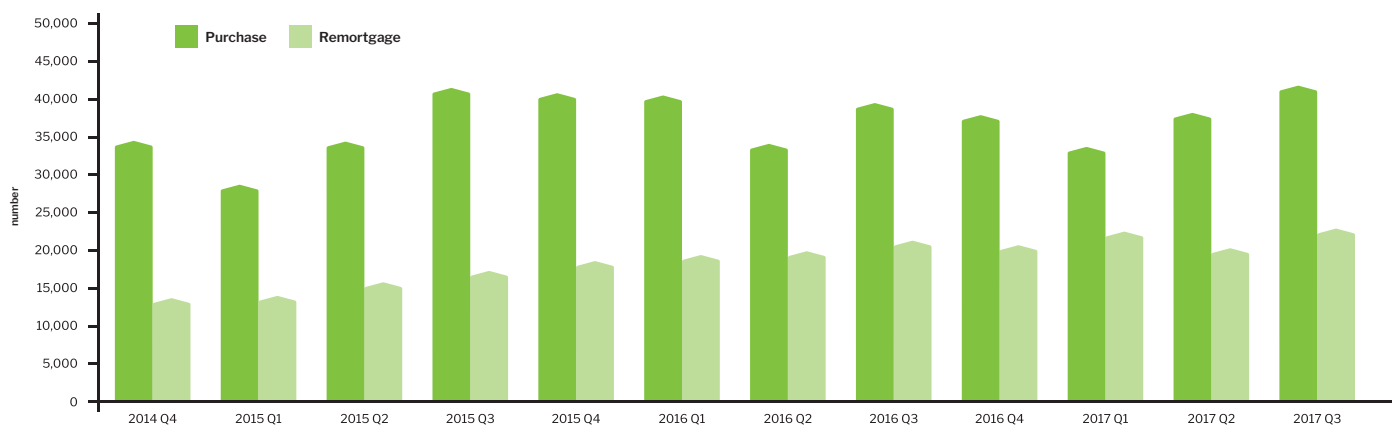
The strength of the first-time buyer segment, supported by the Government's Help-to-Buy scheme, is clearly bolstering housing transactions in general and new build activity in particular. Gross mortgage lending, however, is also benefitting from growth in remortgaging activity which is being driven by increased levels of maturing products in extant mortgage portfolios as well as increased consumer sensitivity to potentially higher interest rates.



This is demonstrated by the quarterly levels of mortgage approvals for purchase and remortgage over the last three years reported by the Bank of England, set out below.

## Number of mortgage approvals

Bank of England



As a result of these activity levels, despite some ongoing weakness in London and the South, particularly for higher value properties, house prices across the country have seen modest increases in the period and the market remains stable.

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

The downside risks centre on the impact of any potential economic downturn, whether as a result of the Brexit process or otherwise. The Group seeks to mitigate its exposure to such conditions through a robust approach to property valuation across all its brands, employing an experienced in-house property team who undertake around two thirds of valuations and conduct validation work on 100% of valuations by third party surveyors. The internally conducted surveys are subject to regular monitoring and the Risk and Compliance function includes qualified property risk resource.

### Buy-to-let

The buy-to-let market in particular has been disrupted through a series of government and regulatory interventions, which are in the process of reshaping the sector. Significant changes have been seen to date, and the effects are yet to work themselves out fully. The principal changes have been:

- the introduction of a stamp duty surcharge on buy-to-let properties
- the restriction of tax relief on finance costs for buy-to-let landlords
- regulatory changes affecting buy-to-let lending

The stamp duty changes appear to have had the least effect, with landlords considering their investment in the long term, mitigating the impact.

Tax relief changes have had a marked effect on customer behaviour, with amateur landlords (those with fewer than four properties) moving away from the market, leading to a fall in the volume of buy-to-let transactions which seems to be establishing a new 'normal' level. The reaction of the more professional landlords, who constitute the Group's main target customer base, has been different. Their focus has generally been to adopt defensive measures, including putting properties into corporate structures and focussing on high yielding properties such as homes in multiple occupation ('HMOs'). This has led to a sharper distinction between professional landlord investors and other buy-to-let borrowers, which the Group regards as a positive development and one beneficial to its business model.

The regulatory changes in the year were implemented in two phases:

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

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

## Lending activity

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

	<b>2017</b>	2016
	<b>£m</b>	£m
First charge buy-to-let	<b>1,399.9</b>	1,161.0
First charge owner-occupied	<b>3.9</b>	-
Second charge	<b>60.7</b>	44.9
	<b>1,464.5</b>	1,205.9

The Group's buy-to-let lending increased by 20.6% year on year, despite the disruption in the market described above and the consequent pressure on volumes. The pipeline of buy-to-let loans in process at the year end was £604.2 million, an increase of 88.2% on the position a year earlier (2016: £321.1 million). It had reduced, however, from the level at the half year as a result of the market disruption caused by the implementation of the second phase of PRA reforms.

The Group launched its pilot offering in the specialist sector of the owner-occupied mortgage market during the year. This is intended to address customers who are poorly served by mainstream lenders and who might benefit from a more bespoke approach to underwriting, including customers with irregular incomes or more complex properties or those who might wish to borrow into retirement, but not sub-prime cases.

The Group's approach to these cases involves a much more holistic assessment of the proposition, speaking directly to customers and their financial advisers to understand the case in the round. The Group initially worked with three intermediaries to prove the proposition, systems and processes were viable. The results so far are pleasing and the offering is now being expanded to a wider network of selected specialist intermediaries. Further increases in capacity will be phased in over the coming financial year, with the business not expected to reach its full capability until after the end of the 2018 financial year.

The Group's second charge mortgage lending has increased 35.2% during the year, but that is largely as a result of starting from a low base. The second charge market is currently not large, with total lending of £979 million in the financial year reported by the Finance and Leasing Association ('FLA'), and a significant part of this total does not fall within the Group's risk appetite. For its new lending, the Group seeks to target the population of customers seeking to access equity in their property while protecting an existing beneficial first mortgage rate, rather than those seeking to refinance consumer debt and adopts a cautious approach to credit quality in this area.

## Performance

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

	<b>30 September</b>	30 September
	<b>2017</b>	2016
	<b>£m</b>	£m
<i>Post 2010 assets</i>		
First charge buy-to-let	<b>3,661.1</b>	3,017.2
First charge owner-occupied	<b>3.9</b>	-
Second charge	<b>98.4</b>	54.1
	<b>3,763.4</b>	3,071.3
<i>Legacy assets</i>		
First charge buy-to-let	<b>6,175.4</b>	6,604.0
First charge owner-occupied	<b>15.1</b>	19.4
	<b>9,953.9</b>	9,694.7

At 30 September 2017 the balance on the Group's mortgage portfolio was 2.7% higher than a year earlier. The annualised redemption rate on post 2010 buy-to-let mortgage assets at 22.7% (2016: 16.2%), has reached the levels seen before the credit crisis as the book matures. Redemption activity has been particularly high over the summer months, influenced by very attractive refinancing options on offer, as lenders have utilised the TFS to subsidise product pricing. The annualised redemption rate on pre-crisis lending, at 6.0%, has marginally reduced from the 6.2% seen in the year ended 30 September 2016.

Average yields on the major product lines are set out below.

	Average Yield		Average Balance	
	2017	2016	2017 £m	2016 £m
Post 2010 buy-to-let	<b>4.48%</b>	4.71%	<b>3,326.8</b>	2,786.0
Second charge	<b>4.65%</b>	4.87%	<b>76.7</b>	36.1
Legacy	<b>2.02%</b>	2.24%	<b>6,386.3</b>	6,831.2

Yields in the segment have tightened somewhat in the year as a result of competitive pressures and market interest rate movements, but remain broadly in line with expectations and at sustainable levels.

Arrears on the buy-to-let book as a whole have reduced in the year to 0.08% (2016: 0.11%), with arrears on post-2010 lending standing at 0.02% (2016: 0.01%). These arrears remain very low compared to market performance, with UK Finance reporting arrears of 0.45% across the buy-to-let sector at 30 September 2017 (2016: 0.52%). This exemplary performance reflects the Group's focus in underwriting on the credit quality and financial capability of its customers, underpinned by a detailed and thorough assessment of the value and suitability of the property as security.

Second charge arrears increased to 0.06% from zero in the year, as the book began to season, but remain negligible compared to market levels.

The Group's receiver of rent process for buy-to-let assets helps to reduce the level of bad debt. At the year end 821 properties were managed by a receiver on the customer's behalf, a reduction of 13.2% since 2016 (2016: 946 properties) as cases on the old book resolve and post 2010 cases perform well.

## Outlook

The Group believes it is well placed to face the challenges of the mortgage market going forward. Aside from an economic downturn, the biggest risk to the business model is from further interventions in the buy-to-let sector. Exposure on owner-occupied lending is low, and the risk position on second charge lending has been carefully maintained.

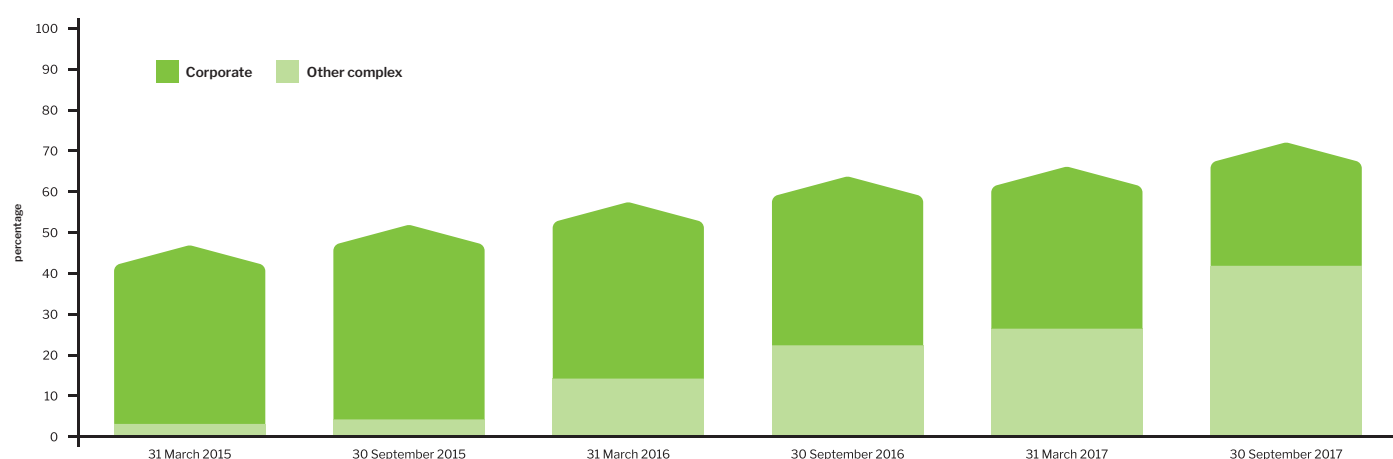
While arrears performance at the moment is exceptional, in the event of an economic downturn the Group believes its strong credit standards and robust assessment of security condition and value will afford it a high degree of protection. Average loan-to-value ratios on new buy-to-let lending remain at around 70% with stressed affordability levels in line with or above the PRA requirements. Continued strong rental demand and good affordability suggests the Group's customers will be resilient in the face of anticipated rate rises.

The Group believes that the current trends in the buy-to-let market are likely to continue with the split between professional and amateur landlords becoming more marked and professional landlords increasingly dominant in the sector. This provides a good match for the Group's offerings and 71.2% of applications at 30 September 2017 were from landlords the Group classes as professional (2016: 67.2%).

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

## Percentage of complex pipeline cases

Number outstanding at date



The Group believes the division is well placed to deploy its core skills of bespoke assessment of credit risk, good customer service, expert understanding of property valuation and modern systems and processes, across a variety of niche markets in the residential mortgage field, as well as in its existing core buy-to-let specialism. These would be significantly large, underserved markets where detailed underwriting and the careful management of credit and property risk can produce a resilient and sustainable lending business with total lending in excess of £1.6 billion anticipated for 2018.

## A3.2.2 Commercial Lending

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

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

The Group recognises that whilst the asset finance market is wide and deep, covering some £75.1 billion of outstanding balances at 30 September 2017 (2016: £70.7 billion) and £31.6 billion of advances in the year then ended, most of this funding is provided by commodity lenders. The Group targets niches within this market where its particular skill sets can be best applied.

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

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

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

### Lending activity

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

	2017	2016
	£m	£m
Asset finance	220.0	144.3*
Motor finance	120.0	79.8
Development finance	48.9	9.1
	388.9	233.2

\*2016 activity for 11 months since acquisition

The asset finance business has seen a 39.8% annualised growth in new advances in the first full year of the Group's ownership, as changes made following the acquisition came into effect. Premier, acquired on 30 September 2016, has proved valuable as a source of new business, particularly in the business finance area. This has taken place against a backdrop of aggressive competition in the market and general economic nervousness in UK industry, leading to some reluctance by SMEs to take on new finance commitments.

The asset finance business also made a significant investment in assets for hire under operating leases, both term and spot, acquiring £12.9 million of assets to generate future income (2016: £8.7 million).

The motor finance business continues its development phase with a 50.4% increase in new lending as its distribution network expands. This rate of growth is expected to moderate as the business becomes more mature.

The development finance business, which provides funding for small scale property developments, was launched at the end of the previous year. It has seen significant growth as it moves from its pilot phase to a wider scale launch, expanding from its initial focus on London and the South East.

## Performance

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

	<b>30 September</b>	30 September
	<b>2017</b>	2016
	<b>£m</b>	£m
Asset finance	<b>325.0</b>	250.4
Motor finance	<b>163.0</b>	95.3
Development finance	<b>42.3</b>	9.1
Invoice factoring	<b>14.8</b>	12.1
Unsecured business lending	<b>9.0</b>	4.8
Other loans	<b>4.7</b>	3.3
	<b>558.8</b>	375.0

The motor finance and development finance businesses continued to mature in the year, with their distribution networks expanding and internal systems developments supporting their growth. The development finance business saw its first projects successfully completed and paid down in the year and has seen significant investment in systems and specialist personnel. Across all business lines growth has been carefully controlled with credit quality and margins prioritised over expansion.

Average yields on the major product lines are set out below.

	<b>Average Yield</b>		<b>Average Balance</b>	
	<b>2017</b>	2016	<b>2017</b>	2016
			<b>£m</b>	£m
Asset finance	<b>9.35%</b>	11.78%	<b>311.1</b>	247.6
Motor finance	<b>5.13%</b>	4.85%	<b>125.7</b>	71.9
Development finance	<b>9.63%</b>	9.34%	<b>29.2</b>	3.2

Yields in the segment have remained strong. While the figures for motor and development finance are affected by their growth trajectories, the decline in the yield in asset finance reflects its strategic repositioning under the Group's ownership, to address the larger, higher quality but lower yielding mid-range segment of the market.

Arrears on the segment's business remain low with arrears in the asset finance business at 0.97% and motor finance at 0.56% (2016: 0.82% and 0.09% respectively), comparable to those in the wider sector, with the FLA reporting average arrears for asset finance at 0.60% and car finance at 1.70% at 30 September 2017 (2016: 0.60% and 1.50%).

Development finance accounts are monitored on a case-by-case basis by the Credit Risk function. At 30 September 2017, no accounts were in default and no defaults had been suffered in the year. The average loan to gross development value for the portfolio at the year end, a measure of security cover, was 60.6%.

Overall the charge for impairment in the segment was £0.1 million (2016: £0.8 million), representing both the quality of the lending and the Group's success in realising security on defaulted cases.

## Outlook

The division seeks to develop its businesses, both increasing the reach of its existing offerings and adding further lines or specialisms either organically or through M&A activity. It seeks to be responsive and flexible in addressing the market, but its UK focus means that it is exposed to a downturn in investment amongst UK business as a whole, particularly one affecting its core construction and broadcast sectors.

The coming year will see development of new product lines, including two already launched, aviation finance and structured lending.

The structured lending team was established to provide senior debt to the UK non-bank lending market. The business will deploy loans of up to £25.0 million to help support 'best-in-class' businesses working across consumer and commercial lending. The Group will work alongside clients to help fund their growth. Each transaction will be secured on underlying assets and structured using established robust methodologies. It is anticipated that each facility will generate attractive returns for shareholders and present a low risk way of accessing familiar and new markets. Structured lending is a means of addressing certain segments where the Group may be underweight or has no exposure at all and where working with a recognised industry expert would be preferable to setting up a business.

Aviation finance builds on the division's existing asset finance lending expertise, supplemented with product-specific teams joining the business from outside. The first advance in this business was made in the first weeks of the new financial year.

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

Overall the division has a good platform on which to build and increasing scale will enable a better return to be generated from its resources, control framework and investments in systems and aggregate new advances of over £0.5 billion are expected in 2018.

### A3.2.3 Idem Capital

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

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

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

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

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

#### *Lending activity*

The portfolio purchase market has been busy in the year, with over 40 transactions in various asset classes coming to market. In transactions where it was successful, Idem Capital invested £98.0 million in loan portfolios (2016: £208.8 million). These portfolios comprised unsecured consumer finance balances. Activity in the asset sales market tends to be 'lumpy' and the level of investment will reflect the number, type and quality of portfolios offered, together with the levels of return other market participants are willing to accept.

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

The Group had also disposed of assets with a carrying value of £18.5 million during the year. These were assets where the Group had exhausted its collection procedures and therefore chose to dispose of the assets to other institutions whose systems are better set up to serve these customers and address such balances.

#### *Performance*

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

	<b>30 September</b>	30 September
	<b>2017</b>	2016
	<b>£m</b>	£m
Second charge mortgage loans	<b>392.3</b>	472.7
Unsecured consumer loans	<b>219.1</b>	195.1
	<b>611.4</b>	667.8

The reduction in balances is a result of the scale of realisations from the brought forward portfolio outstripping the pace of acquisitions in the year. 120 month Estimated Remaining Collections on acquired assets reduced from £740.7 million at 30 September 2016 to £688.8 million at the year end.

Average yields on the major product lines are set out below.

	<b>Average Yield</b>		<b>Average Balance</b>	
	<b>2017</b>	2016	<b>2017</b>	2016
			<b>£m</b>	£m
Second charge	<b>13.13%</b>	13.83%	<b>432.6</b>	435.9
Unsecured	<b>17.73%</b>	19.32%	<b>237.7</b>	210.2

Yields in the segment have remained stable. The reductions in the year can be attributed principally to mix variances as higher yielding seasoned portfolios amortise and new investments are made at yields below historic levels.

None of the division's portfolios at the year end were regarded as materially underperforming, with strong overall cash generation. Operational improvements have been made in systems, including the launch of a new customer facing website designed to further enhance customer service by increasing contact, information levels and payment options. This development is also expected to generate operational efficiencies in future periods.

Arrears on the segment's secured lending business remain in line with recent performance at 17.5% (2016: 17.8%), which while higher than the average for the sector reflect the seasoning of the balances, which are mostly more than ten years old. Average arrears for secured lending of 10.7% at 30 September 2017 were reported by the FLA (2016: 12.4%).

The Group monitors actual cash receipts from acquired portfolios against those forecast in the evaluation which informed the purchase price. Up to 30 September 2017 such collections were 109.3% of those forecast to that point (2016: 109.0%)

Overall the charge for impairment in the segment reduced to £1.5 million (2016: £2.1 million), representing the stable arrears position and the impact of improving house prices on secured provisioning.

## Outlook

The Group expects the flow of sale transactions to continue into the new financial year. Its strategic focus in this market will be on transactions which are more idiosyncratic in nature and therefore make best use of its core skills in pricing, data, operations and account management in generating value.

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

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

## A3.3 Funding review

The Group's reorganisation in the period represents a major stage in its transition from an entirely wholesale funded lender, with equity representing a high proportion of working capital, reflecting more closely a typical funding structure with retail deposits at its core.

The structural changes have enhanced access to deposit funding and facilitated a review of the Group's equity and dividend strategy.

### A3.3.1 Debt funding

During the year, the Group continued to pursue its strategy of making increased use of its retail savings capability.

The availability of central bank funding at attractive rates to support lending in the year impacted on the Group's use of other wholesale funding, with no securitisation transactions taking place. The amount of warehouse facilities available for new lending was also reduced to take account of the increased availability of retail funding.

The Group's funding at 30 September 2017 is summarised as follows:

	<b>2017</b>	2016	2015
	<b>£m</b>	£m	£m
Retail deposit balances	<b>3,615.4</b>	1,873.9	708.7
Securitised and warehouse funding	<b>7,781.8</b>	9,947.1	9,700.0
Central bank facilities	<b>700.0</b>	-	-
Tier 2 and retail bonds	<b>444.8</b>	554.3	404.9
Total on balance sheet funding	<b>12,542.0</b>	12,375.3	10,813.6
Off balance sheet central bank facilities	<b>109.0</b>	108.8	-
	<b>12,651.0</b>	12,484.1	10,813.6

The Group's present medium term strategic funding objective is principally focussed on retail deposits, while optimising the use of central bank facilities. Securitisation will be used tactically if market conditions are favourable, or where it is appropriate for particular transactions.



## Retail funding

Retail deposits represent a reliable, cost-effective and scalable source of finance. As a consequence of the Group adopting its funding strategy, the volume of retail deposits has grown significantly during the year, with balances at 30 September 2017 reaching £3,615.4 million, an increase of 92.9% over the period (30 September 2016: £1,873.9 million).

However, this represents only a small proportion of the UK savings market, with household savings balances reported by the Bank of England increasing by 1.3% in the year to 30 September 2017 to £1,120.8 billion (30 September 2016: £1,105.9 billion). This strong supply has helped to maintain the recent trend for low savings rates with the average annual interest on two year fixed interest bonds, reported by the Bank of England, having increased only from 1.00% in September 2016 to 1.26% in September 2017, in expectation of the autumn increase in bank base rates.

Paragon's savings model provides customers with a range of deposit options, offering value for money and competitive rates, combined with the protection provided by the Financial Services Compensation Scheme ('FSCS'). It provides 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.

The Group's straightforward approach and consistently competitive products have been recognised in the industry and by customers and Paragon was commended in the Best Online Savings Provider category at the 2017 Moneyfacts Consumer awards, the third consecutive year it has received this accolade.

In customer feedback 87% of those opening a savings account with Paragon in the year, who provided data, stated that they would 'probably' or 'definitely' take a second product with Paragon (2016: 87%). The net promoter score in the same survey was +59, up from +51 in 2016.

Savings balances at the year end are analysed below.

	Average interest rate		Average initial balance		Proportion of deposits	
	2017	2016	2017	2016	2017	2016
	%	%	£000	£000	%	%
Fixed rate deposits	<b>1.89</b>	2.11	<b>24</b>	28	<b>74.0</b>	71.1
Variable rate deposits	<b>1.21</b>	1.65	<b>19</b>	15	<b>26.0</b>	28.9
<b>All balances</b>	<b>1.71</b>	1.98	<b>23</b>	25	<b>100.0</b>	100.0

The average initial term of fixed rate deposits was 28 months (2016: 26 months).

Following the restructuring in the year, the scale of deposit-taking activity is expected to expand materially over the next few years.

## Wholesale funding

The year has seen a scaling back of the Group's wholesale funding. The Group's strategic objective of creating a better balanced funding base, coupled with the availability of attractively priced funding from the Bank of England has meant that the Group has not accessed the public securitisation market since November 2015.

At the same time, the quality of the Group's loan assets has enabled three mortgage securitisations to be paid down, including one pre-credit crisis transaction, together with one of the Group's pre 2007 consumer finance transactions. All were refinanced with retail deposits, releasing significant cash balances for use elsewhere in the Group. Further such refinancing transactions should be expected over the coming years.

As a consequence of the increased focus on retail deposit funding, the Group's warehouse capacity, which had been used to fund buy-to-let mortgage originations, was rationalised, reducing from £850.0 million at 30 September 2016 to £550.0 million at the year end, and further, to £350.0 million shortly thereafter. The remaining warehouse provides a standby capability and an alternative to retail deposit funding.

The reduction in the use of securitisation and warehouse facilities reduces the Group's requirement to provide credit enhancement in these structures and releases working capital funds to the Group, where it can be used more effectively.

While the Group has not issued new securitisation debt in the year, it expects to do so in future, on a strategic basis when market conditions are favourable.

## Central bank facilities

In the previous year the Group first accessed the borrowing facilities offered by the Bank of England, which provide flexible, low-cost collateralised funding designed to reinforce the transmission of low base rates to households and businesses. The Group drew down £108.8 million under the Funding for Lending Scheme ('FLS') to support lending to SMEs, which increased to £109.0 million at 30 September 2017. The terms of this facility are such that neither the drawing or the liquidity provided appear on the Group's balance sheet.

During the year the Group has made further use of Bank of England facilities, most significantly through drawings on the Term Funding Scheme ('TFS'), with mortgage loans offered as security. The interest cost of TFS is very attractive compared with either retail deposits or securitisation and repayment is due four years after the drawing, in 2021. The Group uses the TFS to support new lending, rather than for the repayment of other facilities and total drawings are subject to a regulatory limit.



In common with many UK institutions, the Group has made extensive use of this facility and drawings have increased to £700.0 million at the end of the period (2016: £nil). Assets already pre-positioned with the Bank of England potentially give access to a further £114.3 million and the Group intends to optimise its use of this facility until the end of the drawdown window in February 2018.

### *Funding for Idem Capital assets*

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

Since 2015, Idem Capital has had a non-recourse funding facility with Citibank, which it uses to fund assets from time to time, releasing Group working capital. During the year drawings of £69.8 million were made on this facility.

Certain legacy assets, principally second charge mortgage balances are also funded through pre-credit crisis securitisation structures.

At 30 September 2017 the funding of the assets in the Idem Capital segment was distributed as shown below.

	<b>2017</b>	2016	2015
	<b>£m</b>	£m	£m
<i>Purchased assets by funding source</i>			
External non-recourse funding	<b>270.8</b>	414.5	449.2
Retail deposit funding	<b>247.0</b>	250.6	-
Funded through Group resources	<b>93.6</b>	2.7	144.2
	<b>611.4</b>	667.8	593.4

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

The assets funded through the Group also provide an opportunity to raise further liquidity, should it be needed.

### *Corporate funding*

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

During the year, the Group paid down the £110.0 million Corporate Bond which matured in April 2017. This means that all the Group's working capital debt funding has now been raised since the credit crisis.

The Group is rated by Fitch Ratings, and maintains its BBB- senior debt rating, with Fitch confirming this rating with a stable outlook on 13 April 2017. On 25 September 2017, Fitch stated that the Group's reorganisation has no immediate rating implications. The Group's £1.0 billion Euro Medium Term Note Programme announced in January 2013 remains in place and continues to form part of the Group's long-term funding strategy, although no issuance was made in the period.

Further information on all the above borrowings is given in notes 45 to 49.

## **A3.3.2 Capital management**

The Group has reviewed its capital management and maintenance policies following its reorganisation. The primary reliance on retail deposit funding in the new model fundamentally changes the working capital cycle of the Group, reducing the variability in working capital demand and hence enabling a reduction in working capital levels relative to the size of the balance sheet.

The Group has continued to enjoy strong cash generation during the year. Available cash balances were £305.5 million at the year-end (30 September 2016: £383.1 million) (note 30) after investments in loan assets, share buy-backs and the repayment of the £110.0 million Corporate Bond. The Company sees opportunities to deploy capital to support organic growth and invest in portfolio purchases and potentially in further M&A opportunities, but recognises also the opportunity to return more of this cash to its shareholders.

### *Dividend and dividend policy*

Following its review of capital, the Company has determined that it is appropriate to increase its normal level of dividends and will move from the previously announced policy of targeting a dividend cover ratio of 3.00 times, to 2.75 times in 2017 and then to 2.50 times in 2018, subject to the requirements of the business and the availability of cash resources.

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

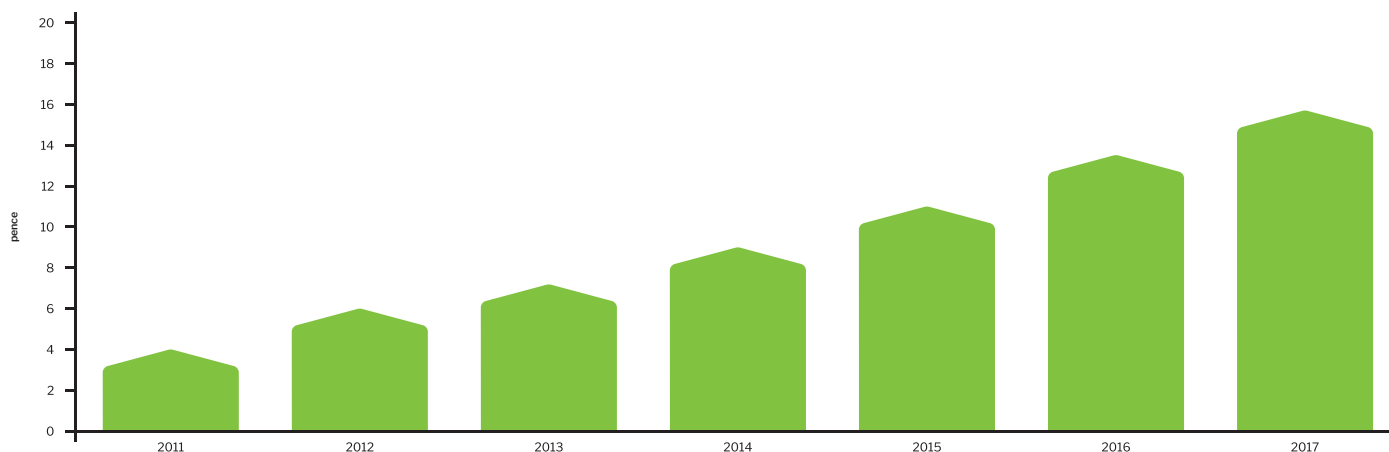
In determining the level of dividend for the year, the Board has considered the dividend policy, but has also taken into account the Group's strategy, capital requirements, principal risks, the level of available retained earnings in the Company, its cash resources and the objective of enhancing shareholder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

On this basis, the Board is proposing, subject to approval at the Annual General Meeting on 15 February 2018, a final dividend of 11.0 pence per share which, when added to the interim dividend of 4.7 pence, gives a total dividend of 15.7 pence per share for the year. This represents an increase of 16.3% from 2016, bringing the dividend cover to 2.75 times (2016: 3.00 times) (note 7(a)).

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

### Dividend for the year (pence)

In respect of the years 2011 - 2017



### Regulatory capital

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

The Group maintains extremely strong capital and leverage ratios, with a capital ratio of 18.7% at 30 September 2017 (2016: 19.0%) and a UK leverage ratio at 6.6% (2016: 6.3%) (note 7(d)), leaving the Group's capital at 30 September 2017 comfortably in excess of the regulatory requirement. The CET1 ratio, 15.9% at 30 September 2017, remained stable in the period (2016: 15.9%), despite the effect of share buy-backs and dividends, as a result of the Group's profit in the period and the actuarial gain on the defined benefit pension plan. The Group's medium term CET1 target is 13.0%.

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

The Group also notes the steps taken by the PRA towards using its assessment of Pillar 2 capital to ameliorate the perceived capital advantage of IRB banks over those using the SA, which they regard as distortive to the market. The regulator published its final policy statement on this in October 2017, and the Group is considering its potential impact.

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

In addition to the potential capital advantages from adopting the IRB approach, the Group sees broader business benefits from adopting the disciplines required by IRB as a core part of its risk management structure and it has continued to progress a project to prepare an application to the PRA to adopt an IRB in future. This will build on the Group's existing core competencies in credit risk and data handling and should lead to further enhancements in the internal risk governance framework.

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

## Gearing and share buy-backs

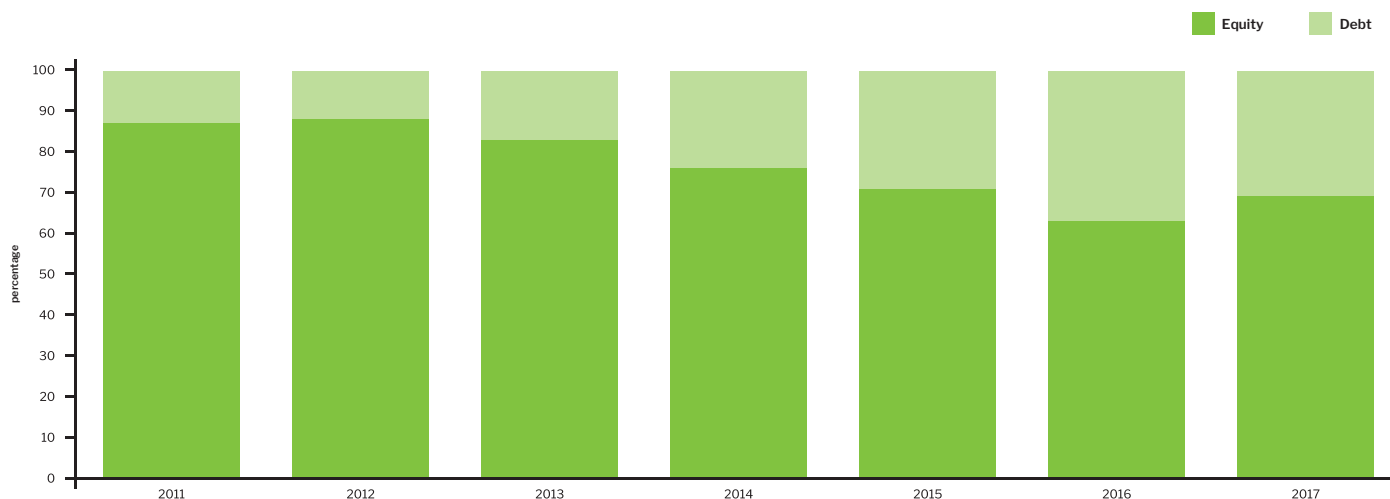
The Group's reorganisation during the year, coupled with the strong capital base and low leverage in the Company's balance sheet, provide the opportunity for the business to reduce its over-reliance on equity capital, improving returns for shareholders. The future requirement to raise debt for liquidity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

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

An analysis of the Group's central funding between corporate debt and equity (note 7(c)) is shown below.

### Balance of central funding resources

At 30 September 2017



The reversal of the trend above from equity toward debt is a result of the raising of the 2016 Tier 2 Bond ahead of the repayment of the £110.0 million Corporate Bond, leading to an element of double funding across the previous year end.

In November 2014 the Group announced a share buy-back programme, which had been extended to £150.0 million by November 2016, and was subsequently extended to £165.0 million in July 2017.

The size of the programme is reviewed periodically to take account of anticipated investment opportunities and the balance of the Group's debt and equity capital resources. During the year the Group bought back 15.3 million of its ordinary shares at a cost of £65.5 million (note 57), these shares being held in treasury. The Board intends to extend the programme by up to £50.0 million in the financial year ending 30 September 2018. These shares will also be initially held in treasury but may be cancelled subsequently.

The Company currently has the necessary shareholder approval to undertake such share buy-backs and will propose the appropriate renewal of the relevant authority at its 2018 Annual General Meeting, when a special resolution seeking authority for the Company to purchase up to 26.5 million of its own shares (10% of the issued share capital excluding treasury shares) will be put to shareholders.

## Capital Outlook

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

## A3.4 Financial review

The financial year ended 30 September 2017 saw the Group's underlying profit (appendix C) increase by 1.0% to £145.2 million (30 September 2016: £143.8 million) while on the statutory basis profit before tax increased by 1.1% to £144.8 million (30 September 2016: £143.2 million). Earnings per share increased by 6.4% to 43.1 pence (30 September 2016: 40.5 pence).

### A3.4.1 Results for the year

#### CONSOLIDATED RESULTS

For the year ended 30 September 2017

	2017	2016
	£m	£m
Interest receivable	409.2	411.4
Interest payable and similar charges	(176.6)	(188.2)
<b>Net interest income</b>	<b>232.6</b>	223.2
Net leasing income	3.0	3.0
Other income	17.2	17.8
<b>Total operating income</b>	<b>252.8</b>	244.0
Operating expenses	(102.3)	(92.5)
Provisions for losses	(5.3)	(7.7)
	<b>145.2</b>	143.8
Fair value net (losses)	(0.4)	(0.6)
<b>Operating profit being profit on ordinary activities before taxation</b>	<b>144.8</b>	143.2
Tax charge on profit on ordinary activities	(27.6)	(27.2)
<b>Profit on ordinary activities after taxation</b>	<b>117.2</b>	116.0
	<b>2017</b>	2016
Dividend – rate per share for the year	<b>15.7p</b>	13.5p
Basic earnings per share	<b>43.1p</b>	40.5p
Diluted earnings per share	<b>41.9p</b>	39.7p

Total operating income increased by 3.6% to £252.8 million (2016: £244.0 million). Within this, net interest income increased by 4.2% to £232.6 million from the £223.2 million recorded in the year ended 30 September 2016. The increase reflects growth in the size of the average loan book, which rose by 5.1% to £10,930.8 million (2016: £10,400.0 million) (appendix A).

Net interest margins ('NIM') in the year ended 30 September 2017 reduced marginally to 2.13% compared to the 2.15% in the previous year (appendix A), driven by increased funding costs from the £150.0 million corporate bond issued in 2016, which attracted interest of £10.9 million in the year, reducing NIM by 0.10%. The Group expects NIM to expand by between 0.05% and 0.10% in 2018.

Other operating income was £20.2 million for the year, compared with £20.8 million in 2016. The reduction principally results from lower levels of third party servicing income, where previously serviced assets were acquired in the previous financial year, partly offset by broker income from the Premier business acquired on 30 September 2016.

Operating expenses increased by 10.6% to £102.3 million from £92.5 million reported in the previous year, partly reflecting the increase in the average number of employees to 1,317, a 5.4% rise (2016: 1,249) and the acquisition of Premier. The year has also seen significant investments in systems and personnel in order to support the launch of new products and the expansion of existing business lines. This resulted in the overall cost:income ratio increasing to 40.5% from 37.9% for the corresponding period last year (appendix B), although it remains significantly below the industry average.

The Board remains focused on controlling operating costs through the application of rigorous budgeting and monitoring procedures. Costs of between £105.0 million and £115.0 million are anticipated for the Group in 2018 and the Group expects the overall cost:income ratio to improve over time as acquired and start-up operations are integrated into the Group and it starts to see the benefits of income growth from its new and expanded operations.

The charge of £5.3 million for loan impairment has decreased from that for 2016 (2016: £7.7 million). As a percentage of average loans to customers (appendix A) the impairment charge remains broadly stable at 0.05% compared to 0.07% in 2016. The Group has seen favourable trends in arrears performance over the period, both in terms of new cases reducing and customers correcting past arrears, whilst increasing property values have served to reduce overall exposure to losses on enforcement of security. The loan books continue to be carefully managed and the credit performance of the buy-to-let book remains exemplary.

Yield curve movements during the period resulted in hedging instrument fair value net losses of £0.4 million (2016: £0.6 million net losses), which do not affect cash flow. The fair value movements of hedged assets or liabilities are expected to trend to zero over time, as such this item represents a timing difference. The Group remains economically and appropriately hedged.

Corporation tax has been charged at the rate of 19.1%, a broadly similar level compared with 19.0% for the previous year. For the next financial year Paragon Bank is expected to reach the threshold for the Bank Tax Surcharge and will pay an additional 8.0% tax on the excess of its company profit over £25.0 million. This is expected to increase the Group's overall tax charge.

Profits after taxation of £117.2 million (2016: £116.0 million) have been transferred to shareholders' funds, which totalled £1,009.4 million at the year end (2016: £969.5 million), representing a tangible net asset value of £3.45 per share (2016: £3.12) and an unadjusted net asset value of £3.84 per share (2016: £3.50) (Appendix D).

## A3.4.2 Segmental results

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

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

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

Results for the year have been presented on the basis of the new segments and comparative amounts restated accordingly.

The underlying operating profits of these business segments are detailed fully in note 14 to the annual report and are summarised below.

	<b>2017</b>	2016
	<b>£m</b>	£m
<b>Segmental profit</b>		
Mortgages	<b>143.3</b>	133.2
Commercial Lending	<b>14.1</b>	9.0
Idem Capital	<b>75.9</b>	79.0
	<b>233.3</b>	221.2
Unallocated central costs	<b>(88.1)</b>	(77.4)
	<b>145.2</b>	143.8

### *Mortgages*

Trading activity during the year in the Mortgages division was very strong, with the segmental profit at £143.3 million, up 7.6% from the previous year (2016: £133.2 million). This increase arose both from increases in the loan book and from improved funding costs as the business made more use of retail funding.

### *Commercial Lending*

Segmental profit in Commercial Lending increased 56.7% in the year to £14.1 million (2016: £9.0 million) as the asset finance operation acquired in 2016 contributed a full year's activity to the results. The Premier brokerage business, acquired on 30 September 2016 also made its first contribution. Loan assets were substantially increased, especially in motor and asset finance, with the segment's loans to customers increasing 49.0% over the year.

### *Idem Capital*

The Idem Capital division's portfolios continued to perform well in the year to 30 September 2017. However, the level of new investment was offset by the scale of reductions in the brought forward balance, reducing earnings marginally, which coupled with the reduction in third party servicing income noted above, reduced segment profit by 3.9% to £75.9 million (2016: £79.0 million).

## A3.4.3 Assets and liabilities

### SUMMARY BALANCE SHEET

30 September 2017

	2017	2016
	£m	£m
Intangible assets	104.4	105.5
Investment in customer loans	11,124.1	10,737.5
Derivative financial assets	906.6	1,366.4
Free cash	305.5	383.1
Other cash	1,191.4	854.5
Other assets	50.2	71.4
<b>Total assets</b>	<b>13,682.2</b>	<b>13,518.4</b>
Equity	1,009.4	969.5
Retail deposits	3,615.4	1,873.9
Borrowings	8,927.2	10,502.6
Pension deficit	29.8	58.4
Other liabilities	100.4	114.0
<b>Total equity and liabilities</b>	<b>13,682.2</b>	<b>13,518.4</b>

The Group's loan assets include:

- Buy-to-let and owner-occupied first mortgage assets in the Mortgages segment
- Second charge mortgages, with new originations in Mortgages and purchased and similar legacy assets in Idem Capital
- Other unsecured consumer lending in Idem Capital
- Asset finance and motor finance loans in the Commercial Lending segment
- Development finance loans in the Commercial Lending segment

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

	2017	2016
	£m	£m
Mortgages	9,953.9	9,694.7
Commercial Lending	558.8	375.0
Idem Capital	611.4	667.8
	<b>11,124.1</b>	<b>10,737.5</b>

An analysis of the Group's financial assets by type is shown in note 32. Movements in the Group's loan asset balances are discussed in the lending review section (Section A3.2).

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.

Cash flows from the Group's securitisation vehicle companies and the acquired portfolios remain strong. These, together with debt raisings, financed further investments in loan portfolios, the capital requirements of Paragon Bank and credit enhancement for mortgage originations. Cash was also utilised in the share buy-back programme, which commenced during December 2014 and where £166.2 million (including costs) had been deployed by 30 September 2017. Free cash balances were £305.5 million at 30 September 2017 (2016: £383.1 million) following the repayment of the Group's £110.0 million corporate bond in the year (note 30).

Movements in the Group's funding are discussed in the funding review section (Section A3.3).

The accounting value of the deficit in the Group's defined benefit pension plan has reduced significantly over the year ended 30 September 2017. The triennial valuation of the Plan was completed in the period and the actual experience of the scheme membership over the three years ended 31 March 2016 was incorporated into the valuation under International Accounting Standard ('IAS') 19. Gilt yields also increased over the year and together these resulted in the deficit under IAS 19 falling to £29.8 million (2016: £58.4 million). A corresponding actuarial gain of £29.0 million before tax was recognised in other comprehensive income (2016: loss of £37.2 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 valuation at the triennial valuation date was £18.0 million and this had reduced to £14.9 million at 30 September 2017, representing an 87.0% funding level.

## A3.5 Operational review

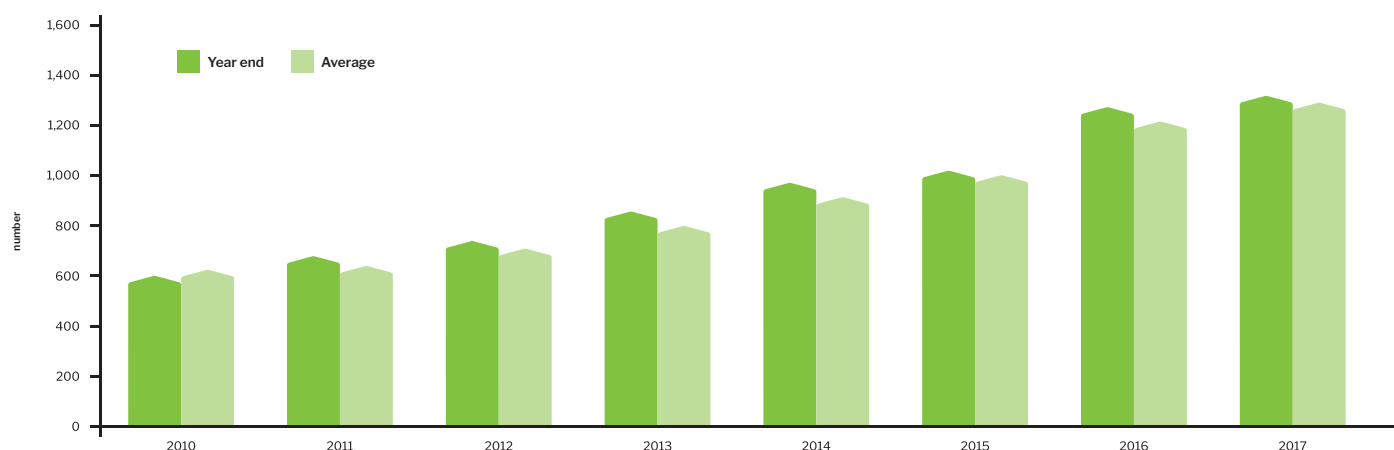
### A3.5.1 Management and people

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

The Group prides itself on the fact that its people remain with it for a long time. Its annual employee attrition rate of 13.2% is below the national average and 28.8% of its people have over ten years service, with 9.3% having achieved over 20 years with the Group. We believe this is due to providing quality development opportunities and creating a place where people want to work, which has meant that knowledge and experience have been retained in each of our specialist areas. We 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 is proud to have signed the Women in Finance Charter, sponsored by HM Treasury, during the year. The Charter's objectives reflect the Group's own aspirations in the field of gender diversity and the Group published its targets under the Charter during the year.

The Group is making good progress and will issue its first report under the Charter in January 2018. The Group notes the publication of the Hampton-Alexander ('HA') review on gender diversity during the year. The Group believes that its Women in Finance objectives are consistent with the review's recommendation and notes that its proportion of female senior managers at the year end, as defined by HA, was 31.4% (2016: 29.2%).

The Group has calculated its gender pay gap at April 2017, as required by law. This calculation shows that median female pay in the Group was 30.4% less than the median male pay. This is broadly in line with the results reported by the few financial services companies to publish their results so far and narrower than the 33.7% gap for the sector reported by the Office of National Statistics in their Annual Survey of Hours and Earnings published in October 2017.

The Group will be analysing its gender pay gap data as part of its Women in Finance initiative to determine if there are areas where urgent action is required, but preliminary results suggest where groups of similar positions exist, there is no evidence of systematic gender bias on pay.

During the year, as part of the preparations for the Group reorganisation, the Board, initially through the Nomination Committee, gave in-depth consideration to the appropriate Board and governance structure for the reorganised Group. It concluded that it was appropriate to invite two independent non-executive directors of the Bank, Patrick Newberry and Finlay Williamson, to join the Board and to appoint two additional non-executive directors, particularly looking to increase the Board's experience and skills in retail banking and risk, as well as improving the Board's diversity.

As a result, Barbara Ridpath and Graeme Yorston, together with the two Bank directors, joined the Board on 20 September 2017. The four newly appointed directors bring a wealth of experience to the Board, including retail banking experience.



Barbara brings listed PLC experience and a strong financial background as well as experience in operational risk and financial ethics, having worked for the Federal Reserve Bank of New York, Standard & Poor's and JP Morgan. She is currently a director of St Paul's Institute which examines moral and ethical aspects of finance and economics, and a non-executive director of ORX, a trade association for operational risk professionals.

Graeme is a former Chief Executive of the Principality Building Society, which operates in many of the same markets as the Group. He has over 43 years experience in the financial services industry and held a number of senior roles with Abbey National including leading IT, change management and call centre activities. His experience will enhance the Board's understanding of operational and customer issues in retail banking.

In appointing Patrick Newberry and Finlay Williamson to the Board, their experience of seeing the Bank through its early development, the launch of its various product lines and the establishment of its relationship with the regulator, is retained. This will be of great value to the Board in its strategic considerations for future developments. Patrick and Finlay also have a broad knowledge of the Group's operations which will enable them to contribute strongly to the Board immediately.

Before joining the Paragon Bank board, Patrick spent 25 years with PricewaterhouseCoopers as a consulting and regulatory partner, focusing on the financial services industry, adding to the Board's regulatory experience. Finlay is a former Finance Director of Virgin Money, having previously held a number of senior finance roles in The Royal Bank of Scotland Group. He brings significant experience of finance, management and accounting in the UK retail banking industry to the Group.

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

## A3.5.2 Risk

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

The Risk Management framework was reviewed in detail during the year as part of the preparations for the Group's internal reorganisation. In particular, the Board reviewed its procedure for setting and managing risk appetites, together with the risk appetites themselves.

The first line of defence has continued to exercise effective control of the risks arising from the Group's operational activities. Supported by the Risk and Compliance function, further progress has been made in the year by business areas in embedding the Group's risk management framework, including enhancements to risk event reporting, risk and control self-assessments and the development of key risk indicators.

The Group has continued to strengthen its second line risk management capabilities including in areas such as cyber security risk, credit risk modelling and data protection. The Risk and Compliance division now includes dedicated functions responsible for the oversight of Credit Risk, Property Risk, Compliance and Conduct Risk, Operational Risk, IT and Cyber Security, and Financial Crime. To progress its objective of obtaining regulatory approval for the implementation of an IRB approach to credit risk, the Risk and Compliance function also has a Director of IRB and supporting specialist resource.

As part of the Group's reorganisation, the former Group and Bank Risk and Compliance functions were integrated, helping to remove unnecessary duplication and thereby maximise the effectiveness of the second line of defence.

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

- The potential impact of the proposals on capital regulation from the BCBS
- Execution and transitional risks arising from the recent major internal reorganisation
- The impact of continuing uncertainty as to the terms on which the UK will leave the EU in March 2019
- The impact of fiscal changes on the demand for buy-to-let mortgages in the UK
- Changes in the regulatory environment relating to the underwriting of buy-to-let mortgages
- Continuing transitional risks arising from the integration and expansion of the acquired Asset Finance business
- Heightened cyber-security risks as a result of the increasing sophistication and frequency of cyber-attacks affecting the financial services sector
- Major regulatory developments including the implementation of the fourth Money Laundering Directive and the impending implementation of the General Data Protection Regulation ('GDPR')

The Group continues to closely monitor its exposure to current and emerging risks as they develop and considers itself well placed to mitigate their impact.

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 B6 of this annual report.



### A3.5.3 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, particularly revisions to the Basel supervisory regime, continue to pose a significant risk for the Group. The governance and risk management framework within the Group has therefore been 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.

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

- The PRA completed the implementation of major policy changes to underwriting standards for buy-to-let mortgage contracts during 2017. These require firms to assess whether the rental income derived from the mortgaged property is sufficient to support the monthly interest cost of the loan payments using an interest coverage ratio ('ICR') test. In addition, supplementary underwriting requirements apply for "portfolio landlords" which the PRA has defined as borrowers with four or more distinct, mortgaged, buy-to-let properties. As a result of its extensive experience within the buy-to-let sector and its historically conservative approach to underwriting, the Group was able to begin operating in line with the new requirements well ahead of the regulatory deadline
- In March 2017, the FCA issued a policy statement to complete the consultation process regarding Payment Protection Insurance ('PPI') that it began in 2015. This included setting a deadline of 29 August 2019 by which consumers will need to make PPI complaints and new rules and guidance on the handling of PPI complaints. The Group has assessed the operational and financial implications arising from the policy statement which it does not consider to be material
- The PRA has updated its supervisory statement setting out the approach to strengthening individual accountability in banking under the Senior Managers Regime ('SMR'). Whilst the Bank has fully implemented the regime, the Group is conscious of its extension to other Financial Services and Markets Acts firms with effect from 2018. It is therefore taking appropriate steps to ensure it is able to comply with the requirements
- In June 2017, the PRA published a policy statement on IRB residential mortgage risk weights. This has been incorporated into the Group's IRB project approach
- In July 2017, the PRA published the results of its review of consumer credit lending, expressing concern that firms' credit models might not always fully consider a borrower's total indebtedness nor how their ability to repay could be affected in the future. The Group has reviewed its approach in this area and is confident with the robustness of its assessment processes and controls
- The GDPR will come into force with effect from May 2018 and represents the most significant revision to data protection legislation for several decades. The Group is therefore taking appropriate steps to ensure it will be compliant with the new legislation by the required deadline

Whilst the Group, along with the rest of the UK corporate sector does not have clear visibility on potential regulatory changes that may be introduced following the UK's decision to leave the EU, it does not have any EU passporting issues that need to be considered.

## A3.6 Conclusion

In recent years Paragon's business model has undergone significant change as it transitioned from a non-bank monoline lender into a retail funded banking group. A diversification strategy has led to the development of six new lending product lines within three years and the formation of a bank to establish a deposit funding franchise, which in 2017 saw balances exceed £3.6 billion. The transition of the model developed further this year with the structural reorganisation, which effectively saw the Bank re-positioned at the top of the Group subsuming virtually all the business' assets and liabilities. This structure has provided numerous immediate benefits to the operating model and will improve funding efficiencies and capital mobility over time. The business is now better positioned to exploit the increasing opportunities in the UK retail banking market as it structurally shifts in favour of specialist lenders which can display a greater understanding of the markets, products and customers they serve.

In 2017 Paragon has, alongside this transition, witnessed strong growth across all products with total lending increasing by 29% to £1.9 billion. Buy-to-let lending benefitted from the increased professionalisation of the sector, a trend that is expected to continue following further regulatory change. Commercial Lending also experienced strong growth following investment in technology and distribution in the year. Notwithstanding this growth, and the benign credit environment, the Group is maintaining a firm discipline on risk and pricing, being cognizant of the potential for more uncertain times ahead.

With a strong capital base, exemplary asset quality, increasingly diversified funding, and a broadening product range supported by a more financially efficient operating model, the Group is well positioned to exploit the opportunities and manage the challenges ahead.

**NIGEL S TERRINGTON**

Chief Executive

**23 November 2017**

# 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 B6.5.

Section B6 of this annual report describes the Group's risk management system and the three lines of defence model it is based upon.

Note 7 to the accounts includes an analysis of the Group's working and regulatory capital position and policies, while notes 9 to 11 include a detailed description of its funding structures, its use of financial instruments, its financial risk management objectives and policies and its exposure to credit, interest rate and liquidity risk. Critical accounting estimates affecting the results and financial position disclosed in this annual report are discussed in note 6.

### **Financial forecasts**

As described under 'Accountability' in Section B3.1, 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 2017 have been approved by the Board and have been compiled taking into consideration the Group's cash flow, dividend cover, 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 managers 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:

- Consideration and challenge of the ratings applied to the various risk categories to which the Group is exposed
- Consideration of the principal risks facing the Group
- Consideration of key regulatory developments

During the year the directors also carried out a high level exercise to identify the most significant risks facing the Group and their relative importance. The results of this exercise were fed back into the Group's risk management process.

The directors specifically considered the impact on risk and viability presented by the reorganisation which took place in September 2017, before it was approved. This included reviewing risk appetites and concluding ICAAP and ILAAP exercises for the reorganised Group.

At the year end the directors reviewed their on-going risk management activities and the most recent risk information available, including the risk register and risk measures, 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 B6.5 of the Risk Management Report.

## ***Availability of funding and liquidity***

The Group's retail deposits of £3,615.4 million (note 44), accepted through Paragon Bank, are repayable within five years, with 61.3% of this balance (£2,215.7 million) payable within twelve months of the balance sheet date. The liquidity exposure represented by these deposits is monitored; a process supervised by the Asset and Liability Committee. The Group is required to hold liquid assets in Paragon Bank to mitigate this liquidity risk. At 30 September 2017 Paragon Bank held £615.0 million of balance sheet assets for liquidity purposes, in the form of central bank deposits (note 30). A further £109.0 million of liquidity was provided by the Bank of England FLS, bringing the total to £724.0 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 Individual Liquidity Adequacy Assessment Process ('ILAAP'). The Bank maintains a liquidity framework that includes a short to medium term cash flow requirement analysis, a longer term funding plan and access to the Bank of England's liquidity insurance facilities, where an additional £84.1 million has been pre-positioned.

The Group's securitisation funding structures, described in note 10, ensure that both a substantial proportion of its originated loan portfolio and a significant amount of its acquired Idem Capital assets are match-funded. Repayment of the securitisation borrowings is restricted to funds generated by the underlying assets and there is limited recourse to the Group's general funds. Recent and current loan originations utilising the Group's available warehouse facilities, described in note 10, are refinanced through securitisation or retail deposits from time to time.

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

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

The Group has demonstrated its ability to raise retail and corporate bond debt when required through its Euro Medium Term Note Programme and other programmes. The Group's access to debt is also enhanced by its corporate BBB- rating, reaffirmed by Fitch Ratings in the year, and its status as an issuer is evidenced by the BB+ rating of its £150.0 million Tier-2 bond issue.

At 30 September 2017 the Group had free cash balances of £305.5 million immediately available for use (note 30).

As described in note 7 the Group's capital base is subject to consolidated supervision by the PRA. Its capital at 30 September 2017 was in excess of regulatory requirements and its forecasts show this continuing to be the case.

### ***Viability statement***

In considering making the viability statement the directors considered the three-year period commencing on 1 October 2017. This aligns with the horizons used in the Group's analysis of risk and only includes 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 forecasts, and the assumptions on which they were based
- the Group's prospective access to future funding
- 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 activities 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 2017.

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 Financial Reporting Council 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 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 employee surveys. The most recent survey returned a response rate of 91% (previous survey: 89%) and an overall engagement score of 86% which compares favourably to the average of 81% in the financial services sector.

Remuneration packages across the business are compliant with the UK's national minimum wage rates. In addition, the Group is an accredited employer with the Living Wage Foundation and first met this standard in June 2016. 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. The Group supports the Living Wage Foundation's principle of a living wage being good for business, good for the individual and good for society and this is an important part of the Group's values and people strategy.

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.

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.

## Women in Finance

The Group's people are at the heart of everything it does and we understand 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 we are proud to have signed the Women in Finance Charter during the year.

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 Chief Financial Officer is the project sponsor and progress against the Charter requirements is monitored by the executive management.

In January 2017 the first set of internal targets under the charter was published on the Group's 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.

The definition of senior management used in the Group's 'Women in Finance' targets is the same as that proposed by the Hampton Alexander review. The number of female senior managers on this basis at 30 September 2017 was 31.4% (2016: 29.2%).

The Group is making good progress towards all of its Women in Finance targets and a detailed report on progress will be published in January 2018.

## Gender Pay

As required by legislation, the Group has calculated its gender pay gap as at April 2017. The results will be published on the government website and on the Group's own website and are summarised below.

	<b>2017</b>
Median gender pay gap	<b>30.4%</b>
Mean gender pay gap	<b>36.2%</b>
Median bonus pay gap	<b>2.2%</b>
Mean bonus pay gap	<b>87.8%</b>

The median and mean pay gaps are in line with the 33.7% median 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 2017. They are also broadly in line with those for the few companies in the sector to report so far.

74.5% of male employees and 85.2% of female employees received a bonus, 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 will be analysing the gender pay gap data as part of the Women in Finance initiative, to determine what action might be required. However, a preliminary review of groups of directly comparable positions did not suggest evidence of systematic gender bias.

## Composition of the workforce

During the year the workforce has grown by 1.46% to 1,318 people (2016: 1,299). Information on the composition of the workforce at the year end is summarised below:

	2017 Females	2017 Males	2016 Females	2016 Males
<b>Employees</b>				
Number	<b>693</b>	<b>625</b>	680	619
Percentage	<b>52.6%</b>	<b>47.4%</b>	52.3%	47.7%
<b>Management grade employees</b>				
Number	<b>113</b>	<b>187</b>	100	170
Percentage	<b>37.7%</b>	<b>62.3%</b>	37.0%	63.0%
<b>Senior managers</b>				
Number	<b>5</b>	<b>21</b>	5	21
Percentage	<b>19.2%</b>	<b>80.8%</b>	19.2%	80.8%
<b>Directors</b>				
Number	<b>2</b>	<b>10</b>	1	7
Percentage	<b>16.7%</b>	<b>83.3%</b>	12.5%	87.5%

Of these employees, ethnic minority employees comprised 11.4% of the workforce (2016: 11.2%) and 3.0% of management grade employees (2016: 4.3%). 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.

Employees on temporary or short-term contracts accounted for 0.1% of the workforce (2016: 0.6%).

The Group's annual employee turnover for the year was 13.2% (2016: 6.5%).

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 March 2017 the Group conducted its first diversity survey to obtain anonymous feedback from employees on their age, gender, ethnicity, sexual orientation, religious beliefs and disability. We received a positive response rate of 78% and as expected, the survey illustrated our workforce is diverse. The results were reviewed at executive level and a number of actions were agreed in line with the Group's commitment to the Women in Finance Charter, including unconscious bias training, requiring improved diversity from our external recruitment partners and providing more flexible working opportunities and mentoring support for individuals.

## Training and development

The Group has been accredited under the 'Investors in People' scheme since 1997 and its Gold status was confirmed once again in February 2016. This demonstrates the Group's commitment to the training and development of all its employees.

In addition, Investors in People also invited the Group to receive Champion status in May 2014, which 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 companies in the UK. This involves the Group in active networking with other organisations and offering mentoring support to smaller organisations that are working towards gaining the Investors in People accolade.

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.

The Group's in-house development team deliver leadership development programmes, externally accredited by the Chartered Management Institute ('CMI'), to support managers. During the year work has continued to embed the internal mentoring programme accredited by the CMI, helping to support succession planning strategy and develop future leaders. The corporate training and development strategy focuses on providing opportunities to develop all employees and is central to the achievement of the Group's business objectives. On average employees received 9.0 days training in the year (2016: 8.5 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 eleven work experience placements to local students this year.

We also run a successful 'refer a friend' scheme whereby employees are awarded with a referral fee if an individual they refer for a role passes probation. This year 52 individuals were successfully recruited through this scheme (2016: 72).

## 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 on matters affecting them.

Employees 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 UK Finance and, in particular, contributing to the Banking Standards Board's survey on culture.

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 policy

The Group strives towards continual improvement of health, safety and welfare in the working environment for its employees and has a published health and safety policy which sets out objectives regarding the health and safety of employees, contractors and visitors, and its application throughout the business. Safety awareness, positive attitudes and continual improvement in safety performance require the commitment and the active involvement of all managers, employees, regular contractors and visitors at all sites.

The Group's health and safety culture has been further developed over the last year. Employees have received external training as well as the entire workforce completing online training modules covering fire safety and general health and safety awareness. All new employees complete a programme of health, safety and environmental induction, including online training and assessment modules. Additional job specific safety training is delivered as required.

The number of fire marshals and first aiders is monitored and continues to be sufficient, with training and adequate cover provided in all offices.

All incidents, regardless of severity are reported internally and attributed to either the work activity or the building environment, providing a clear focus when determining any corrective actions. The appropriate level of investigation, based on the incident or injury is then progressed through to closure.

The structure of the Occupational Health and Safety Management System ('OHSMS') is kept under review and revised as appropriate. Key elements of the OHSMS include:

- health and safety policy
- register of health and safety legislation relevant to the Group's business activities
- regular internal and external audits
- regular health and safety management meetings which monitor and revise the Group's current performance, objectives and targets

Health and safety incidents are classified as operational risk incidents for the purposes of the Group's risk management system and monitored through the Risk and Compliance function and the Operational Risk and Compliance Committee ('ORCC').

The Group's principal source of health and safety related risk is in the vehicle maintenance operations of Specialist Fleet Services ('SFS'). SFS have been accredited to the British Standard 18001:2007, 'Occupational Health and Safety Management Systems' ('BS 18001') and continue to maintain a high standard of compliance with all legislation associated with their industry. The unit has a dedicated health and safety manager who will investigate any incidents within the Group's overall management structure.

For the Group's other, office based, operating units, accreditation of the OHSMS is being obtained under BS 18001. To date, accreditation covers the Group's principal operating sites and it is expected to extend to all of the other current sites by the end of 2018.



Health and safety performance continues to be good with the number of accidents and incidents remaining at a low level in comparison with year-on-year trends. During the financial year ended 30 September 2017 there were no prosecutions or any enforcement action from visits by the authorities for non-compliance in respect of health and safety matters. In August one manual handling incident was reported under the Reporting of Incidents, Disease and Dangerous Occurrences Regulations 2013 ('RIDDOR'). This was the Group's first notification since March 2016 and the only such incident in the period.

The Group's objectives for the next period are; to maintain its BS 18001 certification and extend it to the remaining sites; to move towards the ISO 45001 standard; and to ensure that the approach to health and safety is maintained and updated in line with legislation and regulation.

## A5.2 Environment

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

Specialist Fleet Services ('SFS'), a division of PAF, 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.

### Environmental risk management

The Group's environmental commitment is included within the Health, Safety and Environmental policy that is approved by the Chief Executive and the People Director and which is publicly displayed in its buildings. Energy data is collated by Group Services, the division responsible for managing the Group's properties. Consumption figures for all the premises occupied whether directly owned or tenanted are actively monitored. This is reported to the business 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 their own workshop activities. These are effectively managed under an environmental management system that is certificated to an International Standard – ISO14001:2015. SFS has a dedicated Health and Safety Manager with direct responsibility for environmental issues at all of its sites.

Environmental risk is considered within the Group's operational risk management framework and is monitored by the second line Operational Risk function and the ORCC.

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 2019. The Group has implemented an Energy Working Group which reports to the Property Steering Group to prioritise and drive forward key recommendations for the more efficient use of energy.

### Environmental policy

The Group complies with all applicable laws and regulations relating to the environment. It operates a Green Charter to raise employees' awareness of recycling and campaigns are also run to reduce various forms of waste such as food, consumables or energy. The Group's Green Charter:

- Ensures all buildings occupied by the Group are managed efficiently by its Facilities Team
- Encourages employees to conserve energy
- Promotes recycling by negotiating contracts and providing facilities to enable employees to re-cycle office waste and other used products
- Controls business travel by promoting video conferencing between sites when appropriate and provides opportunities for employees to travel to work in various ways; such as providing cycle racks
- Ensures liaison with the local community
- Ensures that redundant IT equipment is disposed of within current directives / regulations (WEEE - Waste Electrical and Electronic Equipment).
- Ensures that all fluorescent light tubes are disposed of in a safe manner, compliant with appropriate regulations
- Arranges for paper waste products to be recycled, securely, by third parties

The Green Charter is kept under review by the Facilities Team.

## Environmental initiatives

At the Group's Solihull head office a programme to upgrade the lighting is ongoing. LED sensor controlled lighting units are being installed in areas of the site that remain lit all day, effectively reducing consumption in infrequently used areas by dimming, then lights off after 10 minutes until further movement is detected.

The Heating, Ventilation and Cooling system ('HVAC') is currently undergoing an enhanced maintenance programme to confirm that all systems interact efficiently and gas and electricity consumption is minimised.

The Group has benchmarked its energy consumption data and intends to set initial objectives for overall reduction in energy consumption within the next financial year across all sites.

The Group's paper based stationery is procured from Forest Stewardship Council ('FSC') certified suppliers.

All of the Group's redundant IT equipment is collected by an accredited third party company who achieve the maximum amount of plastic and metals recycling possible for this WEEE waste.

The Group operates a Cycle to Work scheme, enabling employees to obtain cycles at preferential rates for commuting purposes, thereby reducing the carbon footprint of travel to work on the local community.

## Performance indicators

The environmental key performance indicators for the Group, determined having regard to the Reporting Guidelines published by the Department for Environment, Food and Rural Affairs ('DEFRA') in June 2013, 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 total operating income of £252.8 million (2016: £244.0 million).

### Greenhouse gas ('GHG') emissions

	2017 Tonnes CO <sub>2</sub>	2016 Tonnes CO <sub>2</sub>
<b>Scope 1 (Direct emissions)</b>		
Combustion of fuel:		
Operation of gas heating boilers	588	520
Petrol and diesel used by company cars	769	554
Operation of facilities:		
Air conditioning systems	21	42
	<b>1,378</b>	1,116
<b>Scope 2 (Energy indirect emissions)</b>		
Directly purchased electricity	1,420	1,654
Total scope 1 and 2	<b>2,798</b>	2,770
<b>Normalised tonnes - scope 1 and 2 CO<sub>2</sub> per £m income</b>	<b>11.1</b>	11.4
<b>Scope 3 (Other indirect emissions)</b>		
Fuel and energy related activities not included in scope 1 or 2	829	765
Water consumption	11	11
Waste generated in operations	23	17
Total scope 3	<b>863</b>	793
<b>Total scopes 1, 2 and 3</b>	<b>3,661</b>	3,563
<b>Normalised tonnes scope 1, 2 and 3 CO<sub>2</sub> per £m income</b>	<b>14.5</b>	14.6

CO<sub>2</sub> values above are calculated based on the DEFRA / Department for Business, Energy and Industrial Strategy ('BEIS') guidelines published in August 2017. CO<sub>2</sub> values for the year ended 30 September 2016 have been restated for the revised conversion factors published by DEFRA / BEIS.

Despite the expansion in the Group's activities, GHG emissions have not increased materially, as increases from higher levels of business activity have been offset by the effect of lower GHG conversion factors for UK electricity calculated by DEFRA/BEIS.

During the year an exercise has taken place to ensure that data from newly acquired subsidiaries is being correctly captured. Where items have been identified which were not reported in the 2016 numbers, values have been restated.

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.

Vehicle fuel usage is based upon expense claims and recorded mileage.

The Group has not been involved in any prosecutions, accidents or similar non-compliances in respect of environmental 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. The amount of power used in the year ended 30 September 2017 is shown below.

	<b>2017</b>	2016
	<b>MWh</b>	MWh
Electricity	<b>4,040.1</b>	4,014.8
Natural gas	<b>3,192.4</b>	2,829.2
	<b>7,232.5</b>	6,844.0
<b>Normalised MWh per £m income</b>	<b>28.6</b>	28.0

Gas and electricity usage is based on consumption recorded on purchase invoices.

### 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 2017 was 10,802m<sup>3</sup> (2016: 10,588m<sup>3</sup>), based upon consumption recorded on purchase invoices, a normalised amount of 42.7m<sup>3</sup> per £m income (2016: 43.4m<sup>3</sup> per £m income). This is a result of the increased size of the Group's operations. A water saving initiative is being introduced 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 streams – including various grades of oil, and a range of metals and plastics. These wastes are managed responsibly in accordance with an ISO 14001:2015 certificated management system.

Waste streams generated by SFS are disposed of appropriately. Waste is transferred to approved waste transfer stations under contract and consignment notes obtained.

The Group's waste output outside SFS consists of general office waste which includes a mixture of principally paper and cardboard with some wood, plastics and metal. 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 2017 together with the methods of disposal are shown below.

	<b>2017</b>	2016
	<b>Tonnes</b>	Tonnes
Recycled	<b>282</b>	236
Landfill	<b>169</b>	114
	<b>451</b>	350
<b>Normalised tonnes per £m income</b>	<b>1.78</b>	1.43

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

## A5.3 Social, community and human rights

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.

### Commitment to our customers

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

Putting the interests of customers at the heart of the business is therefore integral to the achievement of that objective. We want customers to have confidence 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
- Staff 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
- 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 Financial Services Compensation Scheme ('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 and positive 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 understand that we do not always get things right first time and all complaints from our customers are taken very seriously. We acknowledge each complaint promptly and then work with customers to understand their feedback, investigating fully and responding swiftly in a fair and open manner.

Where possible we aim to resolve complaints at the first point of contact, but acknowledge some complaints will require further specialist investigation and time to resolve. Where further investigation is needed, we will stay in regular contact with the customer to keep them informed of what is happening with their complaint. If we need to contact previous service providers, we have established contacts within these companies to ensure any complaint is resolved at the earliest possible opportunity.

Where applicable, 'Alternative Dispute Resolution' information is provided to customers to allow them to appeal to independent parties if they are not satisfied with our response. These include the Financial Ombudsman, the FIA 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.

We genuinely view every complaint as an opportunity to improve our business, an opportunity to identify where we are going wrong and, most importantly, an opportunity to put things right for our customers. As a result, we complete root cause analysis 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 Operational Risk 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 £1,882,000 (2016: £1,443,000) 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 £25,000 (2016: £32,000). 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 such as: Kids Cancer Charity, 3H Fund - Helping Hands for Holidays, Prostate Cancer UK, Renewable World, Down's Syndrome Association, British Heart Foundation, Soroptimist International Solihull and District, Macmillan, WellChild, Kids in Action and Strongbones Children's Charitable Trust.

Employees have been making a difference to the local community in many ways. This year employees have:

- Delivered workshops in local schools and colleges focussing on financial awareness and employability skills
- Donated over 100 shoeboxes for local Samaritans project 'Operation Christmas Purse'
- Made regular contributions to local food banks

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 2016, £15,700 was raised for Alzheimer's Society and Birmingham Children's Hospital, while in the first nine months of 2017, £11,600 has been raised for Marie Curie Hospice Solihull. All employees are given the opportunity to nominate a charity each year and a vote is carried out to select the charity or charities to benefit from the following year's fundraising.

## Taxation payments

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') as 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.

The Finance Act 2016 requires the Group to publish on its website a tax strategy for each financial year, before the year end, covering 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 first such statement was published during the year and can be found on the Group's website.

The published strategy is owned by the Board collectively in accordance with HMRC's published expectations.

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 NI contributions deducted from employee wages and salaries were as follows:

	<b>2017</b>	2016
	<b>£m</b>	£m
Corporation tax	<b>28.9</b>	23.5
PAYE and National Insurance	<b>24.3</b>	21.0
VAT	<b>0.3</b>	1.4
Stamp duty	<b>0.5</b>	0.8
<b>Total national taxation</b>	<b>54.0</b>	46.7
Business rates	<b>1.2</b>	1.2
	<b>55.2</b>	47.9

## Business practices

The Group carries out its business fairly, honestly and openly. It has an anti-bribery and corruption policy, endorsed by the directors and operated throughout the Group. It will not make bribes, nor will it condone the offering of bribes on its behalf. 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 has carried out the risk assessment 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. However, the Group takes its responsibilities seriously and will not tolerate bribery on any scale and as such, its policies and procedures are kept under regular review.

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.

All employees are required to read the Group's anti-bribery and corruption policy and sign to confirm their acknowledgement, understanding and acceptance of its requirements. 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 2017.

The Chief Risk Officer, in conjunction with the Head of Financial Crime, who is part of the 'second line' Risk and Compliance function, is 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.

The Internal Audit Director is responsible for providing assurance that business heads have the appropriate controls in place to ensure all employees adhere to the anti-bribery and corruption policies and procedures at all times.

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 and corruption.

## 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 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 Chief Executive Officer 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 area, 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 supports the objective of the Modern Slavery Act 2015, in raising awareness of modern slavery and human trafficking and published its first annual Modern Slavery Statement on its website in March 2017 and relevant policies have been appropriately updated.

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.

The statement can be found on the Group's website [www.paragonbankinggroup.co.uk](http://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.

# 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

**23 November 2017**

B.



# CORPORATE GOVERNANCE

How the Group is run and how risk is managed

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# B1

## CHAIRMAN'S STATEMENT ON CORPORATE GOVERNANCE



**Robert G Dench**  
Chairman

### Dear Shareholder

It has been a busy year for governance matters both for the Group and for the Board. As noted elsewhere in this report the Group has undergone a strategic reorganisation over the past year or so. One of the prime drivers behind this was to streamline the governance structures within the organisation and this has been achieved.

From late September 2017, the boards of Paragon Banking Group PLC and Paragon Bank PLC have shared the same members and now, on most occasions, the two boards will sit and operate together as though one board and hold joint meetings. This approach will be reflected in the Board's main committees (excluding the Disclosure Committee and the Nomination Committee) and in the executive committees of the Risk and Compliance Committee. It will allow for greater focus on both the strategic and governance mandates of the Board as duplication is avoided. The restructuring will therefore enhance the Board's capacity to consider the corporate governance requirements and expectations which apply to the Company as a FTSE-350 listed entity, the regulatory requirements applicable to the Bank, and the relationship between them.

One of my main areas of focus during the year has been the consideration of the structure, size and ongoing skills requirement for the Board and its committees, taking into account both the Group's strategic reorganisation and the feedback from the external board evaluation in 2016. I was very pleased with the process that was undertaken in the year to confirm and specify in greater detail the Board's requirements.

As Chairman of the Board and of the Nomination Committee I was fully involved, together with the Group's People Director, in considering our approach to determining what skills the Board required (both hard skills such as retail banking and soft skills such as cultural fit and capacity to challenge) and in reviewing and interviewing potential candidates, both internal and external. Additional data on the appointment process is provided in the Nomination Committee Section B3.2.

I am pleased with the rigour of the appointment process and with the quality of the successful candidates; Patrick Newberry and Finlay Williamson, who were already non-executive directors of the Bank, Barbara Ridpath and Graeme Yorston. The newly appointed directors bring a wealth of experience to the Board, including the retail banking experience recommended as an enhancement to the Board's skill set by the external evaluation. All four joined the Board on 20 September 2017. I welcome them to the Board and look forward to working with them in future years.

The first meeting of the joint boards, including the newly appointed directors, was held in late September 2017. This went well and I intend to build on and develop that solid start over the coming year. All the newly appointed non-executive directors will be undertaking an induction, tailored to their specific requirements and needs, over the coming financial year and this has already commenced.

Follow up to the external board evaluation occurred during the year and I am happy to report that the Board concluded satisfactorily on all the points raised. Further detail on this is provided in Section B3.1.

During the year ended 30 September 2017 in addition to its regular business items the Board has:

- Discussed, considered and approved the Group's strategic reorganisation
- Reviewed the Group's funding strategy and position in the light of changes in the business and market conditions
- Agreed the targets for gender and ethnic diversity and other statements in relation to the Group's signing of the Women in Finance charter
- Reviewed and approved the Group's policy on Modern Slavery and the Board's Modern Slavery statement
- Considered preliminary work undertaken examining the potential impact of the proposals in the UK Government's green paper on corporate governance
- Engaged in reviewing, approving and overseeing implementation of acquisitions or potential acquisitions
- Kept under review strategic non-organic growth opportunities within the market
- Kept under review the Group's pilot project entering the owner-occupied mortgage market

I regularly meet with shareholders to discuss general matters affecting the Group and, on an annual basis, the Chairman of the Remuneration Committee and I meet investors to discuss governance and remuneration matters. These meetings assist in the development of governance within the organisation and ensure proper account is taken of shareholders' views. I would like to thank shareholders for their continued interest in the Group and the challenges they raise at these discussions.

Alan Fletcher stepped down as Chairman of the Remuneration Committee in late September and was succeeded by Fiona Clutterbuck, with Fiona's position chairing the Risk and Compliance Committee taken by Finlay Williamson.

I would like to thank Alan for his work as Remuneration Committee Chairman since July 2011, in particular over the last few years when the focus on this area, and how it is reported, has changed significantly. The Board has determined that Alan will cease, in accordance with the recommendation of the UK Code on Corporate Governance (the 'Code') to be an independent non-executive director in February 2018 but we have agreed that he will remain on the Board, so that his valuable experience of the Group can be utilised to assist with governance related items including training and development and the further consideration of the potential impact of the green paper.

I would like to extend my personal thanks as well as those of the Group to Stephen Blaney, Chairman of Paragon Bank since its launch, for steering it through the important initial phase of its development and for his support through the transition process over the past year. Stephen retired as Bank Chairman on 20 September 2017.

As the strategic reorganisation is embedded over the next year it will be of upmost importance to ensure that the Group's strong governance ethic is maintained and enhanced and I look forward to leading the Board through this significant stage in the Group's development.

## **Robert G Dench**

Chairman

**23 November 2017**

# B2

## BOARD OF DIRECTORS

The directors of the Company at the year end were:



**Robert G Dench** (Age 67)

Chairman

**Appointed to the Board as a non-executive director in 2004 and became Chairman in 2007**

### EXPERIENCE

During an extended career with Barclays, Bob Dench held a number of senior positions in the UK and overseas, leaving in 2004.

Bob was Chairman of AXA Ireland Limited from 2008 to 2017, Chairman of AXA PPP Healthcare Limited from 2013 to 2016 and, during the period, a non-executive Director of AXA UK PLC and other AXA Group companies.

During his tenure with AXA, he also held the roles of Senior Independent Non-executive Director and Chairman of the Audit and Risk Committees

### COMMITTEE MEMBERSHIP

Chairman: Nomination Committee  
Member: Risk and Compliance and Remuneration Committees

### CURRENT EXTERNAL APPOINTMENTS

None



**Nigel S Terrington** (Age 57)

Chief Executive

**Appointed to the Board as Treasury Director in 1990, Finance Director in 1992 and became Chief Executive in 1995**

### EXPERIENCE

Nigel Terrington's early career began in investment banking, which included working for UBS. He joined the Group in 1987, shortly becoming Treasurer, before being appointed as Finance Director and then Chief Executive.

He has been Chairman of the CML, Chairman of the Intermediary Mortgage Lenders Association ('IMLA'), Chairman of the FLA Consumer Finance Division, a member of the Mortgage Board of UK Finance (previously CML) and a Board member of the FLA.

Nigel is an associate of the Chartered Institute of Bankers. In 2017, he received an Honorary Doctorate from Birmingham City University for services to the finance industry

### COMMITTEE MEMBERSHIP

Member: Nomination Committee

### CURRENT EXTERNAL APPOINTMENTS

Member of HM Treasury's Home Finance Forum and the Bank of England's Residential Property Forum



**Richard J Woodman** (Age 52)

Chief Financial Officer

**Appointed to the Board as Director of Corporate Development in 2012 and became Group Finance Director in June 2014**

### EXPERIENCE

Richard Woodman joined the Group in 1989 and has held various senior strategic and financial roles, including Director of Business Analysis and Planning and Managing Director of Idem Capital.

He has taken a lead role in the Group's strategic development and, in particular, in the loan portfolio acquisition programme through Idem Capital.

He is a member of the Chartered Institute of Management Accountants

### COMMITTEE MEMBERSHIP

None

### CURRENT EXTERNAL APPOINTMENTS

None



**John A Heron** (Age 58)  
Managing Director, Mortgages

**Appointed to the Board in 2003**

**EXPERIENCE**

John Heron joined the Group in January 1986 following a number of years in the building society industry and is the Group's longest serving employee.

John has been instrumental in the development of Paragon's buy-to-let mortgage lending programme.

As Managing Director, Mortgages, John is responsible for all aspects of the Group's mortgage business which includes the origination and management of buy-to-let and residential first and second charge mortgages.

He has been Chairman of the Buy-to-let Panel of the CML and a member of the IMLA Board.

He is a fellow of the Chartered Institute of Bankers

**COMMITTEE MEMBERSHIP**

None

**CURRENT EXTERNAL APPOINTMENTS**

Member of UK Finance Mortgages Product Board (previously CML)



**Alan K Fletcher** (Age 67)  
Non-executive director

**Appointed in 2009 – eight years served**

**EXPERIENCE**

Alan Fletcher has considerable experience in financial services, including pension fund trusteeship and investment fund management. He was Chairman of Neville James Holdings prior to its acquisition by Challenger International of Australia, following which he was Sales and Marketing Director of Challenger Group Services and a director of Challenger Life (UK) between 2002 and 2003.

He was Chairman of the professional training company, Fresh Professional Development, between 2003 and 2010 and was a Director of CEPB Mortgages Limited between 2010 and 2017. He was a member of the General Synod of the Church of England between 2007 and 2010.

Alan has also served as director of Paragon Pension Trustees Limited, the Corporate Trustee of the Group's pension plan, since 2011

**COMMITTEE MEMBERSHIP**

Member: Audit, Remuneration, Risk and Compliance and Nomination Committees  
Alan was Chairman of the Remuneration Committee until 20 September 2017

**CURRENT EXTERNAL APPOINTMENTS**

Trustee of the Church of England Pensions Board since 2009, member of its Pensions Committee, Chairman of its Investment Committee and member of its Ethical Investment Advisory Group.

Chairman of the Diocese of Leicester Investment Committee and member of the Finance Committee of Leicester Cathedral



**Peter J N Hartill** (Age 68)  
Non-executive director

**Appointed in 2011 – six years served**

**EXPERIENCE**

Peter Hartill spent forty years with Deloitte, becoming a senior audit partner and a business advisor with experience across a wide range of industries and business issues. Specifically he has considerable experience in acquisitions and disposals, capital raising, risk control and corporate governance in the financial services sector.

He is a Chartered Accountant and has been Chairman of the Audit Committee since 2011

**COMMITTEE MEMBERSHIP**

Chairman: Audit Committee  
Member: Risk and Compliance, Remuneration and Nomination Committees

**CURRENT EXTERNAL APPOINTMENTS**

Chairman of Deeley Group Limited  
Non-executive director of A&J Mucklow Group PLC and Scott Bader Limited

# B2

## BOARD OF DIRECTORS

The directors of the Company at the year end were:



### **Fiona J Clutterbuck** (Age 59)

Non-executive director and Senior Independent Director

**Appointed 2012 – five years served**

#### **EXPERIENCE**

Fiona Clutterbuck has many years of corporate finance experience at leading UK and international investment banks, specialising in financial institutions. During her career she has held the positions of Managing Director and Head of Financial Institutions Advisory at ABN AMRO Investment Bank, Managing Director and Global Co-Head of Financial Institutions Group at HSBC Investment Bank and was a director at Hill Samuel Bank Limited

#### **COMMITTEE MEMBERSHIP**

Chairman: Remuneration Committee (from 20 September 2017)

Member: Audit, Nomination and Risk and Compliance Committees

Fiona was Chairman of the Risk and Compliance Committee until 20 September 2017

#### **CURRENT EXTERNAL APPOINTMENTS**

Head of Strategy, Corporate Development and Communications at the Phoenix Group and director of other Phoenix Group companies. Senior Independent Director at WS Atkins PLC until July 2017  
Non-executive director of Hargreaves Lansdown PLC from 1 September 2017



### **Hugo R Tudor** (Age 54)

Non-executive director

**Appointed 2014 – three years served**

#### **EXPERIENCE**

Hugo Tudor spent 26 years in the fund management industry, originally with Schroders and most recently with BlackRock, covering a wide range of UK equities. He is a Chartered Financial Analyst and a Chartered Accountant and brings an investor perspective to the Board

#### **COMMITTEE MEMBERSHIP**

Member: Audit, Risk and Compliance, Remuneration and Nomination Committees

#### **CURRENT EXTERNAL APPOINTMENTS**

Director of Damus Capital Limited  
Director of Vitec Global Limited



### **Patrick J Newberry** (Age 61)

Non-executive director

**Appointed 2017**

#### **EXPERIENCE**

Patrick Newberry spent 25 years as a consulting and regulatory partner with PricewaterhouseCoopers until his retirement in 2013, concentrating on the Financial Services industry. He was a member of PwC's Supervisory Board, Chair of the Strategy, Governance and International Sub Committee and a member of the Audit and Risk Committee.

Patrick was a board member and past president (2010/11) of the Management Consultancies Association Ltd ('MCA') and sits on the judging panel for the MCA 2014 awards, a benchmark for quality in the consulting industry.

He was appointed to the Board of Paragon Bank PLC in May 2014 and was Chairman of its Audit Committee until 20 September 2017.

Patrick is a Chartered Accountant.

#### **COMMITTEE MEMBERSHIP**

Member: Audit, Nomination and Risk and Compliance Committees

#### **CURRENT EXTERNAL APPOINTMENTS**

Non-executive director of Shepherd and Wedderburn PLC  
Adviser to Unipart Expert Practices



**Barbara A Ridpath (Age 61)**

Non-executive director

**Appointed 2017**

**EXPERIENCE**

Barbara Ridpath has worked in finance for most of her career, in New York, London and Paris at the Federal Reserve Bank of New York, Standard & Poor's and JPMorgan.

She was instrumental in the development of UK mortgage securitisation in the late 1980s and went on to lead the Standard & Poor's Ratings Group in Europe, the Middle East and Africa

**COMMITTEE MEMBERSHIP**

Member: Audit and Risk and Compliance Committees

**CURRENT EXTERNAL APPOINTMENTS**

Director of St Paul's Institute which examines moral and ethical aspects of finance and economics

Non-executive director of ORX, a trade association for operational risk professionals

Member of Council and the Executive Committee at Chatham House, the Royal Institute of International Affairs and commissioner of the Marshall Aid Commemoration Commission



**Finlay F Williamson (Age 58)**

Non-executive director

**Appointed 2017**

**EXPERIENCE**

Finlay Williamson was Finance Director of Virgin Money between 2009 and 2014, where he was responsible for supporting the design and delivery of the company's growth strategy, including the assessment of potential markets, the development of key propositions and the pursuit of non-organic opportunities.

Prior to joining Virgin Money, Finlay had a long career at Royal Bank of Scotland (RBS), where he held a number of senior finance roles, latterly as Finance Director for RBS's Manufacturing and Retail Direct divisions.

He was appointed to the Board of Paragon Bank PLC in February 2015 and was Chairman of its Risk and Compliance Committee from that date.

Finlay is a Chartered Accountant

**COMMITTEE MEMBERSHIP**

Chairman: Risk and Compliance Committee (from 20 September 2017)

Member: Audit Committee

**CURRENT EXTERNAL APPOINTMENTS**

None



**Graeme H Yorston (Age 60)**

Non-executive director

**Appointed 2017**

**EXPERIENCE**

Graeme Yorston was Group Chief Executive of Principality Building Society, the 6th largest mutual in the UK. He has over 43 years' experience in financial services having carried out a number of senior roles in Abbey National, including IT Director for its retail bank, Regional Director and ran a number of significant change programmes. He also led its call centre operations.

Graeme has served on the CBI Council for Wales, the Board of Business in the Community in Wales and was HRH Ambassador for BITC in Wales for two years. He was awarded Director of the Year in Wales by the Institute of Directors in 2016.

Graeme is a Fellow of The Chartered Institute of Banking, holds an MBA from Warwick Business School and was awarded an Honorary Doctorate in Business Administration from Cardiff Metropolitan University in 2017

**COMMITTEE MEMBERSHIP**

Member: Audit and Risk and Compliance Committees

**CURRENT EXTERNAL APPOINTMENTS**

Board of Governors, Cardiff Metropolitan University



# B3

## CORPORATE GOVERNANCE

### B3.1 Governance framework

The Board of Directors is responsible for overall Group strategy and for the delivery of that strategy within a robust corporate governance and corporate responsibility framework. That framework is described in the following pages.

The Board is committed to the principles of corporate governance contained in the Code issued by the FRC in April 2016 and which is publicly available at [www.frc.org.uk](http://www.frc.org.uk). Throughout the year ended 30 September 2017 the Company complied with the principles and provisions of the Code. The Board notes that a new edition of the Code is being considered by the FRC and the Board will review it and consider whether any amendments to its practices are appropriate when the revised Code is published.

#### Stakeholders

The Board, in its deliberations and decision making processes takes into account the views of the Group's stakeholders and, where applicable, considers the impact of those decisions on the communities and environment within which the Group operates. While good corporate governance is important to the Board, so too is maintaining a reputation for high standards of business conduct in all of the Group's operations, and management of conduct risk is a key part of the risk management framework. Section A5 sets out information on corporate responsibility including the Group's people policies, its involvement in industry initiatives, its support for the community and its environmental, social and conduct impacts.

The People Director, as well as the executive directors, report regularly on the views of the Group's employees and the impact of new projects on the workforce is taken into account.

The Group has no single major supplier or contractor which could be considered a primary stakeholder but a number of its suppliers are of significant importance to the Group's operations and a close relationship is maintained, and reported to the Board, to help ensure that the Group runs effectively.

The Group also endeavours to maintain an open and transparent relationship with its various regulators, including the PRA and FCA. Its relationship with HMRC and the principles it applies to its tax affairs are described in Section A5.3.

#### Leadership

The schedule of matters reserved for the Board, which was reviewed during the year, details the key matters for which the Board is responsible including:

- The Group's values and standards
- Its strategic aims and objectives
- Approval of major capital projects and material acquisitions and disposals
- Approval of annual operational and capital expenditure budgets
- Approval of the Company's dividend and corporate governance policies
- Agreeing the Group's risk appetite
- Determining the remuneration policy for the executive directors

All directors receive sufficient relevant information on financial, business and corporate issues prior to meetings.



For most of the year the Board consisted of the Chairman, three executive directors and four non-executive directors. On 20 September 2017, an additional four non-executive directors were appointed. All the directors bring a broad and valuable range of experience to the Company and further details of this together with other biographical details are set out in Section B2. Alan Fletcher will cease to be considered an independent non-executive director in February 2018 on the ninth anniversary of his first appointment. From this date he will cease to be a member of any board committees but will remain on the Board. As required by the Code he will be subject to annual re-election. The Board is then expected to comprise the Chairman, three executive directors, seven independent non-executive directors and one non-independent non-executive director. Consequently, the balance between independent and non-independent directors will remain appropriate.

The division of responsibilities between the Chairman and Chief Executive is clearly established, set out in writing and agreed by the Board. This division was fully revised during the year to ensure that it remained fit for purpose following the group reorganisation and was in line with best practice.

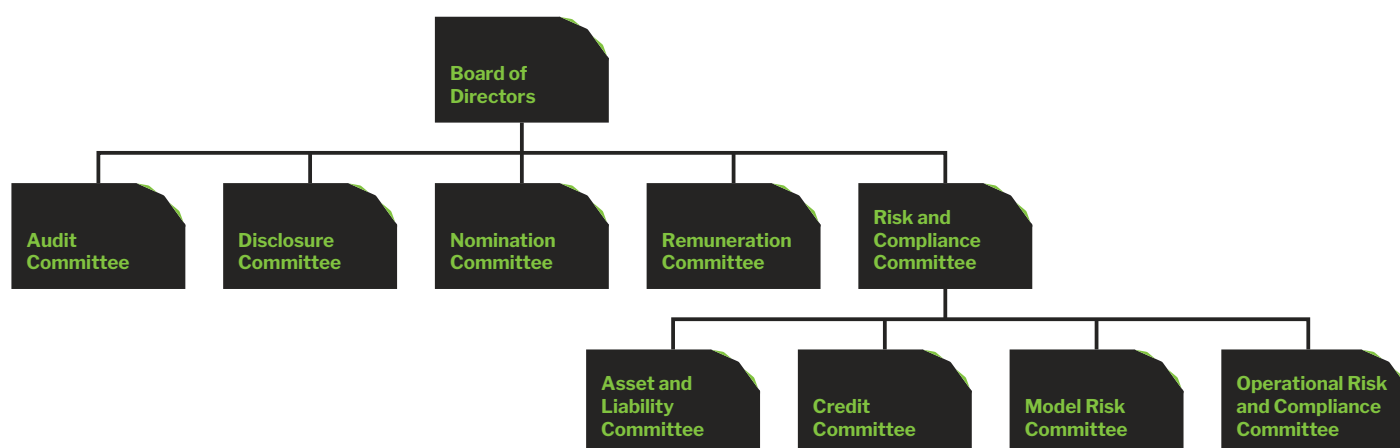
There is a strong non-executive representation on the Board, including the Senior Independent Director, Fiona Clutterbuck. This provides effective balance and challenge.

The Chairman's other business commitments are set out in the biographical details in Section B2. During the year, the Chairman ceased to undertake his role with AXA which he had held for a number of years. Otherwise there have been no significant changes during the period to his commitments.

The Board has agreed a policy for managing conflicts and a process to identify and authorise any conflicts which might arise, which was recently updated. At each meeting of the Board and its committees actual or potential conflicts of interest in respect of any director are reviewed.

The Board also operates through a number of committees covering certain specific matters, illustrated in the chart below.

### Board Committee structure



### Board committees

Summarised information on each of the board committees is set out below.

Committee		Audit	Remuneration	Risk and Compliance	Nomination
Chair	From 20/09/17	P J N Hartill	F J Clutterbuck	F F Williamson	R G Dench
	To 20/09/17	P J N Hartill	A K Fletcher	F J Clutterbuck	R G Dench
Minimum number of meetings		3	3	4	2
Further information		Section B4	Section B5	Section B6	Section B3.2

Members	Independent non-executive	Audit	Remuneration	Risk and Compliance	Nomination
R G Dench	-	No	Yes	Yes	Yes
N S Terrington	-	No	No	No	Yes
F J Clutterbuck	✓	Yes	Yes	Yes	Yes
A K Fletcher†	✓	Yes	Yes	Yes	Yes
P J N Hartill	✓	Yes	Yes	Yes	Yes
H R Tudor	✓	Yes	Yes	Yes	Yes
P J Newberry	✓	Yes*	No	Yes*	Yes*
B A Ridpath	✓	Yes*	No	Yes*	No
F F Williamson	✓	Yes*	No	Yes*	No
G H Yorston	✓	Yes*	No	Yes*	No

\*Member from appointment to the Board on 20 September 2017.

†Alan Fletcher will cease to be a member of all board committees from 25 February 2018.

The Board has considered the requirements of the Code with respect to the composition of audit committees and is satisfied that all members of the Audit Committee have recent and relevant financial experience and that the Committee as a whole has competence relevant to the sector in which the Group operates.

In addition to the committees listed above a further standing committee, the Disclosure Committee, was established during 2016. The purpose of the Committee is to assist in the design, implementation and evaluation of disclosure controls and procedures; monitor compliance with the Company's disclosure controls; consider the requirements for announcement; and overall determine the disclosure treatment of material market information. The Committee's members are Robert Dench, Nigel Terrington and Richard Woodman, of which any two can form a quorum but that quorum should include either the Chief Executive Officer or Chief Financial Officer.

### Executive committees

Four executive committees, the Asset and Liability Committee ('ALCO'), the Credit Committee, the Model Risk Committee ('MRC') and the Operational Risk and Compliance Committee ('ORCC'), consisting of executive directors and appropriate senior employees, report to the Risk and Compliance Committee. The MRC was established during the year broadly to review and advise the Board upon all material aspects of the rating and estimation processes in relation to credit and finance models used by the Group. All of these committees are described further in the Risk Management Section B6.

All board committees operate within defined terms of reference and sufficient resources are made available to them to undertake their duties. The terms of reference of the committees are available on request from the Company Secretary.

The attendance of individual directors at the regular meetings of the Board and its committees in the year is set out below, with the number of meetings each was eligible to attend shown in brackets. Directors who are unable to attend meetings receive the papers and any comments from them are reported to the relevant meeting. Directors have attended a number of ad hoc meetings during the year in addition to the regular Board meetings and have contributed to discussions outside of the regular meeting calendar.

Director	Board	Audit Committee	Risk and Compliance Committee	Remuneration Committee	Nomination Committee
Robert G Dench	12 (12)	-	4 (4)	7 (7)	5 (5)
Nigel S Terrington	12 (12)	-	-	-	5 (5)
Richard J Woodman	12 (12)	-	-	-	-
John A Heron	12 (12)	-	-	-	-
Alan K Fletcher	12 (12)	4 (4)	4 (4)	7 (7)	5 (5)
Peter J N Hartill	11 (12)	4 (4)	4 (4)	6 (7)	4 (5)
Fiona J Clutterbuck	12 (12)	4 (4)	4 (4)	7 (7)	5 (5)
Hugo R Tudor	12 (12)	4 (4)	4 (4)	7 (7)	5 (5)
Patrick J Newberry	1 (1)	1 (1)	0 (0)	-	1 (1)
Barbara A Ridpath	1 (1)	1 (1)	0 (0)	-	-
Finlay F Williamson	1 (1)	1 (1)	0 (0)	-	-
Graeme H Yorston	1 (1)	1 (1)	0 (0)	-	-

Directors also attended an annual two-day strategy event, held off site, to enable further, more detailed, discussion of the Group's position and future development. This strategy event has been a regular fixture in the Group's governance calendar for a number of years and recently has also been attended by the Group's executive management group and by the executive and non-executive directors of the Bank.

The Board regularly receives, reviews and considers reports on the following matters:

- Strategic matters
- Potential acquisition opportunities
- Business performance
- Results, management accounts and financial commentary
- Operational reports from business areas
- Treasury and funding matters
- Legal and governance matters
- The work of the Board's committees
- Matters arising from subsidiary company boards, including that of Paragon Bank
- Investor relations and shareholder feedback

## Subsidiary governance

A number of the corporate entities within the Group are regulated by either the PRA and the FCA or solely by the FCA. The Company has oversight of these entities as part of its overall responsibility for the management of the Group and also to ensure that the Group's values and standards in regulated spheres are met.

Since the completion of the strategic reorganisation in September 2017 the directors of the Company have also comprised the Board of Paragon Bank PLC. The intention of the directors is that the boards of both companies will meet jointly in most foreseeable circumstances. Consequently, oversight of Paragon Bank PLC will form an intrinsic part of the board and committee meetings of the Company going forward.

## Effectiveness

All of the non-executive directors are independent of management and all are appointed for fixed terms. They are kept fully informed of all relevant operational and strategic issues and bring a strongly independent and experienced judgement to bear on these issues. The non-executive directors meet with the Chairman, from time to time, without the presence of the executive directors.

All of the directors holding office at 30 September 2017 had been either reappointed at the AGM on 9 February 2017, or, in the cases of Patrick Newberry, Barbara Ridpath, Finlay Williamson and Graeme Yorston, appointed since that date, and all of them have submitted themselves for election or re-election, as appropriate, at the forthcoming AGM.

All directors have access to the advice and services of the Company Secretary, who is responsible to the Board for ensuring that board procedures are complied with. Both the appointment and removal of the Company Secretary are matters for the Board as a whole.

All directors are able to take independent professional advice in the furtherance of their duties whenever it is considered appropriate to do so and have access to such continuing professional development opportunities as are identified as appropriate in the Board appraisal process.

The Board considers that each of the non-executive directors are independent of the Group and free from any business or other relationship which could materially interfere with the exercise of their independent judgement.

Alan Fletcher serves as a director of the corporate trustee of the Paragon Pension Plan (the 'Plan') and receives £10,000 per annum (increasing to £15,000 per annum from 1 October 2017) in respect of that appointment from Paragon Finance PLC, the sponsoring company of the Plan and a subsidiary of the Company. The Board considers that this does not impact on his independence because the Plan is a trust which is independent of the Company and, as a director of its corporate trustee, he has a fiduciary duty to act in the best interests of the trust and the Plan's beneficiaries.

The composition of the Board and its committees is kept under review, with the aim of ensuring that there is an appropriate balance of power and authority between executive and non-executive directors and that the directors collectively possess the skills and experience necessary to direct the Company's and the Group's business activities. The directors review actual or potential conflicts of interest in respect of any director at each meeting of the Board and its committees.

There is an established process for external appointments through the Nomination Committee. Ultimately, the appointment of any new director is a matter for the Board. Executive director appointments are based upon merit and business need. Non-executive appointments are based upon the candidates' profiles matching those agreed by the Nomination Committee. In all cases the Board approves the appointment only after careful consideration.

Succession planning for the Board is in place with emergency cover available for the executive directors. Further detail is provided in the Nomination Committee Section B3.2.

The Human Resources department has a wider succession development plan for senior management roles across the Group, prioritising those positions likely to require recruitment within the next five years. This data has been considered against internally identified individuals with high potential and the capability to fulfil those roles as they become vacant, to ensure that succession requirements can be met. Internal individuals will be developed for future senior roles and this will be complemented with external recruitment at a senior level where necessary, to balance the required skills and experience of the senior management team and ensure continuing success in the future. This succession plan will be reviewed in the current financial year following the Group's strategic reorganisation.

## Training

All of the non-executive directors have received presentations during the year on various aspects of the Group's activities. In addition, training has been provided by external advisors on topics such as the economy, and the markets and regulatory environments in which the Group operates or is considering operating in.

As part of its development programme the Board has agreed a dedicated day and half for training in each financial year and such days are scheduled into the ongoing board calendar. The session in October 2016 included presentations from external advisors and banking analysts as well as in-house presenters. The session in March 2017 was superseded by various individual sessions related to matters necessary to the strategic reorganisation and accounted for approximately a day of the directors' time covering Group liquidity in general and the Group's ILAAP.

The focus at the October 2017 session was on regulation, including the General Data Protection Regulation and IFRS 9 and the day also included an external presentation on the Group's Recovery and Resolution Plan. Ongoing development opportunities for all directors will be provided, as required, during the forthcoming year. A training schedule is maintained by the Human Resources department.

The directors appointed in September 2017 will receive appropriately tailored induction training during the new financial year to develop their understanding of the Group and its operations.

## Board evaluation

The effectiveness of the Board, individual directors and the Board's main committees are reviewed annually, with an externally facilitated review every three years as required by the Code.

This year's annual board and committee review was internally facilitated. No issues arose that were required to be addressed.

Last year's review was the triennial external evaluation which considered the performance of the Board and its committees, all individual directors, including the Chairman and also the Company Secretary. The review was undertaken by Armstrong Bonham Carter LLP with the lead review work completed by Tom Bonham Carter. Neither Armstrong Bonham Carter LLP nor Tom Bonham Carter had undertaken any other work for the Group.

The review concluded that there was clear evidence of the effectiveness of the Board and identified a small number of issues to be followed up in the current year. A few matters were identified for the long-established Audit and Remuneration Committees and these were addressed immediately. The Risk and Compliance Committee, which was established in 2014, and the Nomination Committee whose role has developed significantly in recent years had some points to address during the financial year. The board evaluation for 2017 concluded that the follow up points from the 2016 evaluation had been sufficiently addressed and were now considered closed.

Detailed below are the recommendations described in the 2016 Annual Report and Accounts, excluding those noted there as already completed, and how they were addressed in the year:

RECOMMENDATION	CONCLUSION
<b>Board</b>	
To ensure that the Group's strategy, as it evolves, is clearly articulated and defined over the short, medium and long-term and that related risk appetite is fully documented	<p>Strategy was considered and reviewed at the strategy days in 2017 and will continue to be monitored at these events and discussed as required during normal business.</p> <p>The strategic reorganisation completed during the year will enable the Group to provide greater clarity to the market of the direction of its future development.</p> <p>Risk appetite was reviewed as part of the strategic reorganisation and revised risk appetite statements documented and approved. Risk appetites and key risk metrics are considered at Risk and Compliance Committee at every meeting and, if necessary, on an ad hoc basis as required by internal and external developments</p>
To consider further enhancing the ongoing investor relations programme	The programme was reviewed and the enhancements described under 'Relations with shareholders' below have been made
To consider the appointment of an additional non-executive director with more retail and SME banking experience	Additional directors with the suggested experience were appointed on 20 September 2017
<b>Nomination Committee</b>	
To consider the appointment of an additional non-executive director with more retail and SME banking experience	See above
<b>Risk and Compliance Committee</b>	
To ensure the Committee has a robust process to check that the risk profile is in line with the approved risk appetite	A formal risk appetite statement, including limits and triggers was adopted and regular reporting is undertaken against those metrics. This is described further in the Risk Report (Section B6)
To ensure that the Committee has a robust risk review process in place for historic risk events	The Committee has an agreed process that any major risk event will be assessed relative to risk appetite; current principal risk register; and local risk and control self-assessments, to evidence the effectiveness of the risk review process. This assessment will be reported by the Chief Risk Officer to a subsequent Committee meeting

## Individual performance

The performance of the Chief Executive is appraised by the Chairman. The performance of the other executive directors is appraised by the Chief Executive in conjunction with the Chairman. The results of these appraisals are presented to the Remuneration Committee for consideration and determination of remuneration.

The Chairman appraises the performance of the non-executive directors, identifying any development opportunities or training needs. The Senior Independent Director leads the review of the performance of the Chairman with the other non-executive directors, taking into account the views of the executive directors.

At the Annual General Meeting the Chairman will confirm to shareholders, when proposing the re-election of any non-executive director, that following formal performance evaluation, the individual's performance continues to be effective and demonstrates commitment to the role. The letters of appointment of the non-executive directors will be available for inspection at the AGM.

## Accountability

Detailed reviews of the performance of the Group's main business lines are included within the Strategic Report. The Board uses this to present a fair, balanced and understandable assessment of the Company's position and prospects.

The directors' responsibility for the financial statements is described in Section B8.

An on-going process for identifying, evaluating and managing the significant risks faced by the Group, which is regularly reviewed by the Board, was in place for the year ended 30 September 2017 and to the date of these financial statements. An overview of this process, and its part in the director's consideration of the Group's viability is given in Section A4.

The directors are responsible for the system of internal control throughout the Group, including the system of internal control over financial reporting, and for reviewing its effectiveness. Such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can provide reasonable, but not absolute, assurance against the risk of material misstatement or loss and that assets are safeguarded against unauthorised use or disposition. In assessing what constitutes reasonable assurance, the directors have regard to the relationship between the cost and benefits from particular aspects of the control system.

The system of internal control includes documented procedures covering accounting, compliance, risk management, personnel matters and operations, clear reporting lines, delegation of authority through a formal structure of mandates, a formalised budgeting, management reporting and review process, the use of key performance indicators throughout the Group and regular meetings of the ALCO, Credit Committee, MRC and ORCC and senior management.

Internal control over financial reporting within the Group is provided by a process designed, under the supervision of the Chief Financial Officer and senior financial management of the Group, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes, including the process of preparing the Group's consolidated financial statements.

Internal control over financial reporting includes policies and procedures intended to ensure that records are maintained that fairly, and in reasonable detail, reflect transactions and dispositions of assets, to provide reasonable assurance that transactions are recorded as necessary to permit the preparation of the financial statements, to ensure that receipts and expenditures are only being made in accordance with management authorisation and to provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use or disposition of assets that could have a material effect on the financial statements.

Internal control systems, no matter how well designed, have inherent limitations and may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that internal controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may reduce.

The Board receives regular reports setting out key performance and risk indicators. In addition the Board operates a formal risk management process, described in more detail in Section B6, from which the key risks facing the business are identified. The process results in reports to the Board, through its Risk and Compliance Committee, on how these risks are being managed. The Board has a programme of regular presentations from senior management to enable the Board to review the operation of internal controls in relation to the risks associated with their specific areas.

The system of internal control is monitored by management and by an internal audit function that concentrates on the areas of greater risk and reports its conclusions regularly to management and the Audit Committee. The internal audit work plan is approved annually by the Audit Committee, which reviews the effectiveness of the system of internal control annually and reports its conclusions to the Board. Further details of the role and activities of the Audit Committee and its relationship with the internal and external auditors are set out in Section B4. The Risk and Compliance Committee is responsible for reviewing the Group's risk management framework and the effectiveness of the Group's systems and controls. Further details of the role and activities of the Risk and Compliance Committee and the Group's risk management system are set out in Section B6. There is some overlap between the work of the Audit Committee and that of the Risk and Compliance Committee and the Board monitors these areas to ensure that no gaps develop in the system of internal control.

The directors confirm that they have reviewed the effectiveness of the Group's system of internal control for the period and that these procedures accord with the 'Guidance on Risk Management, Internal Control and Related Financial and Business reporting' published by the FRC.

## Remuneration

Information on how the Group has applied the provisions of the Code relating to remuneration is set out in the Directors' Remuneration Report in Section B5.

## Relations with shareholders

The Board encourages communication with the Company's institutional and private investors. All shareholders have at least twenty working days' notice of the Annual General Meeting at which the directors and committee chairmen are available for questions. The Annual General Meeting is held in London during business hours and provides an opportunity for directors to report to investors on the Group's activities, to answer their questions and receive their views. At all general meetings shareholders have an opportunity to vote separately on each resolution and all proxy votes lodged are counted and the balances for, against and directed to be withheld in respect of each resolution are announced.

The Chairman, Chief Executive and Chief Financial Officer have a full programme of meetings with institutional investors during the course of the year and investors' comments are communicated to all members of the Board, enabling them to develop an understanding of major shareholders' views of the Group. During the year ended 30 September 2017 meetings were held with investors from the UK, Europe and North America. From time to time other presentations are made to institutional investors and analysts to enable them to gain a greater understanding of important aspects of the Group's business.

This programme was expanded during the year following feedback from last year's Board effectiveness review.

The Chairman, the Chairman of the Remuneration Committee and the People Director hold annual meetings, generally in October, with leading shareholders to discuss remuneration policies and other corporate governance matters and the comments received are reported to the Board and considered by the Remuneration Committee in determining or varying the Group's approach to executive compensation.

The October 2017 meetings were attended by both the current Chairman of the Remuneration Committee (who is also the Senior Independent Director) and the former Chairman of the Remuneration Committee.

The results of all of these meetings are reported to the Board so that all directors are aware of shareholder views.

The Senior Independent Director is also made aware of views expressed by shareholders to other members of the Board, via the Company's brokers or through the Investor Relations team and is available to meet with shareholders should they wish. Such meetings can be arranged via the Company Secretary.

The Company's website at [www.paragonbankinggroup.co.uk](http://www.paragonbankinggroup.co.uk) provides access to information on the Group and its businesses.

## B3.2 Nomination Committee

The Nomination Committee consists of the Chairman of the Company, Robert Dench, who chairs the Committee, Nigel Terrington, the Chief Executive and Alan Fletcher, Peter Hartill, Fiona Clutterbuck and Hugo Tudor, all independent non-executive directors. On 20 September 2017, Patrick Newberry, a further independent non-executive director became a member of the Committee. The majority of the Committee's members are, therefore, independent non-executive directors. In February 2018 Alan Fletcher will cease to be a member of the Committee when he ceases to be an independent non-executive director.

During 2016 the Committee reviewed its terms of reference (which were adopted by the Board in October 2016) to align its remit with best practice. The Committee's purpose has been defined to include ensuring that there is a formal, rigorous and transparent procedure for the appointment of new directors to the Board; leading the process for Board appointments and to make recommendations to the Board on those appointments; and assisting the Board in ensuring its composition is regularly reviewed and refreshed so that it is effective and able to operate in the best interests of shareholders. Ultimate responsibility for any appointment remains with the Board. The Committee also considers re-appointment of directors, re-election of directors and the independence of non-executive directors and makes recommendations regarding these matters to the Board.

The Committee keeps under review the structure, size and composition of the Board (including its skills, experience, independence, knowledge and diversity) and makes any recommendations that it deems necessary.

The Board recognises the benefits that can flow from non-executive directors holding other appointments but requires them to seek the agreement of the Chairman before entering into any commitments that might affect the time they can devote to the Company.

The Committee also has a general responsibility for oversight of the Group's senior management succession policy and its initiatives on workforce and management diversity, with a particular focus on its participation in external programmes, such as Women in Finance.

### Appointments during the year

For the appointment of new directors during the year, the Committee led the evaluation of the Board's requirements, in the light of both the external evaluation undertaken in 2016 and the proposed strategic re-organisation. An external search consultant, Gavin Orr of Lomond Consulting, who has previously assisted the Group with senior appointments, was used in this process.

The Committee determined the skills required (both hard and soft skills) and all potential candidates were considered and ranked against a skills matrix taking account of diversity of possible candidates and the structure, size and composition of any future board configuration. The Chairman also interviewed all potential internal candidates for the non-executive director roles.

An initial longlist of 26 potential candidates was produced and the Chairman interviewed ten, using a competency-based interview approach. They were also all interviewed by independent non-executive directors, Fiona Clutterbuck on behalf of the Company and Finlay Williamson on behalf of the Bank (as these candidates were also being considered as candidates for appointment to the Bank board and its committees), and by Nigel Terrington, the Chief Executive, and Anne Barnett, the People Director.

The four interviewers jointly provided feedback and a shortlist of recommended candidates for consideration by the Committee and the board of the Bank. The shortlisted candidates were referenced at a level commensurate with their potential role, including discussions with the PRA, and they also underwent pre-employment screening, as do all potential Group employees.

Diversity was a factor considered in the initial review of potential external candidates for the Board, the Committee having previously considered its existing diversity levels including its gender balance.

The Committee reviewed and challenged the final proposed external candidates, taking account of references provided, before making recommendations to the boards of the Company and the Bank with regard to both membership of the Board and Committees. The choice of appointees was based entirely on merit. The Committee ensured that prospective non-executive directors could devote sufficient time to the appointment.



Internal candidates for both executive and non-executive roles on the board were also reviewed by at least two members of the Nomination Committee and the People Director, with one-to-one interviews being held by the Chairman with all the internal candidates for non-executive roles from the then current Paragon Banking Group PLC and Paragon Bank PLC boards.

Additionally, the Nomination Committee, considered the candidates for the executive Senior Management Roles for approval by the board of Paragon Bank PLC. Furthermore, the Nomination Committee considered the suitability of internal candidates allocated to the specific Senior Manager Function roles, under the Senior Manager Certification Regime, prior to submission for regulatory approval.

## Diversity

The Group recognises the importance of diversity, including gender diversity, at all levels of the organisation including the Board and the contribution which it can make to board effectiveness. The Group recognises the importance of diversity on the Board, not only of gender, but also of experience and background, and the valuable contribution which such diversity can make towards achieving the appropriate balance of skills and knowledge which an effective board of directors requires.

The Board has always believed and continues to believe in appointing the best person to the role regardless of gender or other points of diversity and this belief is reflected and operates across all appointments made by the Group. However, the Board recognises that measurement and publication of targets can assist in driving forward change and developing a talent pipeline in a sector where gender diversity has been difficult to achieve. For this reason, the Group has signed up to HM Treasury's Women in Finance Charter initiative and has agreed targets in respect of gender diversity amongst the Group's senior management. As is clear from the existence of the Women in Finance initiative, obtaining full diversification of gender in the financial services sector is particularly challenging given the size of the female talent pool across the industry. Similar issues apply to advancing diversity of ethnicity in the sector. The targets adopted reflect the Board's commitment to ensuring that diversity considerations throughout the Group are wider than gender.

The Group's diversity policies are described in Section A5.1 of the Annual Report, where information on the composition of the workforce is also given, together with further information on the Group's Women in Finance targets and details of other initiatives in this field in the period.

## Succession planning

The succession plans for the Board were noted during the year and will be reviewed during the current financial year following the Group's strategic reorganisation. The tenure of the non-executive directors is monitored by the Committee. Emergency cover is in place for the executive directors and their direct reports.

Following review work in 2016, which considered approximately 100 roles, internal development has been undertaken to enhance succession planning with consideration given to possible 'at risk' roles as well as to the development of potential future senior management candidates.

Risk mitigation will continue to include the ongoing development of employees, as well as work to further validate potential candidates for senior positions. Development work on potential candidates occurs with those employees remaining in their current roles, as this training is undertaken so as to minimise business impact while ensuring that candidates are enabled to undertake a more senior role in due course. The Group's preference, where possible, is that internal candidates are developed and supported to undertake senior roles as this assists in the ongoing maintenance of its strong cultural focus on its people.

# B4

## AUDIT COMMITTEE



**Peter J N Hartill**  
Chairman of the  
Audit Committee

### B4.1 Statement by the Chairman of the Audit Committee

#### Dear Shareholder

The year ended 30 September 2017 has seen major changes in both the Group's business and the Committee's responsibilities. The Group's reorganisation in September means that all of the Committee's members now serve on the audit committee of Paragon Bank, the Group's regulated subsidiary, extending the Committee members' regulatory duties.

This has taken place against a background of change within the Group with new business lines launched and new regulatory requirements rolled out.

In September I was pleased to welcome Patrick Newberry, Barbara Ridpath, Finlay Williamson and Graham Yorston to the Committee. Patrick and Finlay previously served on the audit committee of Paragon Bank, Patrick as Chairman, and all of the new members will enhance the Committee's experience and understanding of the retail banking sector and banking regulation.

As a Committee, our responsibility is to ensure that financial information published by the Group properly presents its activities to stakeholders in a way that is useful and understandable, as well as overseeing the effective delivery of both external and internal audit services.

During the year, the Committee met four times and its principal activities were as follows:

- The review of the annual and half-yearly financial statements to ensure these properly present the Group's activities in accordance with accounting standards, law, regulations and market practice
- In particular, the consideration of the Group's accounting policies for the recognition of interest income and loan impairment amongst other significant accounting issues
- The review of other financial information published by the Group, such as Pillar III disclosures required by banking regulations
- The supervision of the internal audit function as its role changes as the business evolves and best practice develops
- Overseeing the Group's preparations for the introduction of IFRS 9 which will be implemented from 1 October 2018 and, with the Risk and Compliance Committee, the early stages of the Group's IRB project
- Overseeing the continuing integration of the PAF and Premier operations acquired in the year ended 30 September 2016 into the Group's financial reporting and control framework
- Considering the Group's readiness to address other forthcoming accounting changes which will affect it, such as IFRS 15 and IFRS 16
- Considering whether the Internal Audit function is compliant with the new guidance from the Chartered Institute of Internal Audit on internal audit in the financial services sector, issued in September 2017

The Committee also considered the impact on its work of the Group's reorganisation and adopted new terms of reference to ensure that changes in its role were addressed.



In the financial year ending 30 September 2018 the Committee's main priorities will include:

- Continued monitoring of the Group's IFRS 9 implementation programme as the implementation date draws near
- Maintaining oversight of the changes in control and reporting arising from the Group's reorganisation
- Ensuring that the Group's control processes develop alongside developments in the business

I commend this report to shareholders and ask you to support the resolutions concerning the reappointment of KPMG LLP ('KPMG') as auditors and their remuneration at the Annual General Meeting in 2018.

**Peter J N Hartill**

Chairman of the Audit Committee

**23 November 2017**

## B4.2 Operations of the Committee

The Audit Committee comprises all of the independent non-executive directors of the Company whose relevant experience is set out in Section B2 and its terms of reference include all matters indicated by Disclosure and Transparency Rule 7.1 and the Code. The latest edition of the Code, which applies to the Group from 1 October 2016 includes increased provisions around the role of audit committees.

The Committee's responsibilities include:

- Monitoring the integrity of the Group's financial reporting
- Reviewing the Group's internal control systems
- Monitoring and reviewing the effectiveness of the Group's internal audit function
- Monitoring the relationship between the Group and the external auditor

It also provides a forum through which the Group's external and internal audit functions report to the non-executive directors.

The Internal Audit Director reports ultimately to the Chairman of the Audit Committee. He attends all meetings of the Audit Committee and also reports regularly to the Risk and Compliance Committee.

The Committee considers that, as a whole, it possesses the competence relevant to the sector in which the Group operates that the Code requires and thus it complies with the new edition. Both Peter Hartill and Patrick Newberry have competence in accounting and auditing while other committee members have experience in various aspects of the financial services industry.

The Committee meets at least three times a year and has an agenda linked to events in the Group's financial calendar. Meetings generally take place before the half year and year end reporting dates in March and September and before the approval of results in May and November. The Committee normally invites the Chairman, the executive directors, Group Financial Controller, Director of Internal Audit and a partner and other representatives from the external auditor to attend meetings of the Committee, although it reserves the right to request any of these individuals to withdraw.

For part of each meeting the Committee meets separately with representatives of the external auditor and with the Director of Internal Audit without any other persons present.

At each meeting the Committee receives reports of reviews conducted throughout the Group by the Internal Audit and, from time to time, Compliance functions.

During the year the Chairman of Paragon Bank's audit committee and its finance director were invited to meetings of the Committee when matters relating to the Bank were to be discussed. As the membership of the Bank audit committee is now the same as that of the Committee, this will not be required in future.

From time to time, when there are major changes in the Group's accounting policies or audit arrangements in progress, the Chairman of the Committee has held meetings with shareholders and is prepared to meet investors in future to discuss such matters.

Details on the Committee members' attendance at meetings and the Board's evaluation of the Committee's effectiveness are given in Section B3.1.

## B4.3 Significant issues addressed by the Committee in relation to the Financial Statements

The Committee considers whether the accounting policies adopted by the Group are suitable and whether significant estimates and judgements made by the management are appropriate. In evaluating the Group's financial statements for the year ended 30 September 2017 the Committee considered particularly:

- The calculation of interest income under the Effective Interest Rate ('EIR') method for both internally originated and purchased loan assets and the Group's borrowings
- The levels of impairment provision against loan assets
- The requirement for any impairment provision against the purchased goodwill carried in the Group's balance sheet
- The valuation of the deficit in the Group's defined benefit pension scheme, particularly in the light of the updated triennial valuation
- The viability statement which the Group is required to make under the Code
- The Group's capital and funding position and the Group forecasts for future periods

The Committee also considered whether this Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's performance, business model and strategy.

In each of these areas the Committee was provided with papers discussing the position shown in the accounts, the underlying market conditions and assumptions and the methodology adopted for any calculations. The papers also detailed any changes in approach from previous periods. These were reviewed in detail and discussed with the relevant Group employees and the results of this work were considered, together with the results of testing by the external auditor. There were no material or significant disagreements between the management and the external auditor.

Particular matters which the Committee focused on in each of these areas were:

Matter	Particular areas of focus
<p><b>Interest income and expense recognition</b></p>	<p>As required by IAS 39, the Group recognises income from loan balances on an EIR basis, which is intended to produce a constant yield throughout the behavioural life of the loan, taking account of such matters as costs of procurement, and initially fixed or discounted interest rates. The calculation therefore rests on assumptions about the future behaviour of the Group's customers. A similar approach is taken to assessing interest on borrowings, where redemption profiles and anticipated refinancing dates influence expense recognition.</p> <p>The Committee assessed the appropriateness of the assumptions made, considering performance of the portfolios against expectations and the impact of changes in product specifications. Redemption profiles used in the modelling of mortgage books and the availability of alternative offerings in the market were areas of particular focus.</p> <p>The Committee also paid particular attention to the accounting for new Idem portfolio purchases, which are generally made at a discount to the gross balance owed by customers on the accounts purchased, and where portfolio performance is a major driver of the EIR calculation.</p> <p><i>Further information on these estimates can be found in note 6b to the accounts, and the interest income and expense recognised on this basis is shown in notes 16 and 17</i></p>
<p><b>Loan impairment</b></p>	<p>IAS 39 requires that companies provide for any financial assets, held at amortised cost, considered to be impaired at the balance sheet date, to the extent that the carrying value might not be recovered.</p> <p>The Group's calculation of impairment provision relies on assumptions to determine when an account might require provision and how large that provision would need to be.</p> <p>In order to satisfy itself that this calculation resulted in appropriate provisioning, the Committee considered actual out-turns against historical impairment provision amounts calculated by the Group's models and the continued relevance of historical cash flow experience to the current loan book, based on present economic conditions and account administration practices.</p> <p>This included an assessment of the impact of the Group's receiver of rent processes on cash flows and ultimate impairment levels, consideration of the likely effects of movements in property prices on security values and an examination of exposure on large portfolios.</p> <p><i>Further information on these estimates can be found in note 6a to the accounts, the impairment charge for the year is shown in note 25 and movements in provision for impairment are shown in note 35.</i></p> <p><i>The Group's exposure to credit risk is discussed in note 9</i></p>
<p><b>Goodwill impairment</b></p>	<p>The Group is required to assess, at the end of the year, whether the carrying value of the acquired goodwill balance in its accounts, which is not subject to amortisation under IFRS, remains appropriate or whether any impairment has occurred.</p> <p>In considering whether any impairment of goodwill had occurred the Committee considered particularly the Group's forecasts for the cash flows to be generated by the acquired businesses and their reasonableness in the light of current trading performance and the Group's strategy for these operations.</p> <p><i>The potential impairment of goodwill is discussed in notes 6c and 42</i></p>

Matter	Particular areas of focus
<b>Pension deficit</b>	<p>The deficit on the Group's defined benefit pension plan is valued in accordance with IAS 19, which requires an actuarial valuation of the plan liabilities. Such a valuation is based on assumptions including market interest rates, inflation and mortality rates in the Plan.</p> <p>The triennial valuation of the Plan at 31 March 2016 was approved by the Trustee in the year and the Committee considered whether the Trustee's conclusions necessitated any changes in the accounting valuation.</p> <p>In order to satisfy itself as to the appropriateness of these assumptions, the Committee considered their derivation and the market data underlying them. These were compared to market benchmarks and advice from the Group's actuarial advisers. The Committee also considered benchmarking data provided by the external auditor.</p> <p><i>Further information on the Plan deficit, the basis of valuation and the assumptions underlying it can be found in note 54 to the accounts, along with an analysis of sensitivities to the more significant assumptions</i></p>
<b>Viability statement</b>	<p>The Board is required by the Code and the Listing Rules to make a viability statement in the Annual Report. The Committee has been asked to express an opinion to the Board as to whether this statement could properly be made.</p> <p>The Committee considered aspects of the work of the Board and its various committees which addressed the Group's business model, risk profile, access to funds and future strategy, they also considered guidance issued by the FRC and stress testing which had been carried out in the year.</p> <p><i>A fuller discussion of the directors' consideration of the viability statement is set out in Section A4</i></p>
<b>Capital and funding</b>	<p>The Board is required by the Code and the Listing Rules to make a going concern statement in the Annual Report. The Committee has been asked to express an opinion to the Board as to whether this statement could properly be made.</p> <p>The Committee considered the Group's detailed forecasts and the implicit cash and capital requirements. The Committee discussed availability of funding, potential stress events and the impact of the economic environment.</p> <p><i>A fuller discussion of the directors' consideration of the going concern statement is set out in Section A4</i></p>
<b>Fair, balanced and understandable</b>	<p>The Board is required by the Code to state whether, in its view, the Annual Report is fair, balanced and understandable. The Committee has been asked to express an opinion to the Board as to whether this statement could properly be made.</p> <p>The Committee considered the draft Annual Report for the financial year, as a whole, satisfying itself that the process for the preparation and review of its various sections, was appropriate. The Committee especially focused on areas where disclosure requirements had changed or where new activities were to be reported on. Based on this exercise, and the Committees own understanding of the business in the year, it determined whether the Annual Report, overall, portrayed the Group's activities, position and results properly.</p>

The Committee also examined the disclosure changes made in compiling the Annual Report and Accounts following the Group's reorganisation. These included the adoption of new reporting segments (described in note 14) and revised presentation (described in note 2). The Committee considered whether these changes met the Group's objectives of increasing clarity and comparability with other similar entities.

The Committee was able to reach satisfactory conclusions on all of these areas and therefore resolved to commend the Annual Report to the Board for approval, and to advise the Board that it can conclude that the Annual Report is fair, balanced and understandable.

Earlier in the year the Committee had considered each of these areas, where applicable, in the same manner in concluding that it could commend the Group's half-yearly financial report for the six months ended 31 March 2017 to the Board for approval.

## B4.4 External auditor

The Committee is responsible for assessing the effectiveness of the external audit process, for monitoring the independence and objectivity of the external auditor and for making recommendations to the Board in relation to the appointment and remuneration of external auditors. The Committee is also responsible for developing and implementing the Group's policy on the provision of non-audit services by the external auditor.

### *Audit tendering*

On 24 September 2014, the Competition and Markets Authority finalised its investigation into the audit market and published The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 (the 'Order'). The provisions of the Order are consistent with new requirements being introduced by European legislation.

The Order first applied to the Group from the beginning of the year ended 30 September 2016 and requires that only the Committee can agree the fees and terms of service of the external auditors, initiate and supervise a tendering process or recommend the appointment of an external auditor to the Board following a tender process. The Group has complied with the requirements of the Order during the year.

KPMG were appointed as auditors, following a competitive tender process, with effect from the year ended 30 September 2016 at the Annual General Meeting in February 2016. The financial year ended 30 September 2017 is the second reported on by KPMG and Andrew Walker has been the engagement partner since their appointment.

The Group is therefore not subject to a legal requirement to undertake an audit tender until ten years have elapsed, and will report to shareholders no later than after the completion of the fifth year (the year ending 30 September 2020), and in each subsequent year thereafter, its conclusions on whether a further tender is in the Group's interest at that time.

Other than the legal requirements of the Order, the Committee has not identified any factors which might restrict its choice of external auditor.

### *Audit effectiveness*

The Committee has considered the effectiveness of the external audit for the year ended 30 September 2017 and the Group's relationship with the external auditor, KPMG, on an on-going basis, and has conducted a formal review of the effectiveness of the annual audit before commending this Annual Report to the Board. This review consisted of the following steps:

- A list of relevant questions was considered by senior management who submitted their responses in writing to the Committee in advance of the meeting convened to consider the Annual Report
- The Committee members, with reference to the same questions considered their experience of the audit process in advance of that meeting
- At the meeting the Committee discussed the results of the exercise with the senior financial management of the Group, without the external auditor present
- The Committee then addressed the evaluation, as appropriate, with the external auditors

The Committee was able to conclude, on the basis of this exercise and its experience over the year, that the external audit process remained effective and that the auditor was independent and objective, up to the signing date of this report. A further review will be carried out following the completion of audit procedures on all Group companies and reported on in next year's Annual Report.

The effectiveness review addressing the conduct of the 2016 audit, undertaken at the time of approval of the 2016 Group accounts was updated once the external audit process for all Group companies had been completed and affirmed the original conclusion, that the external audit was independent and objective and that the audit process was effective for that financial year.

In conjunction with the effectiveness review the Committee considered whether KPMG remained able to provide the required quality of service and were independent of the Group. More specifically the Committee considered whether KPMG's understanding of the Group's business, their access to appropriate financial services and regulatory specialists within their firm, both locally and nationally, and their understanding of the sectors in which the Group operates were appropriate to the Group's needs. As part of this exercise the Committee also considered the transparency report presented by the Auditor and the FRC's most recent audit inspection review on the audit firm.

As a result of these exercises the Committee concluded that it would recommend to the Board that a resolution to reappoint KPMG as auditors for the year ending 30 September 2018 should be proposed at the forthcoming AGM.

## Independence policy

Both the Committee and the external auditor have safeguards in place to avoid any compromise of the independence and objectivity of the external auditor. The Committee considers the independence of the external auditor annually and the Group has a formal policy for the engagement of its external auditor to supply non-audit services, reviewed, most recently, in 2016. The policy is designed to ensure that neither the nature of the service to be provided nor the level of reliance placed on the services could impact the objectivity of the external auditor's opinion on the Group's financial statements.

The policy precludes the appointment of the external auditor to provide any service where there is involvement in management functions or decision making, or any service on which management might place primary reliance in determining the adequacy of internal controls, financial systems or financial reporting. It also precludes the external auditor from providing tax or remuneration advice. Internal audit services may not be provided by the external auditor. The Committee must approve any engagement of the external auditors for non-audit work, except where the fee involved is clearly trivial. The policy sets out rules for the employment of former employees of the external auditor and procedures for monitoring such persons within the organisation.

The Committee reviews, on a regular basis, the levels of fees paid to all major accounting firms to identify any matters which might impact on those firms' ability to tender for the group audit at any future date.

## Fees paid to the external auditor

Fees paid to the external auditor are shown in note 24 to the Accounts. Other than services required to be provided by external auditors by legislation or regulation, non-audit services provided by KPMG related to accounting and regulatory advisory work in respect of the Group's preparation for the introduction of IFRS 9 and its IRB project and other accounting advice (shown as 'other services' in note 24).

Overall the fees paid to KPMG, the Group's external auditor, for non-audit services (excluding VAT), were £52,000 (2016: £103,000), which is equivalent to 5.4% of the total fees paid to them.

The Group actively considers other providers for the type of non-audit services typically provided by accounting firms. It maintains on-going relationships relating to tax, remuneration and regulatory advice with firms other than the Auditor's firm and considers discrete projects on a case-by-case basis. The Group has engaged with a number of firms, including some outside the 'big four' largest audit firms for assignments during the year, assessing each firm's appropriateness for the particular assignment before an appointment was made. Fees paid to audit firms (excluding VAT), excluding the Group audit and related fees can be analysed as shown below:

	<b>2017</b>	2016
	<b>£000</b>	£000
Auditors – KPMG	<b>52</b>	103
Auditors - Deloitte	<b>N/A</b>	161
Other big four firms	<b>673</b>	478
Other firms	<b>33</b>	367
	<b>758</b>	1,109

Fees paid in the year ended 30 September 2016 to the outgoing auditors after their resignation and the incoming auditors before their appointment are included within 'other big four firms'.

The audit tender process conducted in 2015 helped to further relationships with all of the big four firms, not simply the incoming auditors, and those relationships, and the Group's relationship with its former Auditor, Deloitte, have been maintained.

## B4.5 Internal Audit

The Committee is responsible for considering and approving the remit of the internal audit function and ensuring it has adequate resources and appropriate access to information to enable it to perform its function effectively and in accordance with the relevant professional standards. The Committee also ensures that the internal audit function has adequate standing and is free from management or other restrictions which may impair its independence.

### *Operations*

During the year, the Committee considered and approved the three year rolling internal audit plan, which is based on an assessment of the key risks faced by the Group. Progress in respect of the plan is monitored throughout the year and an assessment made of whether the internal audit function has sufficient resource to complete the plan. With the approval of the Committee the audit plan may be revised during the year, based on the ongoing assessment of the key risks or in response to the requirements of the Group.

The Internal Audit Director met regularly throughout the year with the Chairman of the Committee to discuss progress against plan, outstanding agreed actions, and departmental resourcing. Ahead of finalisation of the 2017/18 Audit Plan the Chairman of the Committee and the then Chairman of the Bank Audit Committee met with the Internal Audit Director and his managers to discuss audit planning priorities, key business risks and assess current resourcing. The chairmen then took the opportunity to meet informally with all the Internal Audit team members to enhance understanding on both sides.

At the request of the PRA, in 2016/17 Internal Audit has undertaken specific review work in the areas of Common Reporting ('COREP') and the provision of an independent treasury capability in the Bank. Both of these reviews were co-sourced under the agreement with a third-party accounting firm on a subject matter expertise basis. Certain other technical or specialist reviews of the first and second line have also been undertaken including an element of co-sourced input where it was deemed by the Internal Audit Director that such skills would complement those of the internal team.

All Internal Audit reports are circulated to the full Board. Main findings of reports graded high or above are discussed by the Committee. Overdue actions graded medium or above are challenged at both the Committee and the Risk and Compliance Committee.

The results of this work, together with the Committee's engagement with the management information of the Group and the executive directors, have enabled them to conclude that the statements given in Section B3 relating to the Group's systems of internal control and its management of risk are appropriate.

### *Effectiveness*

In line with the Chartered Institute of Internal Audit ('CIIA') standards, the Committee has agreed to commission an external quality assessment ('EQA') in January 2018 to benchmark internal audit activities against best practice and peers. The previous EQA completed in January 2015 was also undertaken by the CIIA and provided assurance to the Committee that the function complied with all relevant areas.

In September 2017, the CIIA revised their 'Guidance on Effective Internal Audit in the Financial Services Sector' (originally issued in July 2013). A summary of the revisions and the internal audit function's compliance with these revised guidelines has been considered by the Committee and further consideration of these will form part of the EQA.

## B4.6 Whistleblowing

There is an established procedure whereby employees can make disclosures regarding malpractice within the Group on a confidential basis, in accordance with the Public Interest Disclosure Act 1998 ('PIDA'). The policy also makes provision to ensure that no employee making such a disclosure suffers any detriment by doing so. This process is supervised by the Committee and any amendments to the policy require the approval of the Chairman of the Committee. There is a right of appeal to the Chairman where the employee is dissatisfied with the outcome and his decision is final in all cases.

To ensure that the policy is embedded in the operations of the Group all employees received training on the requirements of PIDA and the Group's policy during the year and were tested to ensure their understanding.

During the year ended 30 September 2017 no reports were made through the Group's whistleblowing process which necessitated action being taken.



# B5

## REMUNERATION REPORT

*This report covers the activities of the Remuneration Committee for the year ended 30 September 2017 and sets out the remuneration details for the executive and non-executive directors of the Company. It has been prepared in accordance with Schedule 8 of The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2008, as amended in August 2013, and the principles of the UK Corporate Governance Code.*

*This report consists of the Statement by the Chairman of the Committee (B5.1) and the Annual Report on Remuneration (B5.2). The policy summary tables extracted from the detailed Remuneration Policy are reproduced for reference as Section B5.3. The full Remuneration Policy is set out in the Annual Report and Accounts for the year ended 30 September 2016, a copy of which can be found at [www.paragonbankinggroup.co.uk](http://www.paragonbankinggroup.co.uk).*



**Fiona J Clutterbuck**  
Chairman of the  
Audit Committee

### B5.1 Statement by the Chairman of the Remuneration Committee:

#### Dear Shareholder

##### Introduction

Following my appointment as Remuneration Committee Chair on 20 September 2017, I am pleased to present the Company's remuneration report for the year ended 30 September 2017 to shareholders.

I have been a member of the Board and Remuneration Committee since 2012 and I recognise and support the philosophy the Group has adopted towards pay throughout the organisation; seeking to recognise fairly and equitably the contributions to the Group of all employees. For executive directors, the aim is to ensure that their rewards are aligned with the interests of shareholders through the achievement of the Group's strategic objectives and with a focus on appropriate risk management. These were the principles underpinning the remuneration policy which was put to shareholders at the 2017 Annual General Meeting and the Committee and I were pleased and encouraged by the high level of shareholder support.

An active dialogue with shareholders has been maintained throughout the year. As part of our annual governance review myself, the Chairman, the former Chairman of the Committee, the People Director and the Company Secretary met with a number of major shareholders in October 2017. We also engaged with shareholders earlier in the year to discuss proposed changes to de-risk pension arrangements for the executive directors and more widely in the Group.

I should like to express my sincere thanks to my predecessor as Chairman of the Committee, Alan Fletcher, for his tireless efforts in chairing the Committee, and for developing Paragon's remuneration policy over a period of significant change for both the business and for remuneration reporting, since his appointment in 2011.

##### Business performance

The year saw the completion of the Group's strategic reorganisation with most of the Group's activities moving under its banking subsidiary, which involved a significant amount of management time. Underlying profits rose by 1.0% to £145.2 million (2016: £143.8 million). Profits on the statutory basis increased by 1.1% to £144.8 million (2016: £143.2 million) and basic earnings per share increased by 6.4% to 43.1p (2016: 40.5p) whilst absorbing over £10 million of Tier 2 Bond related costs.

The year has seen continued strong growth levels in organic business generation and further debt purchase activity. Although the level of portfolio acquisitions was lower at £98.0 million (2016: £208.8 million), group wide organic originations rose 28.8% to £1,853.4 million (2016: £1,439.1 million).



## Remuneration outcomes for the year

The Committee recommended salary increases for the executive directors of 3.0%, in line with the average increase of 3.2% for the wider workforce, which came into effect from 1 October 2017. Strong financial performance and risk management resulted in bonus out-turns of 90% of maximum opportunity for Nigel Terrington and Richard Woodman and 82.5% for John Heron. Details of the performance relating to these bonuses are provided in section B5.2.2. In assessing personal performance, the Committee took into account the continued excellent growth and focus on an expanding portfolio at a time when a major Group legal and regulatory re-structuring was also taking place.

As stated last year, full retrospective disclosure of the target range for the bonuses for the year ended 30 September 2017 will be included in the 2018 Annual Report on Remuneration.

Awards granted under the Performance Share Plan ('PSP') in 2014 and which vested in respect of performance in the three years ended 30 September 2017 were subject to a Total Shareholder Return ('TSR') performance condition, measured against the FTSE-250 Index (50% of the award), and an EPS growth condition (50% of the award). Following the delivery of EPS growth above expectation, and share price improvement, the Company's TSR performance over the period ranked above median and EPS exceeded the upper target. This resulted in the awards vesting at 63.51% of maximum.

During the year, the Committee gave careful consideration to the existing pension obligations of the Group to the executive directors and other senior staff who had participated in the Group's defined benefit pension plan (the 'Plan') which was closed to new members from 5 February 2002. These individuals received a pension supplement in exchange for ceasing future accrual in 2006/2007, as a method of de-risking the Plan. Certain employees (including Richard Woodman) also received a supplement for breaking their salary link in 2011, again as a method of de-risking the Plan. These are contractual benefits and the supplement payments are cost neutral to the Group; calculated triennially by Mercer, the Group's actuarial adviser, to be the same as the cost of the benefits surrendered. This legacy pension arrangement reflects the unique tenure of the management team whose combined experience with the Group is approaching 90 years. Workforce tenure generally is also exceptionally high (nearly twice the national average for financial services and three times for management).

The most recent review by Mercer, concluded that changes in financial conditions, particularly over 2016, have significantly increased the supplements for the executive directors: Nigel Terrington from 38% to 55%, John Heron from 38% to 54% and for Richard Woodman from a combined total of 49% to 103% ('the revised supplements'). This level of increase is due to his promotion to Group Finance Director in June 2014 and consequent increase in base salary, contrasted with the previous actuarial assumptions of small increments in salary.

The review also resulted in similar increases for certain senior staff below executive director level. The changes were due to apply from 1 April 2017 and whilst these are contractual rights and cost neutral to the Group, the Committee is aware that the actual percentages are increasingly out of line with peer groups, which mainly consist of individuals in receipt of a company contribution to a defined contribution pension scheme. Taking into account the Group's unique situation, the Committee's overriding concern was that this legacy pension issue may continue and worsen over time if it was not addressed.

The Committee therefore proposed the following. Firstly, that the part of the supplement payable to Richard Woodman, which relates to his past service (i.e. what the Group would legally be required to pay him if he left the Group) should be settled as a lump sum, recognising that this is a contractual liability related to past not future service. This amounted to £1.006 million and is disclosed in the single figure table. This reduced the revised pension supplement figure to 63%. Secondly, that the revised supplements for all three executive directors should be reduced and fixed at 45% with effect from 1 April 2017. There is no compensation proposed for any of the executive directors for the reduction in their pension provision despite the contractual nature of these arrangements.

To ensure equal treatment for everyone in the same situation, where settlement payments were due to other senior managers, similar arrangements were offered (i.e. Richard Woodman was not treated any more favourably than those below Board level). The revised supplements for these employees were also fixed at 45% with effect from 1 April 2017. However, in contrast to the executive directors, these individuals did receive compensation for the difference between their revised pension supplement and 45%, as calculated by Mercer.

Finally, the three executive directors transferred their pension funds out of the Plan, effective 30 September 2016, at no gain or loss to the Group. Details of this transfer are provided in section B5.2.2. The Plan actuary has advised the Pension Trustee that the transfers will benefit the Plan in the long-term by reducing scheme size and improving the funding position relative to a buyout and self-sufficiency basis.

Shareholders will be aware that the pension contribution payable for any new external executive director appointments was capped at a maximum of 25% in the 2017 remuneration policy, although as communicated in the Chairman's statement in the Directors' Remuneration Report last year, this is likely to be 10% to 15% in practice. These changes reflect the very specific position for Paragon with a legacy pension issue arising from the unique long term tenure of the management team.

## Changes proposed for 2018

Changes proposed for the coming financial year are minimal. The TSR comparator group has been reviewed to reflect the changes in the finance sector over the last few months and as a consequence constituents have been amended slightly. Details are in Section B5.2.3. The Committee reviewed the fees payable to the Chairman and agreed to an increase from £240,000 to £255,000 in recognition of the absence of an increase in fees since October 2015 in a role which has become increasingly involved and complex as the Group has expanded. Non-executive directors' base fees were also increased in recognition of the greater complexity involved in a banking group. The Committee will continue to engage with shareholders and hopes that it can rely on your continuing support at the AGM on 15 February 2018.

## Fiona J Clutterbuck

Chairman of the Remuneration Committee

23 November 2017

## B5.2 Annual report on remuneration

### Remuneration summary

The information provided in this section is not subject to audit

Aligning our pay principles to our strategy:

The success factors on which the Group's strategic priorities are based	Translation into reward principles and structure	
	Bonus	Performance share plan
Credit quality	Risk measures and future value of new business	EPS growth and risk assessment
Loan pricing	Future value of new business and financial performance	EPS growth
Funding	Risk measure and financial performance	EPS growth and risk assessment
Strong financial foundations	Financial performance	EPS growth
Efficient utilisation of the Group's capital base	Risk measures	Risk assessment
Cost control	Profit measures and personal objectives	EPS growth
A customer focused culture	Personal objectives	Risk assessment includes customer engagement measures

These success factors deliver enhancement of shareholder value. This is encouraged and aligned with our reward structure through the use of TSR in PSP performance conditions and the encouragement of bonus deferral and personal shareholdings.

At a glance summary of remuneration during the year

	Salary increase	Salary	Bonus earned as % of maximum	PSP vesting in respect of performance in the year
		£000		
N S Terrington	3%	474	90.0%	63.51%
R J Woodman	3%	299	90.0%	63.51%
J A Heron	3%	253	82.5%	63.51%

The annual report on remuneration comprises:

- The Remuneration Committee, key responsibilities and advisers (B5.2.1)
- Details of the remuneration of the directors for the year ended 30 September 2017 (B5.2.2)
- Details of how the remuneration policy will be applied to the directors in the year ending 30 September 2018 (B5.2.3)
- Other disclosures required by the Regulations (B5.2.4)
- Policy summary for executive and non-executive directors approved at the AGM in 2017 (B5.3)

The remuneration policy was approved at the Company's AGM on 9 February 2017 and became effective for three years from the close of that meeting. The remuneration policy is set out in full in the Annual Report and Accounts for the year ended 30 September 2016.

## B5.2.1 The Remuneration Committee, key responsibilities and advisers

The information provided in this section is not subject to audit

### Committee membership during the year ended 30 September 2017

The Committee comprised Alan Fletcher (who chaired the Committee until 20 September 2017), Fiona Clutterbuck, Peter Hartill and Hugo Tudor, all of whom were independent non-executive directors, and the Chairman of the Company, Bob Dench. Alan Fletcher stood down on 20 September 2017 and Fiona Clutterbuck was appointed Chair of the Committee from that date. Alan Fletcher will continue to sit on the Committee until 24 February 2018 when he will cease to be independent in accordance with the Code.

None of the non-executive directors who sit on the Committee has any personal financial interest (other than as a shareholder or debt holder) or conflict of interest arising from cross-directorships or day-to-day involvement in running the business.

### Key responsibilities

The Committee determines the Company's policy on executive remuneration and specific compensation packages for each of the executive directors and the Chairman. No director contributes to any discussion about his or her own remuneration.

The Committee also reviews the level and structure of remuneration of senior management.

The terms of reference for the Committee are available on request from the Company Secretary.

### Attendees

Chief Executive, People Director, external remuneration advisors by invitation.

### Advisors

During the year, the Committee considered advice from:

- Deloitte LLP ('Deloitte') who were appointed as the Committee's independent advisor in February 2016 following a review process. Deloitte is a founder member of the Remuneration Consultants Group and as such voluntarily operates under its Code of Conduct in relation to executive remuneration in the UK. This supports the Committee's view that all advice received during the year was objective and independent. The total fees paid to Deloitte for advice to the Committee during the year amounted to £109,560 (including VAT). Deloitte provided other professional services to the Group during the year including share scheme advice, corporate tax advice, pension structuring advice, regulatory advice, co-sourced internal audit services and advice relating to the Group's structured finance business.
- The Chief Executive and the People Director in determining directors' remuneration for the year.

### Statement of voting at Annual General Meeting

The table below sets out actual voting in respect of the resolutions to approve the Annual Report on Remuneration and Remuneration Policy at the Company's AGM on 9 February 2017.

Resolution	Votes for	% for	Votes against	% against	Total votes cast	Votes withheld
Annual Report on Remuneration	202,523,512	99.13	1,772,831	0.87	204,296,343	943,646
Remuneration Policy	195,090,537	95.06	10,145,210	4.94	205,235,747	4,242

## B5.2.2 Directors' remuneration for the year ended 30 September 2017

The information provided in this section has been audited

Single total figure of remuneration for executive directors

Year ended 30 September 2017	N S Terrington £000	R J Woodman £000	J A Heron £000	Total £000
<b>Fixed remuneration</b>				
Salaries and fees	474	299	253	1,026
Allowances and benefits	14	12	12	38
Pension allowance	197	142	105	444
<b>Variable remuneration</b>				
Cash bonus	653	416	325	1,394
Deferred bonus	201	122	92	415
Dividend on vested deferred bonus <sup>1</sup>	-	-	17	17
Share awards	656	413	350	1,419
<b>Total before pension settlement</b>	<b>2,195</b>	<b>1,404</b>	<b>1,144</b>	<b>4,743</b>
Pension settlement <sup>2</sup>	-	1,006	-	1,006
<b>Total</b>	<b>2,195</b>	<b>2,410</b>	<b>1,144</b>	<b>5,749</b>

Year ended 30 September 2016	N S Terrington £000	R J Woodman £000	J A Heron £000	Total £000
<b>Fixed remuneration</b>				
Salaries and fees	463	291	247	1,001
Allowances and benefits	14	12	12	38
Pension allowance	176	145	94	415
Pension accrual	78	9	44	131
<b>Variable remuneration</b>				
Cash bonus	533	340	244	1,117
Deferred bonus	161	97	64	322
Dividend on vested deferred bonus <sup>1</sup>	20	15	7	42
Share awards <sup>3</sup>	547	292	292	1,131
<b>Total</b>	<b>1,992</b>	<b>1,201</b>	<b>1,004</b>	<b>4,197</b>

1. Dividend on vested bonus is the accrued dividends to the date of exercise paid on deferred bonuses which were exercised during the year. Under the policy which was adopted at the 2017 AGM, dividends will accrue to the point of vesting on deferred share awards made in respect of the year ended 30 September 2016 and thereafter.
2. The pension settlement relates to a legacy payment due to Richard Woodman for past service. Further detail is provided in the pensions note below.
3. The share awards value for the year ended 30 September 2016 has been restated to reflect the market value of the shares under the PSP that vested on 14 December 2016 as at that date.

### Allowances and benefits

Includes private health cover, fuel benefit and company car provision or company car allowance (£10,000 to £12,000).

## Pension allowance and pension accruals

Nigel Terrington, Richard Woodman and John Heron were members of the Paragon Pension Plan ('the Plan'), the Group's defined benefit pension plan, until 30 September 2016. Following which time, they took a cash equivalent transfer of benefits in the Plan, receiving a lump sum value on a no gain, no loss basis. These transfer values were £6.1 million, £2.0 million and £3.4 million respectively. Their entitlements under the Plan are shown below.

Director	Description of entitlement	Accumulated total accrued annual pension at 30 September	
		2017 £000	2016 £000
N S Terrington	Benefits were transferred out of the Plan during the year based on accumulated pension at 30 September 2016.  Formerly entitled to 1/48.375th of final salary per year of service, payable from age 60. Could take reduced early retirement from age 55. Ceased pension accrual on 6 April 2006 but retained final salary linkage.	-	178
R J Woodman	Benefits were transferred out of the Plan during the year based on accumulated pension at 30 September 2016.  Formerly entitled to 1/46.625th of final salary per year of service, payable from age 60. Could take reduced early retirement from age 55. Ceased pension accrual on 9 October 2007 and opted out of final salary linkage from 1 April 2011.	-	62
J A Heron	Benefits were transferred out of the Plan during the year based on accumulated pension at 30 September 2016.  Formerly entitled to 1/49.125th of final salary per year of service, payable from age 60. Could take reduced early retirement from age 55. Ceased pension accrual on 6 April 2006 but retained final salary linkage.	-	100

The entitlements shown above represent the weighted average of service years for which accrual was earned at 1/60 of final salary and those for which accrual was earned at 1/37.5.

The executive directors had previously ceased pension accrual, as shown in the table above. This was in return for a cash supplement calculated, as a percentage of salary, to equate to the cost of the Group's contributions towards future service benefits had each individual stayed within the Plan for his future service accrual. This supplement was assessed every three years and was assessed during the current year by the Group's actuaries.

The outcome of this assessment is set out below and, recognising the substantial cost to the Group of meeting these obligations, the Committee asked the executive directors to agree to fix this cash supplement at 45% of base salary going forward, so that the Group would have known costs associated with pension provision. For all three directors, the fixed percentage was a lower amount than their actual contractual entitlement based on the most recent figures presented by the Group's actuaries.

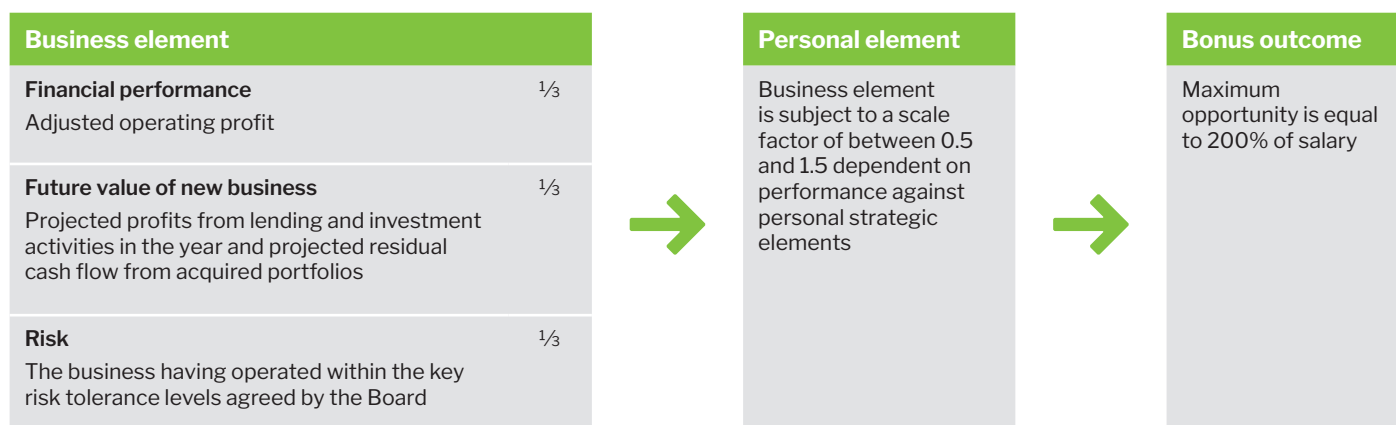
These contributions in respect of further pension provision for each of the directors are shown as 'pension allowance' in the single total figure of remuneration table. The change to 45% was made with effect from 1 April 2017, and no compensation was paid or payable to the executive directors in respect of this change.

% of salary	Contractual pension supplement entitlement based on most recent actuarial assessment	Fixed pension supplement with effect from 1 April 2017
N S Terrington	55%	45%
R J Woodman	103%	45%
J A Heron	54%	45%

In assessing these values, the percentage due to Richard Woodman was higher due to an outstanding amount owed which related to past service (i.e. what the Group would legally be required to pay him if he left the Group). This outstanding entitlement owing to Richard Woodman amounted to £1.006 million and this was paid to him during the year. It is shown in the single figure remuneration table as 'pension settlement'. The consequence of settling this legacy contractual liability, which related to past not future service, was to reduce the pension supplement to 63% from the 103% shown above. As explained above, Richard Woodman agreed to reduce this supplement to 45% without compensation.

## Annual bonus

The annual bonus for the year ended 30 September 2017 was based on performance against business, financial and risk measures and personal strategic objectives.



### Business element assessment

Performance for the year and the resulting award levels in respect of the business element were as follows:

Measure	Weighting	Target performance	Actual performance	Bonus outcome
<b>Financial performance</b> Adjusted operating profit	1/3	£143.5m	£145.2m	18%
<b>Future value of new business</b> Lending Debt purchase investments	1/3	£1,587.1m £100.0m	£1,853.4m £98.0m	Individual ranges between 22% and 27%
			All business written in line with required return and risk appetite	
<b>Risk</b>	1/3	Operating within the risk tolerance levels set by the Board	Met all risk targets, excellent credit performance of the loan book, no material risk events, upgraded the asset finance risk management framework, implemented the organisational restructure which reduced long term debt exposures	Individual ranges between 20% and 26%

Full disclosure of the threshold and maximum ranges will be provided for the bonus earned for the year ended 30 September 2017 in the Annual Report on Remuneration for the year ending 30 September 2018 which will be when it is anticipated that this information is no longer considered commercially sensitive.

### Personal element assessment

Performance against objectives is assessed by the Committee at the end of the year (with input from the Chief Executive as appropriate). A scale factor is determined based on performance as set out in the table below.

Performance	Personal assessment	Scale factor
Poor	0	0.50
Below target	1	0.75
Target	2	1.00
Above target	3	1.25
Exceptionally good	4	1.50

The following overarching objectives were applicable to all executive directors:

- Provide strategic leadership within the parameters of the Group's risk appetite
- Deliver the planned financial performance whilst ensuring fair outcomes for customers
- Ensure platforms are in place to deliver longer term strategic goals
- Ensure the Group meets all risk, compliance and regulatory changes
- Safeguard the Group's strong culture with capable and motivated employees

The directors' individual objectives and the assessments made are set out below:

Executive director	Individual targets	Actual performance	Personal assessment
N S Terrington	In addition to strong leadership, delivery of the Group's business plan and financial performance, upholding our corporate values, ensuring our customers are at the heart of everything we do and extending the Paragon brand and all within the Group's risk management framework, the following annual personal objectives were agreed:		3-4
	Increase growth from non buy-to-let product lines	Total non-buy-to-let lending £453.5m (2016: £278.1m)	
	Reduce dependence on wholesale funding	Retail funding from customers' deposits now exceeds £3.6bn	
	Deliver Group restructuring and rebrand the business with a simplified organisation, ongoing efficiencies and increased transparency	Restructured and rebranded to Paragon Banking Group, reorganised management committees and realigned product lines to improve customer focus	
	Embed Asset Finance into the wider Group	IT upgrade and new risk management framework	
	Assess culture and implement actions where appropriate	Positive internal audit outcome validating the Group's strong culture	

Executive director	Individual targets	Actual performance	Personal assessment
R J Woodman	In addition to strong leadership, delivery of the Group's business plan and financial performance, upholding our corporate values, ensuring our customers are at the heart of everything we do and managing all financial controls, all within the Group's risk management framework, the following annual personal objectives were agreed:		3-4
	Obtain the legal and regulatory approval for the organisational restructure	The cash and capital position is now aligned leaving the Group well placed to deliver growth plans efficiently	
	Progress the Group's application for IRB authorisation	First iteration buy-to-let working model available	
	Lead the Group's involvement in the Women in Finance initiative, to establish targets and actions	Targets published and commended by HM Treasury for going beyond the minimum requirement	

Executive director	Individual targets	Actual performance	Personal assessment
J A Heron	In addition to strong leadership, delivery of the Group's business plan and financial performance, upholding our company values, ensuring our customers are at the heart of everything we do, management of all buy-to-let activities, lending controls and customer engagement, all within the Group's risk management framework, the following annual personal objectives were agreed:		3
	Achieve £1,001.0m of buy-to-let origination	Materially outperformed at £1,399.9m with margins and risk appetite maintained	
	Increase the Group's specialist buy-to-let products and lending to corporate landlords	Lending increased by 26% from 2016 and was 70% of buy-to-let origination (2016: 51%)	
	Deliver the fiscal and regulatory changes for buy-to-let	PRA buy-to-let regulations successfully introduced in two stages and ahead of the required deadlines	

### Annual bonus outcome

The resulting bonuses for the year ended 30 September 2017, after applying the personal element scale factors to the business element award levels, were as follows:

Executive director	Financial performance	Future value of new business	Risk	Scale factor times	Total	Total £000	Cash £000	Share value £000
N S Terrington	18%	23%	25%	1.37	90.0%	854	653	201
R J Woodman	18%	22%	26%	1.36	90.0%	538	416	122
J A Heron	18%	27%	20%	1.27	82.5%	417	325	92

25% of amounts awarded in excess of £50,000 are deferred into nil cost options which can be exercised after three years. No further performance conditions apply to the deferred shares.

### Retrospective disclosure of business element targets for the year ended 30 September 2016

The threshold and maximum performance targets in relation to the business element performance conditions are no longer considered commercially sensitive and are therefore disclosed below. Actual performance has also been provided for reference.

Measure	Threshold performance	Target	Maximum	Actual
<b>Financial performance</b>				
Adjusted operating profit	£130.0m	£144.5m	£158.9m	£143.2m
<b>Future value of new business</b>				
Lending	£1,404.9m	£1,561.0m	£1,717.1m	£1,623.9m
Debt purchase investments	£75.0m	£100.0m	£125.0m	£208.8m
<b>Risk</b>	The future value of new business was written in line with the Group's required return and risk appetite.			

The Group operated within the risk tolerance levels set by the Board for capital ratios, liquidity positions, new business and operational and regulatory risk. It also developed its plan to mitigate longer-term strategic risk.



## Performance Share Plan

### Awards vesting in respect of the year ended 30 September 2017

Awards granted in December 2014 under the Group's PSP which will vest in December 2017 are subject to performance conditions measured over three financial years ended 30 September 2017.

Performance condition	Weighting	Threshold vesting for 25% of maximum award	Maximum vesting	Actual performance	Vesting outcome
Relative TSR	50%	Median performance	Upper quartile performance	Between median and upper quartile	27.02%
EPS growth	50%	RPI plus 3% p.a.	RPI plus 7% p.a.	Above upper target	100.00%
<b>Total</b>					<b>63.51%</b>

There is straight-line vesting between the points and no reward below threshold performance.

The relative TSR comparator group consisted of the FTSE 250 constituents as at the grant date of the awards.

The vesting percentage will be reviewed by the Committee against a financial underpin. The Committee must satisfy itself that the level of vesting reflects the overall financial performance of the Group for the awards to vest.

Details of the proposed vesting outcome in respect of the awards granted in December 2014 is set out below.

	Total shares granted	Vesting outcome	Total shares awarded <sup>1</sup>	Share price <sup>2</sup>	PSP value £000
N S Terrington	228,766	63.51%	145,289	416.5p	656
R J Woodman	144,085	63.51%	91,508	416.5p	413
J A Heron	121,967	63.51%	77,461	416.5p	350

1. In accordance with the rules of the PSP, participants are entitled on exercise to additional value equal to the dividends that would have been paid on vested shares in respect of dividend record dates between the grant date and vesting date. Accordingly, the share award values also include 35.2 pence per vested share in respect of such dividends.

2. The PSP value has been determined using the average closing share price for the three months ended 30 September 2017 as an estimate. The actual value of the awards will not be finalised until the closing share price is known when the awards vest in December 2017.

### Awards granted during the year ended 30 September 2017

During the year ended 30 September 2017 the following awards were granted under the PSP, each with a face value of 200% of salary.

Executive director	Number of shares	Market value at grant <sup>1</sup> £000	Performance period
N S Terrington	262,114	948,540	3 years ending 30 September 2019
R J Woodman	165,074	597,370	3 years ending 30 September 2019
J A Heron	139,753	505,740	3 years ending 30 September 2019

1. Based on the average closing mid-market price of the Company's shares on each of the five dealing days up to and including the day before the grant date (£3.6188).

The awards are subject to the following performance conditions:

Performance measure	Weighting	Threshold vesting for 25% of maximum award	Maximum vesting
Relative TSR	50%	Median performance	Upper quartile performance
EPS growth	25%	RPI plus 3% p.a.	RPI plus 7% p.a.
Risk	25%	Based on an assessment of a balanced scorecard of risk and compliance factors (see below)	

There is straight-line vesting between the points and no reward below threshold performance.

In addition, prior to any awards vesting under any element, the Committee must be satisfied that the requirements of a financial underpin test have been met.

## Relative TSR measure

The comparator group for TSR purposes is:

Aldermore Group PLC	Arrow Global Group PLC	Barclays PLC	Close Brothers Group PLC
CYBG PLC	Lloyds Banking Group PLC	Metro Bank PLC	OneSavings Bank PLC
Provident Financial PLC	Royal Bank of Scotland Group PLC	Shawbrook Group PLC	Secure Trust Bank PLC
Virgin Money Holdings (UK) PLC			

## Risk measure

25% of the award is subject to risk management performance and the application of a strong risk culture across the Group taking into account:

Material regulatory breaches	Customer service	Management of liquidity and capital risk
Credit losses against risk appetite	Risk appetite metrics	Material risk events over the performance period

Disclosure of assessment against performance of the risk element will be made in the Annual Report on Remuneration when the awards vest.

## Chairman and non-executive director fees

	Year ended 30 September 2017			Year ended 30 September 2016		
	Fees £000	Benefits £000	Total £000	Fees £000	Benefits £000	Total £000
<b>Chairman</b>						
R G Dench	240	15	255	240	16	256
<b>Non-executive directors</b>						
F J Clutterbuck	90	-	90	90	-	90
A K Fletcher <sup>1</sup>	70	-	70	70	-	70
P J N Hartill	70	-	70	70	-	70
P J Newberry <sup>2</sup>	2	-	2	-	-	-
B A Ridpath <sup>2</sup>	2	-	2	-	-	-
H R Tudor	50	-	50	50	-	50
F F Williamson <sup>2</sup>	2	-	2	-	-	-
G H Yorston <sup>2</sup>	2	-	2	-	-	-
<b>Total</b>	<b>528</b>	<b>15</b>	<b>543</b>	<b>520</b>	<b>16</b>	<b>536</b>

1. In addition to fees earned as a non-executive director, A K Fletcher serves as a director of the Corporate Trustee of the Plan and receives £10,000 per annum in respect of that appointment from Paragon Finance PLC, the sponsoring company of the Plan and a subsidiary of the Company. The Plan is a trust which is independent of the Company and, as a director of its corporate trustee, A K Fletcher has a fiduciary duty to act in the best interests of the trust and the Plan's beneficiaries.

2. Appointed to the Board on 20 September 2017.

## Directors' share interests

The interests of the executive directors in the shares of the Company at 30 September 2017 (including those held by their connected persons) were:

	N S Terrington Number	R J Woodman Number	J A Heron Number
<b>Unvested awards subject to performance conditions</b>			
PSP	750,824	472,867	400,316
Sharesave	12,026	12,026	7,216
<b>Unvested awards not subject to performance conditions</b>			
DSBP	157,423	90,224	58,999
Total unvested awards	920,273	575,117	466,531
<b>Vested but unexercised awards</b>			
PSP	208,259	643,949	69,525
DSBP	55,302	36,906	-
Total vested but unexercised awards	263,561	680,855	69,525
Shares beneficially held	781,269	151,051	267,507
<b>Total interest in shares</b>	<b>1,965,103</b>	<b>1,407,023</b>	<b>803,563</b>
<b>Awards exercised in the year</b>			
PSP	500,000	385,714	148,595
DSBP	-	-	24,258
<b>Total awards exercised in the year</b>	<b>500,000</b>	<b>385,714</b>	<b>172,853</b>

The interests of the Chairman and the non-executive directors at 30 September 2017, which consist entirely of ordinary shares, beneficially held, were as follows:

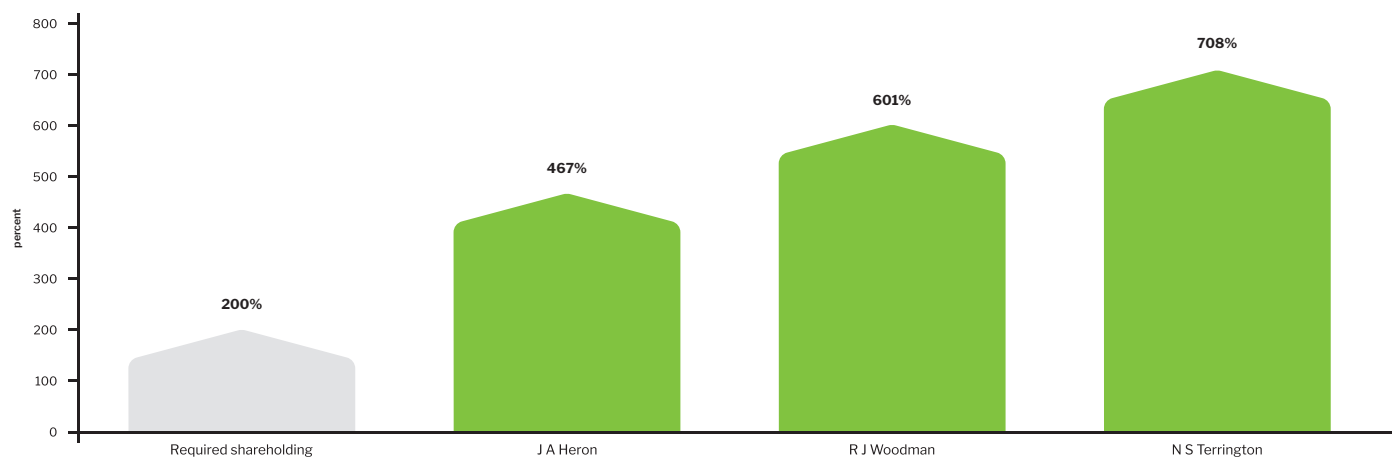
	2017
R G Dench	73,278
F J Clutterbuck	8,372
A K Fletcher	100,000
P J N Hartill	7,000
P J Newberry	-
B A Ridpath	-
H R Tudor	310,000
F F Williamson	-
G H Yorston	-

As at 31 October 2017, the last practicable date prior to approving this Report, the Company has not been advised of any changes to the interests of the directors and their connected persons as set out in the tables above.

## Share ownership guidelines

All executive directors are encouraged to hold a minimum number of shares in the Company with a value of 200% of their salary, calculated at 31 December each year on the basis of the average price of the Company's shares over a rolling three-year period. The number, net of income tax and national insurance, of vested but unexercised shares granted under the DSBP and under the PSP count towards the aggregate shares held by each director in respect of the policy.

The chart below compares the executive directors' holdings at 30 September 2017 to those required by the guidelines, expressed in value terms as a percentage of salary at 31 December 2016.



At 30 September 2017, all of the executive directors' holdings were in accordance with guideline levels. Due to the high level of personal shareholdings and the length of tenure of the three executive directors, the Committee decided, for the present, not to mandate that executives hold awards granted under the PSP for an additional period after the vesting date. For any new external appointment, however, the Committee has introduced a holding period of two years to encourage share participation.

## B5.2.3 Application of remuneration policy for the year ending 30 September 2018

*The information provided in this section of the Directors' Remuneration Report is not subject to audit*

### Executive directors

#### Base salary

The salaries of Nigel Terrington, Richard Woodman and John Heron were increased by 3.0% from 1 October 2017. This is in line with the level of increases for the Group's wider workforce.

	Salary with effect from	
	1 October 2017	1 October 2016
	£	£
N S Terrington	<b>488,500</b>	474,270
R J Woodman	<b>307,650</b>	298,685
J A Heron	<b>260,450</b>	252,870

#### Allowances and benefits and pension contributions

No changes from the stated policy.

#### Annual bonus

The annual bonus structure, maximum opportunity, metrics and deferral arrangements will be unchanged.

The Committee has chosen not to disclose, in advance, the performance targets for the forthcoming year as these are felt to be commercially sensitive. Retrospective disclosure of the targets and performance against them will be set out in next year's Annual Report on Remuneration except to the extent that any measure/target remains commercially sensitive.

The maximum award remains unchanged at 200% of salary and executive directors will be required to defer 25% of amounts awarded in excess of £50,000 in shares. The Committee may require higher levels of deferral or the executive may elect to defer a greater proportion.

## PSP awards

Award levels for executive directors are unchanged at 200% of base salary. The performance conditions and targets are summarised below:

Performance measure	Weighting	Threshold vesting for 25% of maximum award	Maximum vesting
Relative TSR	50%	Median performance	Upper quartile performance
EPS growth	25%	RPI plus 3% p.a.	RPI plus 7% p.a.
Risk	25%	Based on an assessment of a balanced scorecard of risk and compliance factors	

There is straight-line vesting between the points and no reward below threshold performance.

In addition, prior to any awards vesting under any element, the Committee must be satisfied that the requirements of a financial underpin test have been met.

## TSR test

The comparator group for TSR purposes is:

Aldermore Group PLC	Arrow Global Group PLC	Barclays PLC	Charter Court Financial Services Group PLC
Close Brothers Group PLC	CYBG PLC	Lloyds Banking Group PLC	Metro Bank PLC
OneSavings Bank PLC	Provident Financial PLC	Royal Bank of Scotland Group PLC	Secure Trust Bank PLC
S&U PLC	Virgin Money Holdings (UK) PLC		

## Risk test

Risk will be assessed against the same factors outlined in section B5.2.2 in respect of the PSP awards made in the year ended 30 September 2017.

## Chairman's and non-executive directors' fees

	Fee with effect from	
	1 October 2017	1 October 2016
	£000	£000
Chairman's fee	255	240
Base fee	65	50
Additional fee for Senior Independent Director	10	20
Additional fee for Chairmen of Committees <sup>1</sup>	20	20

1. The additional fee for chairmen of committees is currently payable to the Chairmen of the Remuneration, Audit and Risk and Compliance Committees, but would be payable for the chairmanship of such additional Committees as might be authorised by the Board.

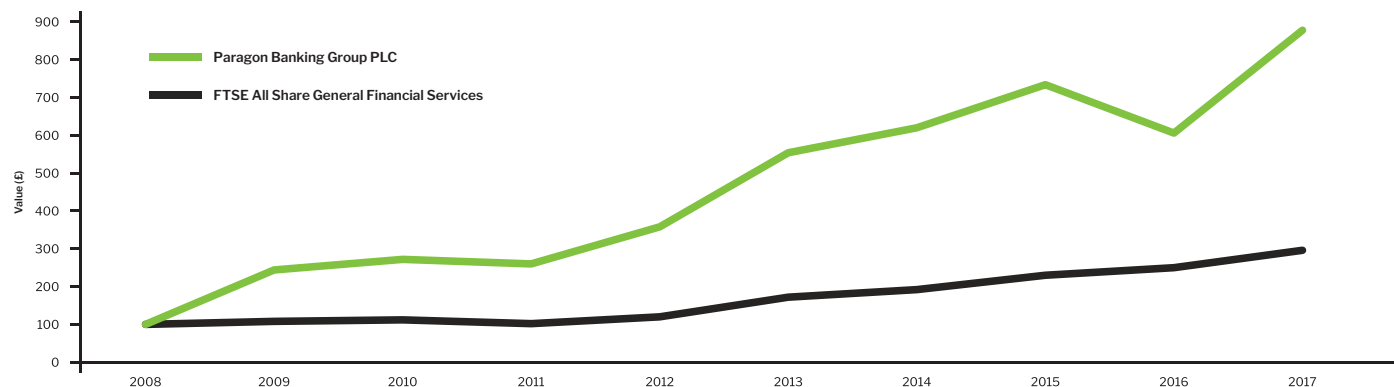
## B5.2.4 Other information

The information provided in this section of the Directors' Remuneration Report is not subject to audit

### Performance graph and table

The following graph shows the Company's TSR performance compared with the performance of the FTSE All Share General Financial sector index. This graph shows the value, by 30 September 2017, of £100 invested in Paragon Banking Group PLC on 30 September 2008, compared with £100 invested in the FTSE General Financial sector index. The General Financial sector has been selected for this comparison because it is the sub-sector index that contains the Company's shares.

#### Nine Year Return Index for the FTSE All Share Financial Sector as at 30 September 2017



The following table shows the total remuneration, as defined by the Regulations, and the amount vesting under short-term and long-term incentives as a percentage of the maximum that could have been achieved, in respect of the Chief Executive over the past nine years.

	Single figure of total remuneration £000	Annual bonus earned against maximum opportunity %	Long-term incentive vesting outcome against maximum opportunity %
2017	2,195	90.0	63.51
2016	1,956	75.0	50.00
2015	2,546	100.0	100.00
2014	3,113	100.0	100.00
2013	2,655	85.0	100.00
2012	2,565	87.5	100.00
2011	2,382	87.5	58.60 and 85.10
2010	1,209	75.0	58.60
2009	932	50.0	-

### Percentage change

The following table shows the change in certain aspects of the remuneration of Nigel Terrington:

Component	2017 £000	2016 £000	Change %
Salary	474	463	2.4
Benefits	14	14	-
Bonus	854	694	23.1

The Group's pay review taking effect on 1 October 2016 awarded average percentage increases in wages and salaries to employees as a whole of 2.5%.

The nature and level of benefits available to employees in the year ended 30 September 2017 was broadly similar to that in the previous year.

## Relative importance of spend on pay

Set out below is a summary of the Group's levels of expenditure on pay and other significant cash outflows.

	Note	2017 £m	2016 £m	Change £m
Wages and salaries	21	51.4	47.8	3.6
Dividend paid	58	38.0	33.9	4.1
Loan advances and investment in portfolios		1,951.4	1,633.2	318.2
Corporation tax paid	59	28.9	23.6	5.3

Loan advances and investment in portfolios is shown above as this is the principal application of cash used to generate income for the Group. Corporation tax is contributed out of profit to the UK Government.

## Current service contracts and terms of engagement

### Chairman and executive directors

The current service contracts for the Chairman and executive directors are dated as follows:

	Contract date
R G Dench	8 February 2007 (amended 27 April 2015)
N S Terrington	1 September 1990 (amended 7 January 1993, 16 February 1993, 30 October 2001 and 10 March 2010)
R J Woodman	8 February 1996 (amended 10 March 2010)
J A Heron	1 September 1990 (amended 14 January 1993, 8 February 1993 and 10 March 2010)

Executive directors may accept an external non-executive appointment with the approval of the Board. Any fees earned are retained by the executive. None of the executive directors currently earns remuneration from external non-executive appointments.

### Non-executive directors

Current terms of engagement for the non-executive directors apply for the following periods:

	Period of engagement
F J Clutterbuck	12 September 2015 to 11 September 2018
A K Fletcher	25 February 2015 to 24 February 2018
P J N Hartill	11 February 2017 to 10 February 2020
P J Newberry	20 September 2017 to 19 September 2020
B A Ridpath	20 September 2017 to 19 September 2020
H R Tudor	24 November 2014 to 23 November 2017 (renewed from 24 November 2017 to 23 November 2020)
F F Williamson	20 September 2017 to 19 September 2020
G H Yorston	20 September 2017 to 19 September 2020

Non-executive director appointments are for three years unless terminated earlier by, and at the discretion of, the director or the Company upon three months' notice.

## Executive directors' share interests

The individual interests of the executive directors under the PSP are as follows:

	Award date	Market price	At 1 October 2016 Number	Awarded Number	Lapsed Number	Exercised Number	At 30 September 2017 Number	Exercisable from
N S Terrington	21/12/2011	176.90p	299,083	-	-	299,083	-	21/12/2014
	28/02/2013	321.20p	278,757	-	-	200,917	77,840	28/02/2016
	10/12/2013	345.30p	130,419	-	-	-	130,419	10/12/2016
	18/12/2014	409.60p	228,766	-	83,477	-	145,289	18/12/2017
	22/12/2015	362.70p	259,944	-	-	-	259,944	22/12/2018
	01/12/2016	369.40p	-	262,114	-	-	262,114	01/12/2019
R J Woodman	21/05/2009	70.00p	385,714	-	-	385,714	-	21/05/2012
	17/12/2010	182.00p	205,886	-	-	-	205,886	17/12/2013
	21/12/2011	176.90p	219,943	-	-	-	219,943	21/12/2014
	28/02/2013	321.20p	148,595	-	-	-	148,595	28/02/2016
	10/12/2013	345.30p	69,525	-	-	-	69,525	10/12/2016
	18/12/2014	409.60p	144,085	-	52,577	-	91,508	18/12/2017
	22/12/2015	362.70p	163,708	-	-	-	163,708	22/12/2018
	01/12/2016	369.40p	-	165,074	-	-	165,074	01/12/2019
J A Heron	28/02/2013	321.20p	148,595	-	-	148,595	-	28/02/2016
	10/12/2013	345.30p	69,525	-	-	-	69,525	10/12/2016
	18/12/2014	409.60p	121,967	-	44,506	-	77,461	18/12/2017
	22/12/2015	362.70p	138,596	-	-	-	138,596	22/12/2018
	01/12/2016	369.40p	-	139,753	-	-	139,753	01/12/2019

Information regarding the performance conditions for the PSP awards can be found in note 23 to the Financial Statements.

The individual interests of the executive directors under the DSBP are as follows:

	Award date	Market price	At 1 October 2016 Number	Awarded Number	Exercised Number	At 30 September 2017 Number	Exercisable from
N S Terrington	10/12/2013	345.30p	55,302	-	-	55,302	10/12/2016
	18/12/2014	409.60p	52,888	-	-	52,888	18/12/2017
	22/12/2015	362.70p	60,042	-	-	60,042	22/12/2018
	01/12/2016	369.40p	-	44,493	-	44,493	01/12/2019
R J Woodman	10/12/2013	345.30p	36,906	-	-	36,906	10/12/2016
	18/12/2014	409.60p	26,965	-	-	26,965	18/12/2017
	22/12/2015	362.70p	36,517	-	-	36,517	22/12/2018
	01/12/2016	369.40p	-	26,742	-	26,742	01/12/2019
J A Heron	10/12/2013	345.30p	24,258	-	24,258	-	10/12/2016
	18/12/2014	409.60p	19,249	-	-	19,249	18/12/2017
	22/12/2015	362.70p	21,901	-	-	21,901	22/12/2018
	01/12/2016	369.40p	-	17,849	-	17,849	01/12/2019



The individual interests of the executive directors under the Sharesave Plan are as follows:

	Award date	Option price	At 1 October 2016 Number	Awarded Number	Vested Number	Exercised Number	At 30 September 2017 Number	Exercisable from
N S Terrington	20/06/2016	249.44p	12,026	-	-	-	12,026	01/08/2021
R J Woodman	20/06/2016	249.44p	12,026	-	-	-	12,026	01/08/2021
J A Heron	20/06/2016	249.44p	7,216	-	-	-	7,216	01/08/2019

## B5.3 Policy summary

For ease of reading of this Report the remuneration policy tables for the executive and non-executive directors, as adopted following the AGM in 2017, are detailed below. However, these are summaries only and do not constitute a Policy Statement in accordance with the Regulations. For the full Policy Statement please refer to the Annual Report and Accounts for the year ended 30 September 2016 available at [www.paragonbankinggroup.co.uk](http://www.paragonbankinggroup.co.uk).

### Elements of the remuneration policy for executive directors

The executive directors receive a combination of fixed and performance-related elements of remuneration. Fixed remuneration consists of salary, benefits and pension scheme contributions or alternative retirement benefit provision. Performance-related remuneration consists of participation in the annual bonus plan and the award of shares under the PSP. The performance-related elements of remuneration are intended to provide a significant proportion of executive directors' potential total remuneration.

Purpose and link to strategy	Operation	Maximum opportunity	Performance conditions
<b>Base salary</b>			
To provide a competitive, fixed cash component that reflects the scope of individual responsibilities and recognises sustained individual performance in the role.	<p>Remunerate fairly for individual performance, having regard to the importance of motivation.</p> <p>Base salaries are typically reviewed annually, taking into account remuneration levels in the Group as a whole, individual and business performance and objective research into comparable companies.</p>	<p>While there is no maximum salary, if the Committee is satisfied with the individual's performance increases will normally broadly follow those awarded for the rest of the organisation, in percentage of salary terms.</p> <p>Increases above the level awarded for the rest of the organisation may be awarded in appropriate circumstances which may include, but are not limited to:</p> <ul style="list-style-type: none"> <li>• Changes in the scope or responsibilities of a director's role</li> <li>• Development or performance in role</li> <li>• A change in the size and/or complexity of the business</li> <li>• Change in market practice or a director's salary substantially falling behind a market competitive rate</li> </ul>	None.

Purpose and link to strategy	Operation	Maximum opportunity	Performance conditions
<b>Benefits</b>			
To provide market levels of benefits on a cost-effective basis.	<p>Private health cover for the executive and their family, life insurance cover of up to seven times salary and company car or cash alternative.</p> <p>Other benefits may be offered from time to time taking into account individual circumstances.</p>	<p>Private health care benefits are provided through third party providers and therefore the cost to the company and the value to the director may vary from year-to-year</p> <p>Whilst no absolute maximum level of benefits has been set, it is intended the maximum value of benefits offered will remain broadly in line with market practice.</p>	None.
<b>Retirement benefits</b>			
To provide competitive post-retirement benefits (or an appropriate cash allowance).	<p>1/37.5 of basic annual salary for each year of eligible service.</p> <p>A cash alternative is offered in lieu of pension accrual, equating to the approximate cost to the Company of defined benefit provision, normally reviewed every five years.</p> <p>For new external appointments, a cash allowance or company pension contribution may be awarded.</p>	<p>Maximum pension 2/3 of salary at retirement or the value of the annual cash alternative calculated by the Company's actuary.</p> <p>The maximum pension contribution (or cash allowance) for new external appointments will be up to 25% of salary.</p>	None.

Purpose and link to strategy	Operation	Maximum opportunity	Performance conditions
<b>Annual bonus</b>			
<p>To incentivise executives to achieve specific, predetermined goals that drive delivery of the Company's operational objectives.</p> <p>To reward individual performance.</p> <p>To encourage retention and alignment with shareholders' interests through a three-year deferral of a proportion of bonus, awarded in shares.</p>	<p>Each executive director's annual bonus is based on a challenging mix of performance measures.</p> <p>25% of amounts awarded in excess of £50,000 are deferred under the DSBP, to be satisfied in shares, for three years. Higher levels of deferral may be required by the Committee or, with the approval of the Committee, may be elected for by the director. The Committee retains discretion to pay the whole of the bonus in cash in circumstances where the amount to be deferred would, in the opinion of the Committee, be so small as to make operation of the DSBP unduly administratively burdensome.</p> <p>Awards under the DSBP can take the form of a nil-cost option with a ten-year life, a conditional award of shares or an award of forfeitable shares.</p> <p>Awards may include the right to receive a benefit of a value determined by reference to dividends that would have been paid on shares in respect of dividend record dates between grant and, except as described in the 'legacy arrangements' section of this policy, vesting. The benefit may assume the reinvestment of dividends and may be delivered in shares or in cash.</p> <p>The annual bonus is non-pensionable. 'Malus' and 'clawback' apply to the annual bonus.</p>	<p>Maximum annual bonus potential is 200% of salary.</p> <p>For target performance a bonus of 100% of salary will be awarded, with additional amounts being awarded for exceptional performance.</p> <p>If a bonus is awarded the minimum that could be paid is 8.25% of salary.</p> <p>For performance below threshold, no bonus is payable.</p>	<p>The performance targets are set by the Committee at the start of the year with input, as appropriate, from the Chairman and Chief Executive.</p> <p>Performance measures and their weightings are reviewed annually to maintain appropriateness and relevance.</p> <p>The bonus is calculated as follows:</p> <ul style="list-style-type: none"> <li>• Performance against a range of measures, with at least 50% relating to financial metrics and any balance reflecting risk-related measures</li> <li>• Each element is then subject to a scale factor that can reduce or increase the bonus (subject to the overall cap of 200% of salary) according to performance against personal and strategic objectives</li> </ul>

Purpose and link to strategy	Operation	Maximum opportunity	Performance conditions
<b>Performance Share Plan ('PSP')</b>			
<p>To incentivise executives to achieve enhanced returns for shareholders.</p> <p>To encourage long-term retention of key executives.</p> <p>To align the interests of executives and shareholders.</p>	<p>An annual award of shares subject to continued service and performance conditions assessed over a three-year performance period.</p> <p>The performance conditions used are reviewed on an annual basis to ensure they remain appropriate.</p> <p>Awards are structured as nil cost options with a ten-year life, a conditional award of shares or an award of forfeitable shares.</p> <p>Awards may include the right to receive a benefit of a value determined by reference to dividends that would have been paid on vested shares in respect of dividend record dates between grant and vesting. The benefit may assume the reinvestment of dividends and may be delivered in shares or in cash.</p> <p>For any externally appointed executive director, awards under the PSP will be subject to an additional holding period of two years following the date of vesting before they are released to the participant.</p> <p>The Committee may at its discretion structure awards as "Qualifying PSP Awards" comprising both an HMRC tax qualifying option and a standard PSP award, with the extent to which the standard PSP award may be exercised being scaled back to take account of any gain made on exercise of the tax-qualifying option.</p> <p>'Malus' and 'clawback' apply to the PSP</p>	<p>Maximum award is 200% of salary in any year. Where a 'Qualifying PSP Award' is granted, the shares subject to the HMRC tax qualifying option part of the award are not taken into account for the purposes of this limit, reflecting the 'scale back' referred to in the 'Operation' column.</p> <p>In determining the number of shares subject to an award, the market value of a share shall, unless the Committee determines otherwise, be assumed to be the average share price for the five days following the announcement of the Company's results for the previous financial year.</p>	<p>Granted subject to challenging performance measures that reflect the Company's strategic priorities. Performance conditions may include financial measures (eg adjusted EPS and/or relative TSR), and/or risk based measures and/or strategic measures. Performance measures and their weightings, where multiple measures are used, are reviewed annually to maintain appropriateness and relevance.</p> <p>25% of the awards will vest for threshold performance, with full vesting taking place for equalling or exceeding the maximum performance target.</p>

Purpose and link to strategy	Operation	Maximum opportunity	Performance conditions
<b>Sharesave Plan</b>			
<p>To provide all employees with the opportunity to become shareholders on similar terms. Periodic invitations are made to participate in the Company's Sharesave Plan.</p>	<p>Periodic invitations are made to participate in the Company's Sharesave Plan.</p> <p>A savings contract over three or five years with the funds used on maturity either to purchase shares by exercising options or returned to the participant.</p> <p>The option is granted at a discount to the share price at the time of grant of up to 20%.</p> <p>The Plan provides tax benefits in the UK subject to satisfying certain HMRC requirements and is operated on an 'all employee' basis.</p>	<p>HMRC monthly savings limits apply</p>	<p>None.</p>

## Elements of the remuneration policy for the Chairman and non-executive directors

The Chairman receives a salary, a company car or cash alternative and is eligible for private health cover for himself and his family in the same way as the executive directors. Non-executive directors are remunerated solely by fees. Neither the Chairman nor the non-executive directors are eligible to participate in any of the Company's incentive or pension schemes and they are not entitled to receive compensation for early termination of their terms of engagement.

Benefits may also be provided to non-executive directors related to the performance of their duties (e.g. travel and hospitality).

Purpose and link to strategy	Operation	Maximum opportunity	Performance conditions
<b>Salary and fees</b>			
To ensure that the Group can attract and retain the appropriate number and mix of non-executive directors with the correct experience to provide balance, oversight and challenge.	<p>Non-executive director fees are reviewed on a periodic basis and are subject to the Articles of Association. The Chairman's fee is set by the Committee, whilst the non-executive directors' fees are determined by the Board.</p> <p>The Board will exercise judgement in determining the extent to which non-executive directors' fees are altered in line with market practice, given the requirement to procure and retain the appropriate skills and given the expected time commitments.</p> <p>Non executive directors are paid an annual base fee with additional fees for the roles of Senior Independent Director and / or chairman of a board committee.</p>	<p>Increases above those awarded for the rest of the organisation may be made to reflect the periodic nature of any review.</p> <p>Changes in the scope or responsibilities of a director's role, or the time commitment required, may require an adjustment to the level of their fee.</p> <p>The Articles of Association of the Company contain a maximum level of fees that can be paid annually to non-executive directors (currently £400,000)*. This is reviewed by the Board from time to time.</p>	None.

\*a resolution to change this to £2,000,000 is being put to the AGM in February 2018.

## B5.4 Approval of remuneration report

This Directors' Remuneration Report, section B5 of the Annual Report and Accounts, including the Statement by the Chairman of the Committee, the Annual Report on Remuneration and the Policy Summary, has been prepared in accordance with Schedule 8 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 as amended and has been approved by the Board of Directors.

Signed on behalf of the Board of Directors

**Fiona J Clutterbuck**

Chairman of the Remuneration Committee

23 November 2017



# B6

## RISK MANAGEMENT



**Finlay F Williamson**  
Chairman of the  
Risk and Compliance  
Committee

### B6.1 Risk and Compliance Committee Chairman's Report

#### Dear Shareholder

I am pleased to write to you as Chairman of the Risk and Compliance Committee with our report as to how we have discharged our responsibilities in the last year. In doing so, I would firstly wish to express my sincere thanks to Fiona Clutterbuck, who held the position of Chairman for most of the year prior to the Group's reorganisation in September 2017. She remains a member of the Committee and we will continue to benefit from her knowledge and experience.

As part of the reorganisation, the opportunity was taken to combine the meetings of the previously separate Bank and Group Risk and Compliance Committees. I am confident that the creation of a single, integrated committee meeting is a positive development which will help to simplify and enhance the Group's governance arrangements.

As a Committee, our primary responsibility remains the maintenance of oversight of the effectiveness of the Group's risk management framework and of the Group's systems and controls for compliance with its statutory and regulatory obligations. The Committee also oversees the risk culture within the Group to ensure that this is adequately embedded and is supportive of the overall risk appetite set by the Board.

Over the last year, the Committee has continued to monitor the further development of the operational risk management framework and its embedding within all business areas across the Group. The Committee is particularly pleased with the level of progress in this area over the last twelve months.

The Committee has again sought to ensure that its agenda is dynamic, balancing regular standing agenda items with reviews of new risks that have emerged during the year and of areas considered worthy of particular focus. Standing items covered in each meeting have included:

- Consideration and challenge of management's rating of the various risk categories to which the Group is exposed
- Reviews of the principal risks facing the Group
- Consideration of the potential impact of key regulatory developments
- Consideration of the root causes and impact of material risk events and the adequacy of actions undertaken by management to address them
- Horizon scanning for emerging risks

Additional areas of focus have included reviews of the Group's management of risks relating to its corporate reorganisation, changes to the regulatory regime for buy-to-let lending, cyber security and incident planning and developments in the property and rental market in the UK.



In addition, during the year, the Committee:

- Undertook a full review of the Group's qualitative and quantitative risk appetite prior to referral to the Board for approval
- Reviewed the Group's operational risk management scenarios
- Reviewed the Group's ICAAP report prior to submission to the PRA
- Received a presentation on the ILAAP report for the Bank
- Reviewed risks arising from the acquisition of businesses and portfolios
- Reviewed risks arising from new business activities before and following launch
- Reviewed and approved a number of revised Group policies, including those covering conduct risk and data protection
- Reviewed the annual Money Laundering Reporting Officer's report in relation to the adequacy of the Group's financial crime prevention arrangements
- Reviewed the Group's Compliance Monitoring Plan

The Committee has also continued to monitor the development of the Group's risk management framework, including enhancements to its independent Risk and Compliance function, in order to ensure this remains appropriate for the scale and complexity of the business. The Group has made further progress in this area and has integrated the formerly separate Bank and Group Risk and Compliance functions from the end of the year.

During the coming year, the Committee's priorities will include:

- Reviewing the Group's risk appetite to ensure it remains consistent with delivery of the Group's strategic objectives and proposing any required changes in risk appetites to the Board
- Reviewing the management of any residual transition risk following the Group's corporate reorganisation
- Monitoring developments in the buy-to-let market in light of the implementation of regulatory changes in 2017
- Reviewing the potential impacts on the Group of the UK's decision to withdraw from the EU as the likely future relationship becomes clearer
- Monitoring progress in the development of policies and procedures to enable the Group to comply with the forthcoming General Data Protection Regulation
- Monitoring progress with regard to the Group's strategic decision to seek regulatory approval to implement an IRB approach for credit risk
- Monitoring the Group's adherence to the FCA and PRA requirements in relation to the Senior Managers and Certification Regimes as they are expanded across the financial services sector
- Undertaking deep dives in relation to specific risk categories and business areas, including conduct risk, market risk, liquidity and capital risk and outsourced supplier arrangements

Overall, I am pleased to confirm that, in the last year, the Committee has again met its key objectives and carried out its role effectively. It is clear that the economic, political and regulatory environment within which the Group operates is likely to continue to be challenging. The basis of the UK's future relationship with the EU is still unclear, regulatory impacts on the Group's main business lines, especially buy-to-let, are ever growing and the political outlook in the UK is uncertain. However, I remain confident that the Group maintains the necessary skills and experience to manage the risks it is likely to encounter in the year ahead in line with its strategic objectives and the Board's stated risk appetite.

**Finlay F Williamson**

Chairman of the Risk and Compliance Committee

**23 November 2017**

## B6.2 Risk governance

The Risk and Compliance Committee assists the Board in fulfilling its responsibilities for risk management and comprises the independent non-executive directors and the Chairman of the Company. Its terms of reference, which were reviewed and approved by the Board in September 2017, include all matters indicated by the Code.

The Committee's responsibilities include reviewing:

- The effectiveness of the Group's risk management framework and the extent to which risks inherent in the Group's business activities are controlled within the risk appetite established by the Board
- The effectiveness of the Group's systems and controls for compliance with statutory and regulatory obligations, as well as its obligations under significant contracts
- The oversight of the timely completion of any remedial actions found to be necessary
- The appropriateness of the Group's risk culture, to ensure it supports the Group's stated risk appetite
- The effectiveness of the Group in addressing issues requiring remedial attention to ensure actions are completed in a timely manner and minimise the potential for risk appetite thresholds to be exceeded

The Risk and Compliance Committee provides oversight and challenge to the Group's enterprise-wide risk management arrangements. The Committee is supported by an executive level Operational Risk and Compliance Committee, Credit Committee, Asset and Liability Committee and Model Risk Committee. In the new financial year, it is intended that a further executive committee, the Customer and Conduct Committee, be set up to address these particular risk areas.

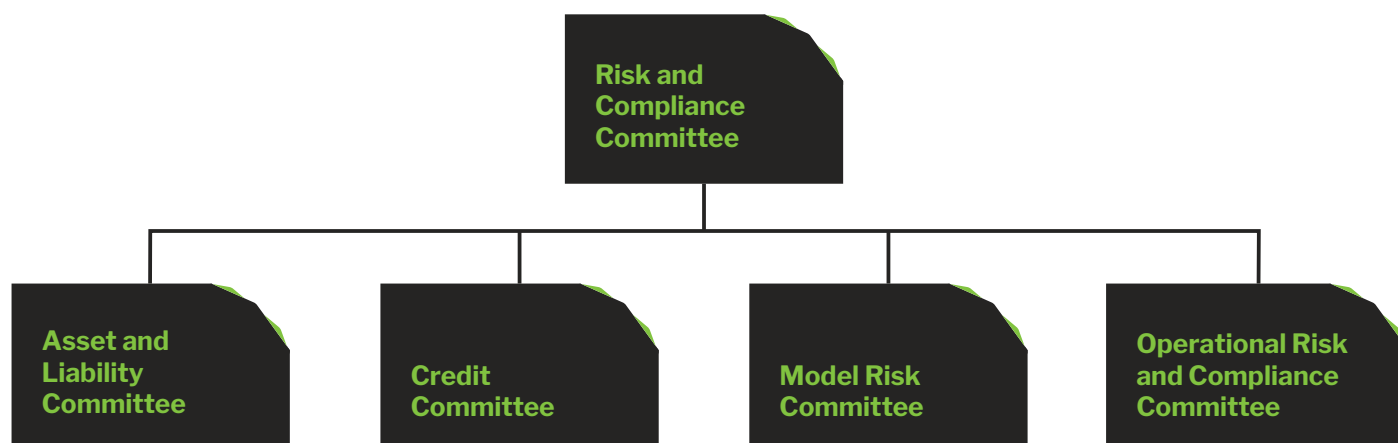
The Committee meets at least four times a year and normally invites the executive directors, Chief Risk Officer ('CRO'), Chief Operating Officer and Director of Internal Audit to attend its meetings. However, it reserves the right to request any of these individuals to withdraw or to request the attendance of any other Group employee. The Committee meets with the CRO at least once a year, without the presence of executive management, to discuss his remit and any issues arising from it.

The Committee also has the opportunity to meet with the Director of Internal Audit and / or the external auditor without the presence of executive management to discuss any matters that any of these parties believe should be discussed privately.

Agenda items for regular meetings of the Committee include:

- Reviewing the Group's register of principal risks
- Receiving and considering reports relating to the Group's consolidated risk profile, its performance against risk appetite and the progress of any resulting management actions and key risks
- Reviewing any proposed material changes to the Group's risk appetite prior to approval by the Board
- Reviewing and approving the Group's Compliance Monitoring Plan and the proposed management actions to address any adverse reports
- Receiving reports relating to key regulatory developments affecting the Group
- Reviewing the Group's conduct strategy and receiving reports from management on conduct risk
- Receiving reports from the Money Laundering Reporting Officer on compliance with Anti Money Laundering requirements
- Reviewing material operational risk events to assess the effectiveness of the Group risk and control assessment framework
- Reviewing the timeliness, effectiveness and progress of any executive management actions required to remediate issues identified
- Reviewing the Group's capital and liquidity adequacy assessments and stress testing analysis
- Considering the minutes of its executive sub-committees

The structure of the executive committees reporting to the Committee and their reporting lines is illustrated below:



Each of the executive committees operates within terms of reference formally approved by the Risk and Compliance Committee. The primary functions of each of these committees are described below.

### ***Asset and Liability Committee ('ALCO')***

ALCO comprises heads of relevant functions and is chaired by the CFO.

The principal purpose of ALCO is to monitor and review the financial risk management of the Group's balance sheet. As such, it is responsible for overseeing all aspects of market risk, liquidity risk and capital management as well as the treasury control framework. ALCO operates within clear delegated authorities, monitoring exposures and providing recommendations on actions required. It also monitors performance against appetite on an on-going basis and makes recommendations for revisions to risk appetites to the Risk and Compliance Committee.

### ***Credit Committee***

The Credit Committee comprises senior managers from the risk, finance and collections functions and is chaired by the CRO.

The Credit Committee approves credit risk policies and defines risk grading and underwriting criteria for the Group. It also provides guidance and makes recommendations in order to implement the Group's strategic plans for credit. The committee oversees the management of the credit portfolios, the post origination risk management processes and the management of past due or impaired credit accounts. It also monitors performance against appetite on an on-going basis and makes recommendations for revisions to the credit risk appetites to the Risk and Compliance Committee.

### ***Model Risk Committee ('MRC')***

The MRC comprises senior managers from risk, finance and the main business areas and is chaired by the CRO.

The role of the MRC is to review and make recommendations on all material aspects of the rating and estimation processes in relation to credit and finance models.

### ***Operational Risk and Compliance Committee ('ORCC')***

The ORCC comprises heads of relevant functions and is chaired by the CRO.

The ORCC is responsible for overseeing the Group's operational risk, conduct risk and business risk management and compliance arrangements. The Committee considers key operational risk information such as loss events, emerging risks and control failures. It also monitors performance against appetite on an on-going basis and makes recommendations for revisions to the Risk and Compliance Committee. With respect to compliance, the ORCC is responsible for overseeing the maintenance of effective systems and controls to meet conduct related regulatory obligations, including countering the risk that the Group might be used to further financial crime. It is also responsible for reviewing the quality, adequacy, resources, scope and nature of the work of the Compliance function, including the annual Compliance Monitoring Plan.

## **B6.3 Risk management culture**

The Board is committed to maintaining an effective risk management framework that is consistent and commensurate with the nature, complexity and risk profile of the business and is responsive to both internal and external events. The Group's inherently risk-averse approach to its business is expressed through the culture promoted by the Board and senior management. This has resulted in historically low levels of credit and operational losses and the absence of any material conduct issues affecting customers. The Group aims to help its customers by offering financial options which meet individual needs and achieve fair customer outcomes in a well-controlled environment.

The following risk principles are designed to support and protect the Group's strategic goals:

- Risk management is used to protect the Group's customers, shareholders, creditors and its reputation
- The fair treatment of customers and the delivery of fair outcomes, particularly for those customers considered to be vulnerable, is central to the Group's risk management approach
- The Group encourages a risk culture that has robust risk management at the heart of all decision-making within an open and transparent environment
- The Group only carries out business where the potential risk to itself and its customers has been considered together with the potential reward and where the residual risk exposure is within its defined risk appetite
- The Group utilises appropriate risk management processes to ensure that risks are identified, assessed, prioritised and managed in a consistent way

- Appropriate, timely and accurate risk management information is maintained and developed to support business decisions and to ensure the Group operates within its agreed risk appetite
- An independent Risk and Compliance function provides an effective second line oversight capability together with a source of specialist support and advice for business areas in relation to the management of risk

## B6.4 Risk management framework

### *Introduction*

The Group's risk management framework is designed to enable management to identify and focus attention on the risks most significant to its objectives and to provide an early warning of events that put those objectives at risk. The framework includes:

- The Risk and Compliance Committee and its sub-committees as described in B6.2
- Dedicated teams within the Risk and Compliance function covering particular risk areas, described below
- A suite of risk policies, which include policies addressing:
  - Conduct risk
  - Complaint handling
  - Forbearance
  - Vulnerable customers
  - Operational risk
  - Credit risk
  - Treasury operations
  - Financial crime
- A Compliance Handbook to advise business areas on regulatory matters supported by a proactive Advisory team
- Risk Champions appointed within all business areas to support the embedding of an effective risk culture across the Group
- A well-established and experienced Internal Audit function, supported by ongoing co-source arrangements with external providers when specific specialist skills are required

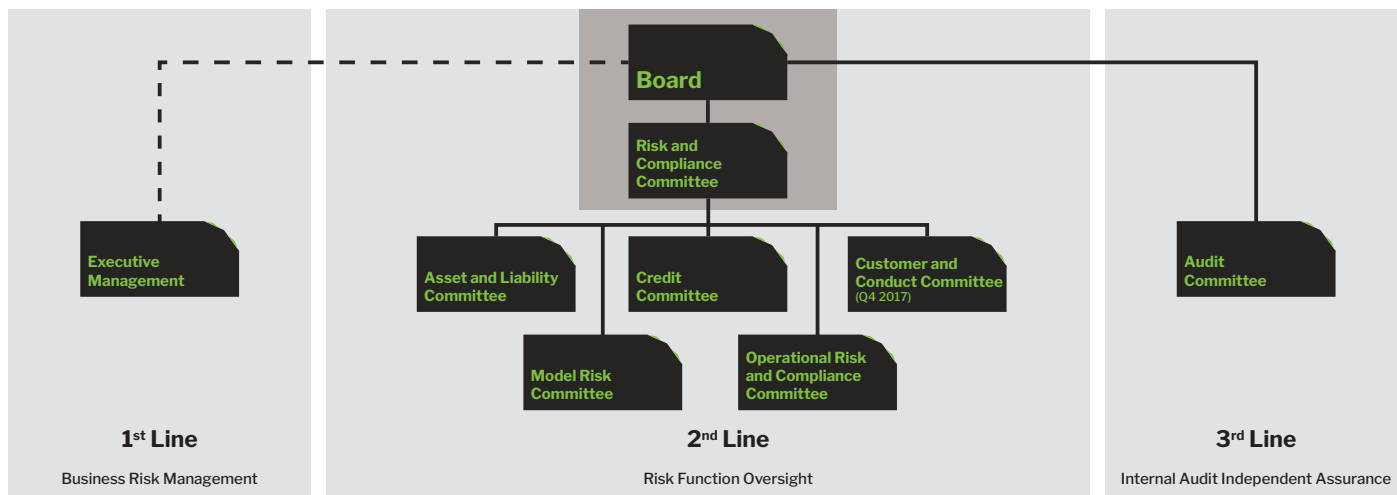
### *Three lines of defence model*

The committee structures outlined above form the cornerstone for the governance of risk in a management framework organised within a Three Lines of Defence model as follows:

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

In addition, there are further external levels of control that complement the three internal layers, provided by the external audit process and the monitoring activities of regulatory bodies.

The way in which the three lines of defence model aligns with the wider governance framework is illustrated below:



The risk management framework is intended to provide a structured and disciplined approach to the management of risk within agreed appetites thereby supporting the achievement of the Group's strategic objectives. The key objectives of the risk management framework are to:

- Establish standards for the consistent identification, measurement, monitoring, management and reporting of risk exposure and loss experience
- Outline the approach that will be taken in respect of setting and defining risk appetite and risk tolerances
- Promote risk management and the proactive reduction of the frequency and severity of risk events
- Facilitate adherence to regulatory requirements, including threshold conditions, capital standards and to support the regulatory requirements associated with the ICAAP
- Provide senior management and relevant committees with risk reporting that will be relevant and appropriate, enabling timely action to be taken in response to the information included within these reports
- Promote an appropriate risk culture across the Group

The Group publishes further information on its risk management system and risk profile in its Pillar III report, which can be found on the investor relations section of the Group's website at [www.paragonbankinggroup.co.uk](http://www.paragonbankinggroup.co.uk).

### *Risk management function*

The Group's Risk and Compliance function is headed by the CRO, who reports directly to the Chief Executive. The key responsibilities of the CRO are to:

- Develop and maintain the risk management framework covering all areas of the Group
- Develop and maintain risk policies within that framework, ensuring these are consistent with the Board's risk appetite
- Ensure that risks generated by the business are measured, monitored, controlled and reported on a timely basis
- Ensure compliance with all new and existing regulatory requirements
- Maintain open and constructive engagement with the regulatory authorities

The CRO is also responsible for the effective day-to-day running of the Risk and Compliance function and its relationship with the Board, its committees and senior management as well as for championing the Group's risk culture, providing support and advice to employees in the discharge of their risk responsibilities.

Integral to the Group's risk management framework are the following dedicated second line functions which report to the CRO:

- Credit Risk
- Compliance and Conduct Risk
- Operational Risk
- Property Risk
- Financial Crime Risk
- IRB Development
- Liquidity and Market Risk

## B6.5 Principal risks and mitigation

The Group is exposed to a number of principal risks and uncertainties that arise from the operation of its business model and strategy. A summary of those risks and uncertainties which could prevent the achievement of the Group's strategic objectives, how the Group seeks to mitigate those risks and the change in the perceived level of each risk in the last financial year are described below. These risks are discussed in more granular detail in the Group's Pillar III report, published on the Group website.


This analysis represents the Group's gross risk position as presented to, and discussed by, the Risk and Compliance Committee as part of their ongoing monitoring of the Group's risk profile.

This summary should not be regarded as a complete statement of all potential risks and uncertainties faced by the Group but rather those which the Group believes have the potential to have a significant impact on its financial performance and future prospects.

To identify and control the risks to which it is exposed, the Group employs a risk management framework. As part of this framework, principal risks are identified and assessed within the key categories of Business Risk, Credit Risk, Conduct Risk, Operational Risk, Liquidity and Capital Risk, Market Risk, and Pension Obligation Risk.

The changes in the perceived level of each risk in the last financial year are indicated using the symbols shown below:

 <b>Risk Increasing</b>	 <b>Risk Decreasing</b>	 <b>Risk Stable</b>
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BUSINESS RISK		
Economic Risk		
Description	Mitigation	
<p>The Group could be materially affected by a severe downturn in the UK economy given its income is wholly derived from activities within the UK. This is more difficult to forecast given current uncertainties on the terms on which the UK will leave the EU in March 2019.</p> <p>This could reduce demand for the Group's loan products, increase the number of customers that default on their loans and cause security asset values to fall.</p>	<p>The Group closely monitors economic developments in the UK and overseas, with support from leading independent macro-economic advisors. This information supports the senior management's annual review of strategic objectives and business plans for each of the Group's principal trading operations.</p> <p>As a lender and acquirer of credit portfolios the Group is inevitably exposed to any material deterioration in economic conditions. The Board's defined strategy is to limit this risk by operating as a specialist lender in carefully chosen markets where its employees have significant levels of experience and expertise.</p> <p>A robust stress testing framework is maintained which provides the Board with an informed understanding and appreciation of the Group's capacity to withstand shocks of varying severities.</p>	
<b>Change</b>	<p>Whilst UK economic performance has remained broadly stable in the last financial year, given the heightened level of economic and political uncertainty, the overall risk assessment is considered to have increased in the last year.</p>	

## BUSINESS RISK

### Concentration Risk

#### Description

Lending to customers investing in the UK private rented sector forms a substantial part of the Group's advances and assets.

It is therefore exposed to any deterioration in performance of the sector, which will be influenced by factors such as house prices, supply of rental property, fiscal and regulatory intervention and demographic changes.

#### Mitigation

The Group has a very deep understanding of the private rented sector built up over many years of successful operations in the buy-to-let market. This includes a long history of performance data through the economic cycle.

It seeks to use this expertise constructively by playing an active role through several routes, in shaping the development of policy for the private rented sector.

Given its specialist knowledge of the sector and its historically prudent approach to underwriting, the Group has been well placed to respond promptly and effectively to recent regulatory changes relating to buy-to-let lending.

The Group also continues to exploit opportunities to diversify the range of its activities and income streams, consistent with its strategic objective of operating as a prudent, risk-focussed specialist lender. This has been illustrated in recent years through acquisitions and diversification into new product areas.

#### Change

The Group continues to have significant exposure to buy-to-let lending but is confident in its ability to operate successfully in this evolving environment. It has therefore assessed the overall risk resulting from its reliance on the buy-to-let exposure in the last 12 months as stable.



### Transition Risk

#### Description

Failure to effectively manage the transition and implementation risks resulting from the recent major internal reorganisation and from the acquisitions of two asset finance businesses could impact adversely on the Group's financial performance and its reputation.

#### Mitigation

The corporate reorganisation has been managed through a formal project governance programme involving key executives chaired by the CFO reporting to the Board.

Extensive proactive engagement has been undertaken with relevant regulatory bodies and detailed advice provided by leading legal and accountancy firms.

In relation to the Board's M&A strategy, the Group will only consider acquisitions in areas of business that it understands and which are complementary to its existing activities.

Formal governance arrangements are applied to any proposed acquisition and to subsequent integration projects, with regular progress reporting to the executive team and the Board.


#### Change

The recent corporate reorganisation and the continuing integration activity relating to prior year acquisitions has inevitably led to a potential for exposure to greater risk in this area during the reporting period.

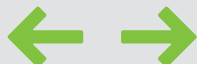


## CREDIT RISK

### Customer Risk

Description		Mitigation
<p>As a lender, failure to target products and underwrite credit decisions effectively could result in customers becoming less able to service debt, exposing the Group to unexpected material losses.</p> <p>Recoverable amounts on loans may also be affected by adverse movements in security values such as house and commercial asset prices.</p>		<p>The Group has comprehensive policies in place that set out detailed criteria which must be met before loans are approved.</p> <p>Credit policies incorporate limits for concentration risks arising from factors such as large exposures to counterparties, geographical areas or types of lending.</p> <p>The Group uses a range of sources to inform expectations of key external factors such as interest rate movements and house price inflation which are in turn used to guide policy and underwriting.</p> <p>The Group's approach to the management of credit risk and the systems in place to mitigate that risk on both originated and purchased assets are further described in note 9 to the accounts.</p>
<b>Change</b>	<p>The Group's impairment rate has remained very low, reflecting the maintenance of robust, proven credit disciplines, generally stable economic conditions and the credit quality of its borrowers.</p>	


### Counterparty Risk

Description		Mitigation
<p>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.</p>		<p>The Group has a strictly controlled number of approved treasury counterparties. To be approved, counterparties must meet specific credit rating criteria.</p> <p>Exposure to approved counterparties is monitored intra-day by senior management within the Treasury function with all trading performed within approved limits.</p> <p>The credit quality of all treasury counterparties and the Group's exposure to them is reported monthly to ALCO.</p> <p>Treasury counterparties are typically highly rated banks and, for all cash deposits and derivative positions held within the Group's securitisation structures, they must comply with criteria set out in the financing arrangements, which are monitored externally.</p>
<b>Change</b>	<p>The credit quality of the treasury counterparties, with whom the Group transacts has been maintained during the year and this risk is therefore considered to be stable.</p>	




## CONDUCT RISK

### Customer Fair Outcomes

Description	Mitigation	
<p>The Group provides a broad range of financial services products across a number of brands to consumers and small business customers.</p> <p>As a result, the Group is exposed to potential conduct risk should it fail to deliver fair outcomes for its customers.</p> <p>Systemic poor customer treatment may lead to regulatory censure and / or reputational damage.</p>	<p>The Group's Conduct Risk Policy sets out the conduct risk framework requirements within which business areas are required to develop systems and processes to identify, measure, manage, monitor and report risks in accordance with stated risk appetites.</p> <p>Underpinning this Policy are additional policies and standards to ensure the fair treatment of customers such as; complaint handling, responsible lending, sales and distribution practices, forbearance, and vulnerable customer treatment.</p> <p>Business areas dealing with consumers have dedicated Quality and Control teams which validate process adherence and the delivery of fair treatment for customers. The Group's Compliance function provides oversight by way of their monitoring plan which is focused on conduct risk and the fair treatment of customers.</p> <p>All employees are required to undertake conduct risk related training and, where appropriate, staff receive additional focused training on a variety of customer centric topics.</p>	
<p><b>Change</b></p>	<p>The increasingly regulated nature of the Group's operations and continuing changes to the regulatory conduct landscape heightens the potential risk.</p>	


## OPERATIONAL RISK

### People Risk


Description	Mitigation	
<p>The Group is exposed to the risk that it is unable to recruit and retain skilled senior management and key personnel at all levels.</p> <p>Failure to maintain the necessary skill base within its workforce could have a material impact on the Group's ability to deliver its business plan and strategic objectives.</p> <p>This is a particular risk in respect of key specialist and executive positions, where the institutional knowledge of the incumbents would be hard to replicate in the short term.</p>	<p>The Group manages and controls its key person dependency risk through effective succession planning, recruitment, development and retention strategies.</p> <p>External remuneration and reward structures are monitored to ensure it remains competitive and is able to recruit and retain key personnel.</p> <p>A range of employee benefits are offered in addition to base salaries including a defined contribution pension scheme, Sharesave Plan and an annual profit related performance scheme for most employees.</p> <p>Manager and team leader academies are run to develop pools of strong, capable individuals with the potential to fill future managerial and specialist roles within the business.</p> <p>The Group has been accredited under the 'Investors in People' scheme since 1997 and retains the Champion status which it achieved in 2014.</p>	
<p><b>Change</b></p>	<p>During the last year, a strong employment market and buoyant demand for skilled financial services staff has led to greater competition. Despite this, the Group remains confident in its ability to manage this risk.</p>	

## OPERATIONAL RISK

### Systems Risk

Description		Mitigation
<p>The Group is exposed to the risk that its IT infrastructure and systems are unable to support its operational needs and fail to offer adequate protection against the threat of cyber-crime.</p> <p>This risk also includes the potential that the Group's key outsourcing arrangements with third parties could expose it to material loss or reputational damage.</p>		<p>During the course of the year, the Group has further strengthened its capabilities in relation to its IT infrastructure management and security.</p> <p>The Group has a formally agreed IT strategy which ensures that priority is given to those areas which are most critical to the delivery of the Group's strategy and business plan.</p> <p>The Group maintains an ongoing programme of investment in IT infrastructure and systems. This includes investment in security solutions to counteract cyber security threats and specialist resource.</p> <p>A formal Cyber Incident Response Plan has been developed and reviewed to ensure that the Group is well placed to deal with any such issues or events.</p> <p>The Group continues to be certified to ISO 27001 (Information Security Management) and ISO 22301 (Business Continuity).</p>
<b>Change</b>	<p>Whilst the Group continues to maintain a robust and secure IT infrastructure that supports its operational needs, the level and sophistication of cyber-crime continues to increase, heightening the risk of an impact on its business model and strategic objectives.</p>	

### Regulatory Risk

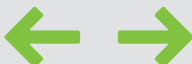
Description		Mitigation
<p>Given the highly-regulated sectors in which the Group operates, compliance failures or failures to respond effectively to new and emerging regulatory and legal developments could result in reputational damage and financial loss.</p>		<p>The Group has Risk and Compliance and Legal teams who review key regulatory and legal developments to assess the impact on the Group's operations. These teams then work with business areas to provide advice on the implementation of appropriate measures to meet identified requirements. Expert external advice is also sought where necessary.</p> <p>Major regulatory or legal change initiatives are subject to formal change governance with progress reporting to the Risk and Compliance Committee.</p> <p>All employees are required to undertake regulatory training and testing to ensure appropriate levels of competence are maintained. Those in relevant specialist roles are also required to adhere to formal regulatory training and competence regimes.</p> <p>The Compliance function has developed a formal monitoring plan which is reviewed by the ORCC and the Risk and Compliance Committee to ensure that regulatory requirements have been satisfactorily embedded.</p>
<b>Change</b>	<p>Whilst the Group considers that it continues to have robust arrangements in place, the increasingly regulated nature of its operations heightens the potential risk arising from any failure to comply effectively with regulations.</p>	

## LIQUIDITY AND CAPITAL RISK

### Funding Risk


Description		Mitigation
<p>The Group relies on access to various sources of funding to finance its operations. If access to funding became restricted, either through market movements or regulatory intervention, this might result in the scaling back or cessation of some business lines.</p> <p>Retail deposit taking is central to the Group's funding plans and therefore changes in market conditions could impact the ability of the business to maintain the level of liquidity required to sustain normal business activity.</p>		<p>The Group maintains a diversified range of both retail and wholesale medium and long term funding sources to cover future business requirements and liquidity to cover shorter term funding needs. The Group remains well funded with sufficient liquidity to meet all its financial obligations as they fall due.</p> <p>The Group, through Paragon Bank, is authorised to accept retail deposits. As such, it is subject to regulation by the PRA, which aims to ensure that sufficient liquid assets are held, at all times, to mitigate the liquidity risk inherent in deposit taking.</p> <p>The Bank has also been able to make drawings under the Bank of England's TFS to support its ongoing lending activities.</p> <p>Internally, comprehensive treasury policies are in place to ensure sufficient liquid assets are maintained and that all financial obligations can be met as they fall due.</p>
<b>Change</b>	<p>Following its recent corporate reorganisation, the Group is now better placed to access funding from a wide range of sources to meet its future funding requirements. Strong competition for retail deposits amongst challenger banks during the year means the overall risk is considered to have remained stable.</p>	

### Capital Risk

Description		Mitigation
<p>The major part of the Group's lending portfolio is secured on residential property. Proposals made by the BCBS regarding potential changes from 2021 to the minimum capital requirements for lending secured on such assets could have a material impact on the Group.</p>		<p>In order to further enhance its existing robust credit management capabilities and to mitigate the risks of the proposed BCBS changes, the Group took a strategic decision in 2016 to seek the necessary regulatory approval to implement an IRB approach for credit risk.</p> <p>A formal IRB project has been initiated with support from respected external specialist advisors to enable the Group to submit an application to the relevant regulatory authorities as soon as possible.</p> <p>In June 2017, the PRA published an updated approach to IRB applications. The process is now modular, with each element covering a different aspect of a firm's plan for IRB implementation. This new application process is now embedded in the Group's IRB project plan.</p>
<b>Change</b>	<p>Whilst the Group has made good progress in relation to its IRB project, further clarity on the BCBS proposals is still awaited, particularly those relating to new capital floors. As a result, this risk is considered to have remained stable during the year.</p> <p>Further information on the Group's management of capital and liquidity risk is given in notes 7 and 10 to the accounts.</p>	


## MARKET RISK

### Interest Rate Risk

Description		Mitigation
<p>The Group is exposed to the risk that changes in interest rates may adversely affect its net income and profitability. In particular, the Group's profitability is determined by the difference between the interest rates at which it lends and those at which it borrows. Changes in market interest rates could therefore materially impact the Group's profits as a result of significant mismatches between its assets and liabilities.</p>		<p>This risk is managed through Board approved risk appetite limits with comprehensive treasury policies in place to ensure that the risk posed by changes and mismatches in interest rates are effectively managed.</p> <p>The Board's risk management framework for Interest Rate Risk in the Banking Book ('IRRBB') has been enhanced over the last year to reflect the updated BCBS principles and methods expected to be used by banks for controlling such risks.</p> <p>Day-to-day management of interest rate risk is the responsibility of Treasury with control and oversight provided by ALCO.</p> <p>The Group seeks to match the structure of assets and liabilities by using appropriate financial instruments, such as interest rate swaps or cap agreements and fixed rate retail liabilities.</p>
Change	<p>The Group's interest risk exposure profile, relative to its balance sheet has remained broadly similar and therefore associated risk levels remain generally stable compared to previous periods.</p> <p>Further information regarding the Group's management of interest rate risk is given in note 11 to the accounts.</p>	

## PENSION OBLIGATION RISK

### Pension Obligation Risk

Description		Mitigation
<p>The Group operates both a defined benefit and defined contribution pension scheme in the UK.</p> <p>There is a risk that the Group's commitments under its defined benefit scheme expose it to the risk that the assets of the scheme may be insufficient to meet its liabilities.</p>		<p>The Group's defined benefit scheme ('the Plan') was closed to new members with effect from February 2002.</p> <p>To mitigate the risks inherent in its exposure to the Plan, the Group conducts regular asset-liability reviews in conjunction with the Trustee.</p> <p>These reviews are used to assist the Trustee and the Group to determine the optimal long-term asset allocation with regard to the structure of liabilities within the Plan and help in managing the volatility in the underlying investment performance.</p> <p>The Plan is subject to triennial formal valuation by the Plan actuary. The most recent valuation, as at 31 March 2016, was agreed by the Trustee during the year and a recovery plan was put in place which aims to clear the deficit of the Plan by January 2023.</p>
Change	<p>During the last year, changes in bond yields, equity prices, interest rates, mortality assumptions and inflation rates have all impacted favourably. The triennial valuation and agreed recovery plan have also helped to reduce the risk in the Plan as have some significant transfers out. Further details of the Group's exposure to the Plan are given in note 54 to the accounts.</p>	

# B7

## DIRECTORS' REPORT

The directors of Paragon Banking Group PLC (registered number 2336032) submit their Report prepared in accordance with Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 ('Schedule 7'), which also includes additional disclosures made in accordance with the Listing Rules of the UK Listing Authority.

The Company changed its name from The Paragon Group of Companies PLC on 21 September 2017.

### Directors and their interests

The directors of the Company during the year were:

R G Dench

N S Terrington

R J Woodman

J A Heron

A K Fletcher\*

P J N Hartill\*

F J Clutterbuck\*

H R Tudor\*

P J Newberry\* (appointed 20 September 2017)

B A Ridpath\* (appointed 20 September 2017)

F F Williamson\* (appointed 20 September 2017)

G H Yorston\* (appointed 20 September 2017)

\*Non-executive directors.

The directors' interests in the shares of the Company are disclosed in the Directors' Remuneration Report in Section B5. There have been no changes in the directors' interests in the share capital of the Company since 30 September 2017.

Mr H R Tudor additionally has an interest in £500,000 of the Company's 6.00% sterling denominated notes due 2020.

Other than as stated above, the directors had no interests in securities issued by the Company. The directors have no interests in the shares or debentures of the Company's subsidiary companies.

The appointment and replacement of the Company's directors is governed by the Articles of Association of the Company (the 'Articles'), the Code, the Companies Act 2006 and related legislation, and the individual service contracts and terms of appointment of the directors. The powers of the directors, and their service contracts and terms of appointment, are described in the Corporate Governance section, Section B3.1. The Articles may only be amended by the Company's shareholders in general meeting.

Under Article 161 of the Articles, the Company has qualifying third party indemnity provisions for the benefit of its directors, which were in place throughout the year and which remain in force at the date of this report, in the form of directors' and officers' liability insurance. The directors' and officers' liability insurance covers directors of all the Company's subsidiary entities.

Under Article 85 of the Articles certain directors are required to submit themselves for reappointment. In accordance with the Code, however, the Board of Directors has decided that it is appropriate for all directors to submit themselves for reappointment on an annual basis. Accordingly, all current directors will retire and seek reappointment at the AGM.

None of the directors has a service contract with the Company requiring more than 12 months' notice of termination to be given.

A director has a statutory duty to avoid a situation in which he or she has, or can have, an interest that conflicts or possibly may conflict with the interests of the Company. A director will not be in breach of that duty if the relevant matter has been authorised in accordance with the Articles by the other directors. The Articles include the relevant authorisation for directors to approve such conflicts.

None of the directors had, either during or at the end of the year, any material interest in any contract of significance with the Company or its subsidiaries.

## Capital structure

Details of the issued share capital of the Company, together with details of movements in its issued share capital in the year, are given in note 55 to the accounts. The Company has one class of ordinary shares which carries no right to fixed income. Each ordinary share carries the right to one vote at general meetings of the Company. The rights and obligations attaching to ordinary shares are set out in the Articles.

There are no specific restrictions on the size of a member's holding or on the transfer of shares. Both of these matters are governed by the general provisions of the Articles and prevailing legislation. The Articles may be amended by special resolution of the shareholders. The directors are not aware of any agreements between holders of the Company's shares in respect of voting rights or which might result in restrictions on the transfer of securities.

Details of employee share schemes are set out in note 23 to the accounts. Votes attaching to shares held by the Group's employee benefit trust are not exercised at general meetings of the Company.

The Company presently has the authority to issue ordinary shares up to a value of £28.0 million and to make market purchases of up to 28,000,000 £1 ordinary shares, granted at the Annual General Meeting on 9 February 2017. These authorities expire at the conclusion of the forthcoming Annual General Meeting on 15 February 2018 and resolutions will be put to that meeting proposing that they be renewed.

## Purchase of own shares

On 25 November 2014 the Group announced a share buy-back programme, which had been extended to £100.0m by the start of the year. On 23 November 2016 the programme was extended by £50.0m and was further extended by £15.0m on 26 July 2017. During the year 15,344,929 £1 ordinary shares (2016: 16,663,408) having an aggregate nominal value of £15,344,929 (2016: £16,663,408), were purchased under this programme. The reasons for this purchase were set out in Section A3.3 of the Annual Report for the year ended 30 September 2016. Total consideration paid in the year was £65.5 million, including costs (2016: £51.0 million).

All of the shares acquired under these programmes were held initially as treasury shares.

On 1 June 2017, 15,000,000 of the treasury shares acquired under this programme were cancelled. These shares had a nominal value of £15,000,000 and represented 5.51% of the issued share capital excluding treasury shares at that time.

The number of treasury shares held at 30 September 2017 was 15,693,643 (2016: 15,348,714), representing 5.90% of the issued share capital excluding treasury shares (2016: 5.47%). The maximum holding of treasury shares during the year was 24,251,153 (2016: 27,716,094) representing 8.91% of the issued share capital excluding treasury shares at that time (2016: 9.83%).

On 23 November 2017 the Company announced that the buy-back programme would be extended by a further amount of up to £50.0 million. The reasons for this extension are set out in Section A3.3 of this Annual Report.

## Dividends

The directors recommend a final dividend of 11.0p per share (2016: 9.2p per share) which, taken with the interim dividend of 4.7p per share (2016: 4.3p per share) paid on 28 July 2017, would give a total dividend for the year of 15.7p per share (2016: 13.5p per share).

## Major shareholdings

Notifications of the following major voting interests, comprising over 3%, in the Company's ordinary share capital, notifiable in accordance with Chapter 5 of the FCA's Disclosure and Transparency Rules or section 793 of the Companies Act 2006, had been received by the Company as at 30 September 2017 and at 31 October 2017, being a date not more than one month before the date of the notice convening the forthcoming Annual General Meeting.

Shareholder	31 October 2017		30 September 2017	
	Ordinary Shares	% Held	Ordinary Shares	% Held
Royal London Asset Management Limited	19,263,761	7.25	19,263,761	7.25
Prudential plc group of companies	18,012,554	6.78	18,012,554	6.78
Norges Bank	11,007,893	4.14	11,007,893	4.14

## Significant agreements

The Company is not party to any significant agreements that would take effect, alter or terminate following a change of control of the company.

The Company does not have any agreements with any director or employee that would provide compensation for loss of office or employment resulting from a takeover of the Company, except that provisions of the Company's share based remuneration arrangements may cause awards granted to employees under such plans to vest in such circumstances.

## Political expenditure

Company law requires the disclosure of political donations and political expenditure by any Group company. During the year ended 30 September 2017 no such payments were made (2016: £nil).

## Auditors

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

The directors, having considered the requirements for rotation of auditors, the length of service of KPMG and the conduct of the audit concluded there was no present need to retender the audit. Therefore, a resolution for the reappointment of KPMG, who have expressed their willingness to continue in office, as the auditors of the Company is to be proposed at the forthcoming Annual General Meeting. The evaluation process is described more fully in the Audit Committee Section B4.

## Annual General Meeting

The Annual General Meeting of the Company will take place on 15 February 2018 in London. A notice convening the Annual General Meeting is being circulated to shareholders with this Annual Report and Accounts.

## Listing Rule LR9.8.4

There are no matters which the Company is required to report under Listing Rule LR9.8.4, other than the fact that the trustees of its employee share ownership trusts (note 57) have waived their right to receive dividends on any shares held from time to time. As these shares are held on the consolidated balance sheet, this has no effect on the amounts reported by the Group.

## Information presented in other sections

Certain information required to be included in a directors' report by Schedule 7 can be found in the other sections of the Annual Report, as described below. All of the information presented in these sections is incorporated by reference into this Directors' Report and is deemed to form part of this report.

- Commentary on the likely future developments in the business of the Group is included in the Strategic Report (Section A)
- A description of the Group's financial risk management objectives and policies, and its exposure to risks arising from its use of financial instruments are set out in note 8 to the accounts and related notes
- Information concerning directors' contractual arrangements and entitlements under share based remuneration arrangements is given in Section B5, the Directors' Remuneration Report
- Information concerning the employment of disabled persons and the involvement of employees in the business is given in Section A5.1 – 'Employees'
- Disclosures concerning greenhouse gas emissions are given in Section A5.2 – 'Environmental policy'

Rule DTR7.2.1 of the Disclosure Guidance and Transparency Rules requires the Group's disclosures on Corporate Governance to be included in the Directors' Report. This information is presented in Sections B3, B4, B5 and B6 and the information in these sections is incorporated by reference into this Directors' Report and is deemed to form part of this report.

Rule DTR 4.1.5 of the Disclosure and Transparency Rules requires that the annual report of a listed company contains a management report containing certain prescribed information. This Directors' Report, including the other sections of the Annual Report incorporated by reference, comprises a management report for the Group for the year ended 30 September 2017, for the purposes of the Disclosure and Transparency Rules.

Section B7 of this Annual Report, together with the other sections of the Annual Report incorporated by reference, comprise a directors' report for the Company which has been drawn up and presented in accordance with, and in reliance upon, applicable English company law and the liabilities of the directors in connection with this report shall be subject to the limitations and restrictions provided by such law.

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

## Pandora Sharp

Company Secretary

23 November 2017

# B8

## STATEMENT OF DIRECTORS' RESPONSIBILITIES

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations. The directors are required to prepare accounts for the Group in accordance with IFRS and have also elected to prepare company financial statements in accordance with IFRS. In respect of the financial statements for the year ended 30 September 2017, company law requires the directors to prepare such financial statements in accordance with IFRS, the Companies Act 2006 and Article 4 of the IAS Regulation.

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

- Properly select and apply accounting policies
- Make an assessment of the Group's and the Company's ability to continue as a going concern
- Present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information
- Provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance

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

The directors are responsible for keeping adequate accounting records which disclose with reasonable accuracy at any time the financial position of the Company, for safeguarding the assets, for the Group's systems of Internal Control, as described in Section B3.1, and for taking reasonable steps for the prevention and detection of fraud and other irregularities. They are also responsible for the preparation of a strategic report, directors' report, directors' remuneration report and corporate governance statement which comply with the applicable requirements of the Companies Act 2006.

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

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

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

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

**Pandora Sharp**  
Company Secretary

**23 November 2017**





C.

# INDEPENDENT AUDITOR'S REPORT

Report by the independent auditor of the Company, KPMG LLP on the  
financial statements

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# C INDEPENDENT AUDITOR'S REPORT

To the members of Paragon Banking Group PLC

## 1 Our opinion on the financial statements is unmodified

We have audited the financial statements of Paragon Banking Group PLC ('the Company') for the year ended 30 September 2017, set out in section D of the Annual Report, which comprise the:

- Consolidated and Company Balance Sheets
- Consolidated Income Statement
- Consolidated Statement of Comprehensive Income
- Consolidated and Company Cash Flow Statements
- Consolidated and Company Statements of Movements in Equity
- Related notes, including the accounting policies in note 4, other than the disclosures labelled as unaudited in note 7.

### In our opinion:

- The financial statements give a true and fair view of the state of the Group's and of the Company's affairs as at 30 September 2017 and of the Group's profit for the year then ended
- The Group financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union (IFRSs as adopted by the EU)
- The Company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as applied in accordance with the provisions of the Companies Act 2006
- The financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

### Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ('ISAs (UK)') and applicable law. Our responsibilities are described below. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion. Our audit opinion is consistent with our report to the Audit Committee.

We were appointed as auditor by the shareholders on 9 February 2016. The period of total uninterrupted engagement is for the two financial years ended 30 September 2017. We have fulfilled our ethical responsibilities under, and we remain independent of the Group in accordance with, UK ethical requirements including the FRC Ethical Standard as applied to listed public interest entities. No non-audit services prohibited by that standard were provided.

## 2 Overview

This being the second year of our audit tenure, we combined our knowledge and understanding gained throughout the audit of the Group in the previous year with a consideration of external and internal developments and the risks they present to the Group's business model and how these risks are mitigated. These have been continually reassessed through our half year review, interim and final audits. That consideration includes conversations not only with the Group, and ongoing knowledge gained through reading pertinent information, but also reflected the views of the Prudential Regulatory Authority, market analysts, specialists within our firm, and peer comparisons.

The final result of our risk consideration is shown in the table below, where we have also shown for the first time this year the segments of the Group in which each of the risks arise and the movements in those risks compared with the prior year. We have identified seven areas of significant risk at Group level, but we are of the view that five of these - revenue recognition on loans and advances, interest payable on asset backed loan notes, impairment of loans and receivables, recoverability of goodwill and the retirement benefit obligation valuation - represent the greatest significance. For the first time this year, we have also identified one key audit matter for the parent company only, being investment in subsidiaries risk. These key audit matters are detailed within Section 3 of our report.

Audit Risk	GROUP				
		IDEM, Mortgages and Central Component			Commercial Component
	Segments	IDEM	Mortgages	Central	Commercial
	Revenue recognition on loans and advances	↑	●	●	●
	Impairment of loans and receivables	↔	●	●	●
	Interest payable on asset backed loan notes	↓		●	
	Recoverability of goodwill	↔		●	
	Retirement benefit obligation valuation	↓		●	
	Hedge accounting and valuation of derivatives	↔		●	
	Conduct and regulatory redress	↓	●	●	●
	Accounting for one-off transactions			●	
	Share option scheme			●	●
	Financial reporting		●	●	●
	Taxation risk		●	●	●
	Going concern		●	●	●
	Financial control process		●	●	●
	Consolidation adjustments		●	●	●
	<b>PARENT COMPANY-ONLY</b>				
	Investments in subsidiaries			●	

**Key:**

- Key audit matter
- Significant risks not considered to be key audit matter
- Other areas of audit focus
- ↔ Movement in risk compared to prior year

The factors that have caused the greatest impact on the changes in audit risk arising from significant risks are the impacts of regulatory and tax changes in the buy-to-let market and the strategic reorganisation of the Group.

The regulatory and tax changes in the buy-to-let market, together with the greater competition in this market, have introduced greater uncertainty over the expected remaining lives of current buy-to-let lending which has resulted in an increased audit risk in the area of revenue recognition on loans and advances.

The increased historical experience of asset backed loan notes and, following the Group's reorganisation, the increased availability of alternative sources of funding by the Group, have together increased information about the future expected lives of the asset backed loan notes and thereby decreased the audit risk of the recognition of interest payable on asset backed loan notes.

The conclusion by the courts of the award of costs in the Plevin v Paragon Personal Finance Limited case has decreased the conduct and regulatory provisioning risk.

### 3. Key audit matters: our assessment of risks of material misstatement

Key audit matters are those matters that, in our professional judgment, were of most significance in the audit of the financial statements and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by us, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. We summarise below the key audit matters (unchanged from 2016), in decreasing order of audit significance, in arriving at our audit opinion above, together with our key audit procedures to address those matters and, as required for public interest entities, our results from those procedures. These matters were addressed, and our results are based on procedures undertaken, in the context of, and solely for the purpose of, our audit of the financial statements as a whole, and in forming our opinion thereon, and consequently are incidental to that opinion, and we do not provide a separate opinion on these matters.

#### Revenue recognition on loans and advances

£375.1 million (2016: £377.8 million)

Refer to section B4.3 (Audit Committee Report), note 4(h) (accounting policy) and notes 6(b) and 16 (financial disclosures)

#### The risk

##### Subjective estimate:

The recognition of revenue (interest receivable) on loans and advances to customers under the effective interest rate ('EIR') method requires the directors to apply judgement, with the most critical estimate being the loans' expected behavioural life for originated assets and estimated remaining collections ('ERCs') for acquired loan portfolios.

##### Originated assets:

The expected life assumptions utilise repayment profiles which represent how customers are expected to pay. These profiles extend significantly into the future which creates a high level of estimation uncertainty and subjects the judgement to future market changes. The Group makes its expected life assumptions based on its forecasting process which incorporates both historical experience and judgemental overlays by management.

The cohort of loans and advances which require the most judgement are buy-to-let products which were originated by the Group post-2010, these represent 32.9% of the Group portfolio. Following recent developments in regulation and tax on buy-to-let products, the future expected lives of these loans are likely to be impacted by the availability to customers of re-mortgages or alternative funding from other providers, which has increased the level of judgement required over expected lives. There is also less historical experience for the newer lending in this segment due to their relatively unseasoned nature.

##### Acquired loan portfolios:

For the Group's acquired debt portfolio, the risk is that estimated future cash collections are not reflected by actual cash receipts. Given the nature of the Company's debt portfolios, estimation of future cash collections requires significant judgement to make assumptions about the value, probability and timing of expected future cash flows for each type of asset class within a portfolio.

#### Our response

##### Our procedures included:

##### Originated assets:

- **Historical comparison:** We critically assessed the Group's analysis and key assumptions over the repayment profiles by comparing them to the Group's historical trends and actual portfolio behaviour;
- **Our sector experience:** We challenged the Group's repayment profiles by applying our own expectations based on our knowledge of the Group and experience of the industry in which it operates; and
- **Sensitivity analysis:** We performed sensitivity analysis over the repayment profiles by applying alternative profiles based upon the above procedures.

##### Acquired loan portfolios:

- **Historical comparison:** We critically assessed the Group's cash flow forecasts by comparing them to current and past performance of the Group's portfolios, including recent cash collections.

##### Both portfolios:

- **Assessing transparency:** We critically assessed the adequacy of the Group's disclosures about the sensitivity of the revenue recognition on loans and advances to changes in key assumptions reflected in the inherent risk.

##### Our results

We found the resulting estimate of the revenue recognition on loans and advances to be acceptable (2016: acceptable).

## Impairment of loans and receivables

£110.6 million (2016: £112.6 million)

Refer to section B4.3 (Audit Committee Report), note 4(j) (accounting policy) and notes 6(a), 25 and 35 (financial disclosures).

### The risk

#### Subjective estimate:

The impairment provision relating to the Group's loan portfolios requires the directors to make significant judgements and assumptions over the recoverability of loans and receivables. Impairment provisions are assessed on an individual and collective basis and we consider the key assumptions and risks for each in turn.

#### Individual impairment:

TA critical assumption is the appropriate identification of the impairment trigger. The individual provision model uses arrears as the primary impairment trigger and for buy-to-let properties in receivership of rent, the property status (vacant, held for sale or let) and the cure from impaired to non-impaired. There is a risk that other impairment triggers are not identified on a timely basis or that cured accounts remain impaired.

The other key assumption used within the model is the estimation of the quantum and timing of future cash flows on impaired loans. This estimation includes past payment behaviour, the expected collections approach, including net rental income from the receivership of rent arrangement through its subsidiary Redbrick, and the likely collateral valuation. Where the expected collections approach is through net rental income, a key estimate is the expected future rental period.

#### Collective impairment:

For the purposes of the collective provision assessment, the Group calculates an emergence provision based on the previous loss experience for loans that have become individually impaired, overlaid with management judgement. There is a risk that the overall provision is not reflective of the incurred losses at the end of the period due to the period of time assumed that it takes for incurred losses to emerge, changes in customer credit quality or other market factors not sufficiently incorporated into the model, such as the tax position of borrowers, changes in rental income on buy-to-let properties, and house prices.

### Our response

#### Our procedures included:

- **Controls:** We tested the key controls over the acceptance, monitoring and reporting of credit risk;
- **Historical comparisons:** We critically assessed the Group's assumptions on past payment behaviour, including net rental income and growth, collateral valuations and growth, the rental periods, the proportion of properties that are vacant, and emergence provisions by comparing them to the Group's historical experience;
- **Benchmarking assumptions:** We compared the Group's key assumptions on past payment behaviour and emergence period to comparable peer group organisations;
- **Our sector experience:** We challenged the Group's key assumptions on impairment triggers, cured accounts, net rental income and emergence provisions by applying our own expectations based upon our knowledge of the Group and experience of the industry in which it operates;
- **Sensitivity analysis:** We performed sensitivity analysis over the Group's key assumptions on net rental income, rental periods, likely collateral valuations and emergence provisions based upon our findings from the above procedures; and
- **Assessing transparency:** We critically assessed the adequacy of the Group's disclosures about the sensitivity of the impairment of loans and receivables to changes in key assumptions reflected in the inherent risk.

#### Our results

We found the resulting estimate of the impairment of loans and receivables to be acceptable (2016: acceptable).

## Interest payable on asset backed loan notes

£70.2 million (2016: £103.4 million)

Refer to section B4.3 (Audit Committee Report), note 4(r) (accounting policy) and notes 6(b) and 17 (financial disclosures).

### The risk

#### Subjective estimate:

The recognition of interest payable on asset backed loan note liabilities under the EIR method requires the directors to apply significant judgement in forecasting the future cash flows. The most significant judgement is the expected date of redemption, as this is under the Group's control and will be based upon commercial circumstances at the time, which includes the availability and rates of alternative funding.

Due to the significant carrying value of the loan notes, small changes in the expected redemption date or in the methodology used to recognise interest payable would have a significant effect on the Group's interest payable and the carrying amount of the liability.

### Our response

#### Our procedures included:

- **Methodology choice:** We critically assessed the methodology used to recognise interest over the expected life of the loan notes against our interpretation of the requirements of the relevant accounting standards;
- **Historical comparison:** We compared the expected date of redemption to the Group's historical experience of similar arrangements;
- **Our sector experience:** We critically assessed the expected date of redemption against the Group's latest three year plans and anticipated movements in market and regulatory conditions which may affect the availability and attractiveness of alternative sources of funding; and
- **Assessing transparency:** We critically assessed the adequacy of the Group's disclosures about the sensitivity of the interest payable on asset backed loan notes to changes in key assumptions reflected in the inherent risk.

#### Our results

We found the resulting estimate of the interest payable on asset backed loan notes to be acceptable (2016: acceptable).

## Recoverability of goodwill

£98.1 million (2016: £98.4 million)

Refer to section B4.3 (Audit Committee Report), note 4(d) (accounting policy) and note 42 (financial disclosures).

### The risk

#### Forecast-based valuation:

Goodwill is significant and at risk of irrecoverability due to changes in market factors since acquisition. The estimated recoverable amount is subjective due to the inherent uncertainty involved in forecasting and discounting future cash flows.

In calculating the recoverable amount, the directors made assumptions over the following key inputs; profitability growth, the discount rate and the long-term growth rate.

### Our response

#### Our procedures included:

- **Historical comparisons:** We compared the Group's previous forecasting with actual results;
- **Benchmarking assumptions:** We compared the Group's assumptions to externally derived data in relation to key inputs such as projected economic growth, terminal growth, cost inflation and discount rates;
- **Sensitivity analysis:** We performed breakeven analysis and applied alternative scenarios based on the assumptions noted above; and
- **Assessing transparency:** We critically assessed whether the Group's disclosures about the sensitivity of the outcome of the impairment assessment to changes in key assumptions reflected the risks inherent in the valuation of goodwill.

#### Our results

We found the resulting estimate of the recoverable amount of goodwill to be acceptable (2016: acceptable).



## Retirement benefit obligation valuation

£128.1 million (2016: £162.5 million)

Refer to section B4.3 (Audit Committee Report), note 4(x) (accounting policy) and note 54 (financial disclosures).

### The risk

#### Subjective valuation

Small changes in the assumptions and estimates used to value the Group's pension obligation (before deducting scheme assets) would have a significant effect on the Group's net pension deficit.

#### Accounting treatment

As detailed in section B5.2.2, during the year three executive directors and other senior management undertook voluntary transfers out of the defined benefit pension scheme. The determination by the directors that the transfers out did not contain an enhancement to benefits for the individuals and so do not represent a plan amendment requires judgement.

### Our response

#### Our procedures included:

- **Benchmarking assumptions:** We critically assessed, with the support of our own actuarial specialists, the key assumptions applied, being the discount rate, inflation rate and mortality / life expectancy against externally derived data;
- **Accounting analysis:** Using our own pensions and technical accounting specialists, we critically assessed whether the accounting treatment applied to the voluntary transfers out was appropriate; and
- **Assessing transparency:** We critically assessed the adequacy of the Group's disclosures in respect of the sensitivity of the deficit to these assumptions and the transfers out.

#### Our results

We found the valuation of the pension obligation to be acceptable (2016: acceptable).

We found the accounting treatment of the voluntary transfers out to be appropriate.

## Recoverability of parent company's investment in subsidiaries

£819.1 million (2016: £984.8 million)

Refer to note 4(o) (accounting policy) and notes 43 and 65 (financial disclosures).

### The risk

#### Low risk, high value

The carrying amount of the parent company's investments in subsidiaries represents 70.9% (2016: 67.9%) of the company's total assets. Their recoverability is not at a high risk of significant misstatement or subject to significant judgement. However, due to their materiality in the context of the parent company financial statements, this is considered to be the area that had the greatest effect on our overall parent company audit.

### Our response

#### Our procedures included:

- **Tests of detail:** Comparing the carrying amount of 100% of investments with the relevant subsidiaries' draft balance sheet to identify whether their net assets, being an approximation of their minimum recoverable amount, were in excess of their carrying amount and assessing whether those subsidiaries have historically been profit-making.

#### Our results

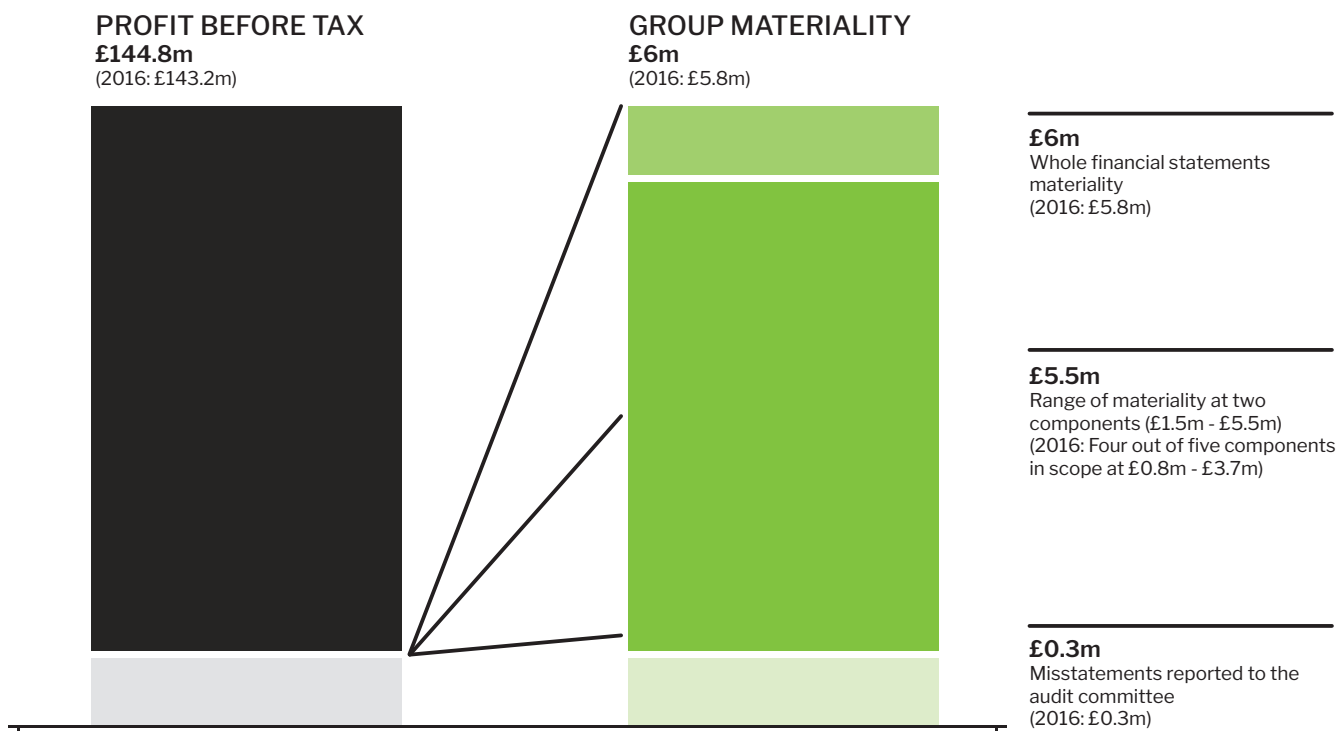
We found the resulting estimate of the impairment of investments in subsidiaries to be acceptable (2016: acceptable).

## 4 Our application of materiality and an overview of the scope of our audit

Materiality for the consolidated financial statements as a whole was set at £6m, determined with reference to a benchmark of consolidated profit before tax, of £144.8m, of which it represents 4.1% (2016: 4.1%).

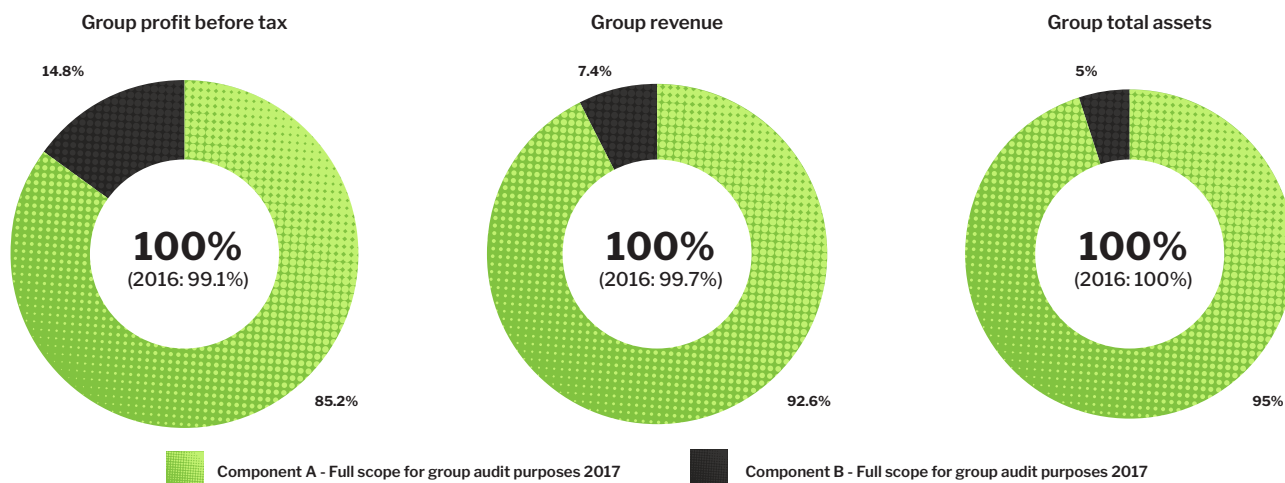
Materiality for the Company financial statements as a whole was set at £3.9m (2016: £3.8m), determined with reference to a benchmark of company net assets, of which it represents 0.6% (2016: 0.5%).

We agreed to report to the Audit Committee any corrected or uncorrected identified misstatements exceeding £0.3m (2016: £0.3m), in addition to other identified misstatements that warranted reporting on qualitative grounds.



Following the Group's strategic reorganisation, we identified two components (2016: five) both of which were subjected to audits for Group reporting purposes. Component A is comprised of the Idem Capital, Mortgages and Central segments; component B is comprised of the Commercial Lending segment.

The components within the scope of our work accounted for the percentages illustrated below.



The group team approved the component materialities, which ranged from £1.5m to £5.5m, having regard to the mix of size and risk profile of the Group across the components. This year, the work on both of the components, including the audit of the Company, was performed by the group team. In 2016, the audit one of the five components (Paragon Asset Finance) was performed by a component audit team separate to the Group team.

## 5 We have nothing to report on going concern

We are required to report to you if:

- We have anything material to add or draw attention to in relation to the directors' statement in note 4(c) to the financial statements on the use of the going concern basis of accounting with no material uncertainties that may cast significant doubt over the Group and Company's use of that basis for a period of at least twelve months from the date of approval of the financial statements; or
- The related statement under the Listing Rules set out in section A4 is materially inconsistent with our audit knowledge.

We have nothing to report in these respects.

## 6 We have nothing to report on the other information in the Annual Report

The directors are responsible for the other information presented in the Annual Report together with the financial statements. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except as explicitly stated below, any form of assurance conclusion thereon.

Our responsibility is to read the other information and, in doing so, consider whether, based on our financial statements audit work, the information therein is materially misstated or inconsistent with the financial statements or our audit knowledge. Based solely on that work we have not identified material misstatements in the other information.

### Strategic report and directors' report

Based solely on our work on the other information:

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

### Directors' remuneration report

In our opinion the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006.

### Disclosures of principal risks and longer-term viability

Based on the knowledge we acquired during our financial statements audit, we have nothing material to add or draw attention to in relation to:

- The directors' confirmation within the 'Future Prospects' section, Section A4, that they have carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency and liquidity;
- The Principal Risks disclosures, in Section B6.5, describing these risks and explaining how they are being managed and mitigated; and
- The directors' explanation in the Viability Statement of how they have assessed the prospects of the Group, over what period they have done so and why they considered that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

Under the Listing Rules we are required to review the Viability Statement. We have nothing to report in this respect.

### Corporate governance disclosures

We are required to report to you if:

- We have identified material inconsistencies between the knowledge we acquired during our financial statements audit and the directors' statement that they consider that the annual report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's position and performance, business model and strategy; or
- The section of the annual report describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.

We are required to report to you if the Corporate Governance Statement does not properly disclose a departure from the eleven provisions of the UK Corporate Governance Code specified by the Listing Rules for our review.

We have nothing to report in these respects.

## 7 We have nothing to report on other matters on which we are required to report by exception

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

- Adequate accounting records have not been kept by the Company, or returns adequate for our audit have not been received from branches not visited by us;
- The Company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns; or
- Certain disclosures of directors' remuneration specified by law are not made; or
- We have not received all the information and explanations we require for our audit.

We have nothing to report in these respects.

## 8 Respective responsibilities

### Directors' responsibilities

As explained more fully in their statement set out in Section B8, the directors are responsible for: the preparation of the financial statements including being satisfied that they give a true and fair view; such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; assessing the Group's and Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and using the going concern basis of accounting unless they either intend to liquidate the Group or the Parent Company or to cease operations, or have no realistic alternative but to do so.

### Auditor's responsibilities

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud, other irregularities, or error, and to issue our opinion in an auditor's report. Reasonable assurance is a high level of assurance, but does not guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud, other irregularities or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. The risk of not detecting a material misstatement resulting from fraud or other irregularities is higher than for one resulting from error, as they may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control and may involve any area of law and regulation not just those directly affecting the financial statements.

A fuller description of our responsibilities is provided on the FRC's website at

[www.frc.org.uk/auditorsresponsibilities](http://www.frc.org.uk/auditorsresponsibilities).

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

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

### Andrew Walker (Senior Statutory Auditor)

for and on behalf of KPMG LLP, Statutory Auditor

Chartered Accountants

One Snowhill

Snow Hill Queensway

Birmingham

B4 6GH

23 November 2017



D.

# THE ACCOUNTS

Showing the financial position, results and cash flows of the Group and the Company prepared in accordance with IFRS and UK law

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## D1.1 Consolidated Income Statement

For the year ended 30 September 2017

	Note	2017 £m	2017 £m	2016 £m	2016 £m
Interest receivable	16		409.2		411.4
Interest payable and similar charges	17		(176.6)		(188.2)
<b>Net interest income</b>			<b>232.6</b>		223.2
Other leasing income	18	14.4		13.0	
Related costs	18	(11.4)		(10.0)	
<b>Net leasing income</b>		<b>3.0</b>		3.0	
Other income	19	17.2		17.8	
Other operating income			20.2		20.8
<b>Total operating income</b>			<b>252.8</b>		244.0
Operating expenses	20		(102.3)		(92.5)
Provisions for losses	25		(5.3)		(7.7)
<b>Operating profit before fair value items</b>			<b>145.2</b>		143.8
Fair value net (losses)	26		(0.4)		(0.6)
<b>Operating profit being profit on ordinary activities before taxation</b>			<b>144.8</b>		143.2
Tax charge on profit on ordinary activities	27		(27.6)		(27.2)
<b>Profit on ordinary activities after taxation for the financial year</b>			<b>117.2</b>		116.0

	Note	2017	2016
<b>Earnings per share</b>			
- basic	29	43.1p	40.5p
- diluted	29	41.9p	39.7p

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

## D1.2 Consolidated Statement of Comprehensive Income

For the year ended 30 September 2017

	Note	2017 £m	2017 £m	2016 £m	2016 £m
<b>Profit for the year</b>			<b>117.2</b>		116.0
<b>Other comprehensive income</b>					
<i>Items that will not be reclassified subsequently to profit or loss</i>					
Actuarial gain / (loss) on pension scheme	54	29.0		(37.2)	
Tax thereon		(5.5)		6.8	
			<b>23.5</b>		(30.4)
<i>Items that may be reclassified subsequently to profit or loss</i>					
Cash flow hedge gains taken to equity		0.5		5.0	
Tax thereon		(0.1)		(1.0)	
			<b>0.4</b>		4.0
<b>Other comprehensive income for the year net of tax</b>			<b>23.9</b>		(26.4)
<b>Total comprehensive income for the year</b>			<b>141.1</b>		89.6



## D1.3 Consolidated Balance Sheet

30 September 2017

	Note	2017 £m	2016 £m	2015 £m
<b>Assets</b>				
Cash – central banks	30	615.0	315.0	286.0
Cash – retail banks	30	881.9	922.6	770.0
Short term investments	31	-	7.1	41.1
Loans to customers	32	11,115.4	10,750.0	10,067.6
Investments in structured entities	37	-	-	18.1
Derivative financial assets	38	906.6	1,366.4	660.1
Sundry assets	39	12.7	12.7	6.2
Property, plant and equipment	40	46.2	39.2	22.1
Intangible assets	41	104.4	105.4	7.7
<b>Total assets</b>		<b>13,682.2</b>	<b>13,518.4</b>	<b>11,878.9</b>
<b>Liabilities</b>				
Short term bank borrowings		0.6	1.2	0.7
Retail deposits	44	3,611.9	1,874.7	708.7
Derivative financial liabilities	38	7.1	15.8	6.7
Asset backed loan notes	45	6,475.8	8,374.1	8,274.6
Secured bank borrowings	46	1,306.0	1,573.0	1,425.4
Retail bond issuance	47	295.7	295.3	294.9
Corporate bond issuance	48	149.1	259.0	110.0
Central bank facilities	49	700.0	-	-
Sundry liabilities	50	74.6	78.7	43.1
Current tax liabilities	52	17.4	16.7	12.5
Deferred tax liabilities	53	4.8	2.0	11.3
Retirement benefit obligations	54	29.8	58.4	21.5
<b>Total liabilities</b>		<b>12,672.8</b>	<b>12,548.9</b>	<b>10,909.4</b>
Called up share capital	55	281.5	295.9	309.3
Reserves	56	811.0	736.1	760.2
Own shares	57	(83.1)	(62.5)	(100.0)
<b>Total equity</b>		<b>1,009.4</b>	<b>969.5</b>	<b>969.5</b>
<b>Total liabilities and equity</b>		<b>13,682.2</b>	<b>13,518.4</b>	<b>11,878.9</b>

Approved by the Board of Directors on 23 November 2017.  
Signed of behalf of the Board of Directors

**N S Terrington**  
Chief Executive

**R J Woodman**  
Chief Financial Officer

## D1.4 Company Balance Sheet

30 September 2017

	Note	2017 £m	2016 £m	2015 £m
<b>Assets</b>				
Cash – retail banks	30	<b>277.6</b>	361.3	196.8
Sundry receivables	39	<b>40.1</b>	84.6	141.3
Property, plant and equipment	40	<b>18.6</b>	18.9	19.3
Investment in subsidiary undertakings	43	<b>819.1</b>	984.8	1,018.3
<b>Total assets</b>		<b>1,155.4</b>	1,449.6	1,375.7
<b>Liabilities</b>				
Retail bond issuance	47	<b>295.7</b>	295.3	294.9
Corporate bond issuance	48	<b>149.1</b>	259.0	110.0
Sundry liabilities	50	<b>39.4</b>	173.2	248.7
Current tax liabilities	52	-	0.4	2.6
Deferred tax liabilities	53	<b>1.8</b>	1.9	1.9
<b>Total liabilities</b>		<b>486.0</b>	729.8	658.1
Called up share capital	55	<b>281.5</b>	295.9	309.3
Reserves	56	<b>454.5</b>	470.1	497.5
Own shares	57	<b>(66.6)</b>	(46.2)	(89.2)
<b>Total equity</b>		<b>669.4</b>	719.8	717.6
		<b>1,155.4</b>	1,449.6	1,375.7

Approved by the Board of Directors on 23 November 2017.  
Signed of behalf of the Board of Directors

**N S Terrington**  
Chief Executive

**R J Woodman**  
Chief Financial Officer

## D1.5 Consolidated Cash Flow Statement

For the year ended 30 September 2017

	Note	2017 £m	2016 £m
Net cash generated by operating activities	59	1,474.7	865.2
Net cash generated / (utilised) by investing activities	60	3.2	(278.6)
Net cash (utilised) by financing activities	61	(1,218.0)	(405.5)
<b>Net increase in cash and cash equivalents</b>		<b>259.9</b>	181.1
Opening cash and cash equivalents		1,236.4	1,055.3
<b>Closing cash and cash equivalents</b>		<b>1,496.3</b>	1,236.4
<b>Represented by balances within:</b>			
Cash	30	1,496.9	1,237.6
Short term bank borrowing		(0.6)	(1.2)
		<b>1,496.3</b>	1,236.4

## D1.6 Company Cash Flow Statement

For the year ended 30 September 2017

	Note	2017 £m	2016 £m
Net cash (utilised) / generated by operating activities	59	(44.5)	67.6
Net cash generated by investing activities	60	172.8	32.5
Net cash (utilised) / generated by financing activities	61	(212.0)	64.4
<b>Net (decrease) / increase in cash and cash equivalents</b>		<b>(83.7)</b>	164.5
Opening cash and cash equivalents		361.3	196.8
<b>Closing cash and cash equivalents</b>		<b>277.6</b>	361.3
<b>Represented by balances within:</b>			
Cash	30	277.6	361.3
Short term bank borrowings		-	-
		<b>277.6</b>	361.3

# D1.7 Consolidated Statement of Movements in Equity

For the year ended 30 September 2017

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Cash flow hedging reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m	£m
<b>Transactions arising from</b>								
Profit for the year	-	-	-	-	-	117.2	-	117.2
Other comprehensive income	-	-	-	-	0.4	23.5	-	23.9
Total comprehensive income	-	-	-	-	0.4	140.7	-	141.1
<b>Transactions with owners</b>								
Dividends paid (note 58)	-	-	-	-	-	(38.0)	-	(38.0)
Shares cancelled	(15.0)	-	15.0	-	-	(45.1)	45.1	-
Own shares purchased	-	-	-	-	-	-	(69.7)	(69.7)
Shares issued to ESOP	-	-	-	-	-	-	-	-
Exercise of share awards	0.6	0.9	-	-	-	(4.0)	4.0	1.5
Charge for share based remuneration (note 21)	-	-	-	-	-	4.2	-	4.2
Tax on share based remuneration	-	-	-	-	-	0.8	-	0.8
<b>Net movement in equity in the year</b>	<b>(14.4)</b>	<b>0.9</b>	<b>15.0</b>	<b>-</b>	<b>0.4</b>	<b>58.6</b>	<b>(20.6)</b>	<b>39.9</b>
Opening equity	295.9	64.6	13.7	(70.2)	2.1	725.9	(62.5)	969.5
<b>Closing equity</b>	<b>281.5</b>	<b>65.5</b>	<b>28.7</b>	<b>(70.2)</b>	<b>2.5</b>	<b>784.5</b>	<b>(83.1)</b>	<b>1,009.4</b>

For the year ended 30 September 2016

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Cash flow hedging reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m	£m
<b>Transactions arising from</b>								
Profit for the year	-	-	-	-	-	116.0	-	116.0
Other comprehensive income	-	-	-	-	4.0	(30.4)	-	(26.4)
Total comprehensive income	-	-	-	-	4.0	85.6	-	89.6
<b>Transactions with owners</b>								
Dividends paid (note 58)	-	-	-	-	-	(33.9)	-	(33.9)
Shares cancelled	(13.7)	-	13.7	-	-	(94.0)	94.0	-
Own shares purchased	-	-	-	-	-	-	(59.9)	(59.9)
Shares issued to ESOP	0.3	-	-	-	-	-	(0.3)	-
Exercise of share awards	-	-	-	-	-	(3.7)	3.7	-
Charge for share based remuneration (note 21)	-	-	-	-	-	4.4	-	4.4
Tax on share based remuneration	-	-	-	-	-	(0.2)	-	(0.2)
<b>Net movement in equity in the year</b>	<b>(13.4)</b>	<b>-</b>	<b>13.7</b>	<b>-</b>	<b>4.0</b>	<b>(41.8)</b>	<b>37.5</b>	<b>-</b>
Opening equity	309.3	64.6	-	(70.2)	(1.9)	767.7	(100.0)	969.5
<b>Closing equity</b>	<b>295.9</b>	<b>64.6</b>	<b>13.7</b>	<b>(70.2)</b>	<b>2.1</b>	<b>725.9</b>	<b>(62.5)</b>	<b>969.5</b>

## D1.8 Company Statement of Movements in Equity

For the year ended 30 September 2017

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m
<b>Transactions arising from</b>							
Profit for the year	-	-	-	-	47.4	-	47.4
Other comprehensive income	-	-	-	-	-	-	-
Total comprehensive income	-	-	-	-	47.4	-	47.4
<b>Transactions with owners</b>							
Dividends paid (note 58)	-	-	-	-	(38.0)	-	(38.0)
Shares cancelled	(15.0)	-	15.0	-	(45.1)	45.1	-
Own shares purchased	-	-	-	-	-	(65.5)	(65.5)
Shares issued to ESOP	-	-	-	-	-	-	-
Exercise of share awards	0.6	0.9	-	-	-	-	1.5
Charge for share based remuneration (note 21)	-	-	-	-	4.2	-	4.2
<b>Net movement in equity in the year</b>	<b>(14.4)</b>	<b>0.9</b>	<b>15.0</b>	<b>-</b>	<b>(31.5)</b>	<b>(20.4)</b>	<b>(50.4)</b>
Opening equity	295.9	64.6	13.7	(23.7)	415.5	(46.2)	719.8
<b>Closing equity</b>	<b>281.5</b>	<b>65.5</b>	<b>28.7</b>	<b>(23.7)</b>	<b>384.0</b>	<b>(66.6)</b>	<b>669.4</b>

For the year ended 30 September 2016

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m
<b>Transactions arising from</b>							
Profit for the year	-	-	-	-	82.4	-	82.4
Other comprehensive income	-	-	-	-	-	-	-
Total comprehensive income	-	-	-	-	82.4	-	82.4
<b>Transactions with owners</b>							
Dividends paid (note 58)	-	-	-	-	(33.9)	-	(33.9)
Shares cancelled	(13.7)	-	13.7	-	(94.0)	94.0	-
Own shares purchased	-	-	-	-	-	(51.0)	(51.0)
Shares issued to ESOP	0.3	-	-	-	-	-	0.3
Exercise of share awards	-	-	-	-	-	-	-
Charge for share based remuneration (note 21)	-	-	-	-	4.4	-	4.4
<b>Net movement in equity in the year</b>	<b>(13.4)</b>	<b>-</b>	<b>13.7</b>	<b>-</b>	<b>(41.1)</b>	<b>43.0</b>	<b>2.2</b>
Opening equity	309.3	64.6	-	(23.7)	456.6	(89.2)	717.6
<b>Closing equity</b>	<b>295.9</b>	<b>64.6</b>	<b>13.7</b>	<b>(23.7)</b>	<b>415.5</b>	<b>(46.2)</b>	<b>719.8</b>

## D2 NOTES TO THE ACCOUNTS

For the year ended 30 September 2017

### 1. GENERAL INFORMATION

Paragon Banking Group PLC is a company domiciled in the United Kingdom and incorporated in England and Wales under the Companies Act 2006 with company number 2336032. It adopted its present name on 21 September 2017 and was previously named The Paragon Group of Companies PLC. The address of the registered office is 51 Homer Road, Solihull, West Midlands, B91 3QJ. The nature of the Group's operations and its principal activities are set out in the Strategic Report in Section A2.

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

### 2. CHANGE OF PRESENTATION

During September 2017, the Group underwent an internal reorganisation, as a result of which the majority of the Group's activity is now undertaken through its banking subsidiary, Paragon Bank PLC ('the Bank') and other entities falling within the scope of banking regulation. Following this reorganisation, the directors concluded that the financial statements of the Group should be presented in a way which enhances comparability with other banking entities.

The changes made affect presentation only and the Group's accounting policies and its reported assets, liabilities, equity, profits and cash flows in preceding years remain as previously disclosed. The most significant change is the reordering of the balance sheets to reflect liquidity, an approach taken by most banks in the UK.

The new Group structure also affects the segments reported by the Group under International Financial Reporting Standard 8 – 'Operating Segments' and in these financial statements new segments, reflecting the new organisational structure, have been adopted, as described in note 14. As required by IFRS 8, comparative disclosures on the basis of the new segments have been provided.

### 3. ADOPTION OF NEW AND REVISED REPORTING STANDARDS

In the preparation of these financial statements no new reporting standards are being applied for the first time.

#### (a) Standards not yet adopted

At the date of authorisation of these financial statements the following International Financial Reporting Standards and Interpretations, which have not been applied in these financial statements, were in issue but not yet effective:

- IFRS 9 – 'Financial Instruments'
- IFRS 15 – 'Revenue from Contracts with Customers'
- IFRS 16 – 'Leases'
- IAS 7 – 'Disclosure initiative amendments'

Other standards and interpretations in issue but not effective do not address matters relevant to the Group's accounting and reporting.

#### IFRS 9

IFRS 9 largely replaces the requirements of the existing financial instruments standard, IAS 39: 'Financial Instruments: Recognition and Measurement'. It addresses the areas of recognition, bases of valuation, income recognition methods, impairment and hedging for financial instruments and will become the standard governing the Group's accounting for Loans to Customers, Borrowings and Derivative Financial Assets and Liabilities. Only the rules relating to the Group's portfolio hedging arrangements will remain subject to IAS 39.

This standard will come into force with effect from the Group's financial statements for the year ending 30 September 2019 and work is well progressed to assess its impact and develop new procedures. Many of the current rules are repeated in broadly similar form in the new standard. In particular, the amortised cost basis of valuation and the related EIR method of income recognition remain largely unchanged. The greatest impact from the new standard is likely to be on impairment provisions, but the requirements addressing classification and measurement and hedging also change.

## ***Impairment of financial assets***

IFRS 9 changes the basis of recognition of impairment of financial assets from an incurred loss to an expected credit loss ('ECL') approach for financial assets held at amortised cost. This introduces a number of new concepts and changes to the approach to provisioning set out in IAS 39.

ECLs are based on an assessment of the probability of default ('PD'), loss given default ('LGD') and exposure at default ('EAD'), discounted to give a net present value. The estimation of ECL should be unbiased and probability weighted, considering all reasonable and supportable information, including forward looking economic assumptions and a range of possible outcomes. This has the effect of recognising losses on loans earlier than at present, as IAS 39 requires provisions to be made only at the point where there is objective evidence of credit impairment.

IFRS 9 divides loans into three classes: those where there has been no significant increase in credit risk since advance; those where there has been a significant increase in credit risk; and loans which are impaired. It is an important feature of the standard that 'increase in credit risk' is not defined solely by the performance of the account, but also by other information available about the customer, such as credit bureau information.

- On initial recognition, and for assets where there has not been a significant increase in credit risk since the date of advance, provisions will be made to the level of expected credit default events within the next year. These accounts would be largely unprovided for under IAS 39, although some cases with adverse qualitative indicators might attract an emergence provision
- Where a loan has experienced a significant increase in credit risk since initial recognition, even though this may not lead to a conclusion that the loan is credit impaired, provisions will be made based on the expected credit losses over the full life of the loan. This is likely to lead to an increase in provision in general, though the emergence provision would also address some of this risk
- For credit impaired assets, provisions will be made on the basis of lifetime expected credit losses, taking account of forward looking economic assumptions and a range of possible outcomes. Under IAS 39 provisions are based on the asset's carrying value and the present value of the estimated future cash flows. IAS 39 does not explicitly take account of a range of possible economic outcomes including forecasts of any downturn in the economic cycle. However, it is likely that, subject to conditions at the time of implementation, provisions for loans in this condition will be broadly similar to their existing values
- For assets which were credit impaired at origination or acquisition, such as certain of the Group's acquired assets, the required treatment is largely identical under IAS 39 and IFRS 9

Overall, the introduction of IFRS 9 is likely to result in companies carrying a larger provision balance and recognising losses earlier. However, the profit and loss effect is broadly one of timing, with the same amount of provision per case ultimately charged to profit.

## ***Impairment implementation***

During the year, the Group has continued its project to ensure it will be able to comply with the new requirements. The project includes finance, analysis and credit risk personnel, is sponsored by the Chief Financial Officer and reports regularly to the Audit Committee. Model builds are subject to the oversight of the Model Risk Committee.

Project workflows have included analysis of historic internal and external credit performance metrics, prototype model design and consideration of how external economic factors should affect IFRS 9 impairments. External consultants and the Group's auditors have been engaged with as appropriate, with initial work focussing on the Group's most significant asset classes. The project team have also engaged with external initiatives to gauge best practice and have also engaged in dialogue with regulators.

Base models have been completed for the Group's most material asset classes and indicative outputs are being provided to Credit Committee on a business-as-usual basis. Work will continue to finalise these models and complete work on models for other, less material, asset classes in the year. Work will continue on the project through the year ending 30 September 2018 and a further report on progress will be given in that year's half-year report.

The Group is not obliged to restate comparatives on the initial adoption of IFRS 9 but will provide detailed transitional disclosures. The communication strategy for this information, including the timing of publication, will be determined over the next financial year, based on emerging best practice and consultation with analysts, shareholders and advisers.

The Group is also considering emerging practice with regards to the transitional arrangements on capital currently proposed by the PRA and will determine its approach during the coming year.

## ***Classification and measurement***

The classification of financial assets under IFRS 9 is based on the objectives of a company's business model and the contractual cash flow characteristics of the instruments. Financial assets are classified as held at amortised cost, at fair value through other comprehensive income, or at fair value through profit or loss. The changes from the classification under IAS 39 are not expected to be significant for the Group.

## ***Hedge accounting***

The hedge accounting requirements of the new standard are designed to create a stronger link with financial risk management, however this does not cover macro hedge accounting. A separate financial reporting standard is to be developed in this area. IFRS 9 allows the option to continue to apply the existing hedge accounting requirements of IAS 39 until this is implemented. As the Group's hedging arrangements are either macro hedges, which are unaffected by the new standard or bespoke cash flow hedges which would not be affected by the change of standard, the Group has decided to defer application of these rules until the full new hedge accounting regime is in place.

## IFRS 15

IFRS 15 will replace the standards currently governing the recognition of that part of the Group's income which does not derive directly from financial assets, that is the amounts shown as 'maintenance income' in note 18 and the amounts shown in note 19. It affects the timing of recognition of revenue items, but not generally the overall amount recognised. The standard will come into force with effect from the Group's financial statements for the year ending 30 September 2019. A preliminary review exercise has taken place and the Group has concluded that the introduction of the new standard will not have a material impact on its results or financial position.

## IFRS 16

IFRS 16 will replace the standards currently governing the accounting for operating and finance leases and will come in to force with effect from the Group's financial statements for the year ending 30 September 2020, unless the Group decides to adopt it early.

The standard will address accounting by lessees and lessors, but the provisions for lessor accounting are little changed from those in IAS 17 and so the accounting for the Group's finance lease receivables will be largely unaffected.

Accounting by lessees will be changed significantly, with a right of use asset recognised on the balance sheet for all leases, based on discounted future commitments. This includes leases presently treated as operating leases and not recognised on the balance sheet. The Group's commitments under such leases are described in note 63(b) and a preliminary review of the standard indicates the changes are unlikely to have a material impact on the Group's results or financial position.

## IAS 7

The Disclosure Initiative amendments to IAS 7 – 'Statement of Cash Flows', which will come into force with effect from the Group's financial year ending 30 September 2018, will require entities to present a note to the accounts describing movements in liabilities arising from financing cash flows. The Group already presents such a note on a voluntary basis (note 62), therefore the introduction of the amended standard will have minimal impact.

## 4. ACCOUNTING POLICIES

The financial statements have been prepared in accordance with International Financial Reporting Standards as adopted by the EU. In the financial years reported upon this means that the financial statements accord also with International Financial Reporting Standards as approved by the International Accounting Standards Board.

The particular policies applied are described below.

### (a) Accounting convention

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

### (b) Basis of consolidation

The consolidated financial statements deal with the accounts of the Company and its subsidiaries made up to 30 September 2017. Subsidiaries comprise all those entities over which the Group has control and are listed in note 65. The results of businesses acquired are dealt with in the consolidated accounts from the date of acquisition.

In accordance with IFRS 10 – 'Consolidated Financial Statements' companies owned by charitable trusts into which loans originated by group companies were sold as part of its warehouse and securitisation funding arrangements, where the Group enjoys the benefits of ownership, are treated as subsidiaries.

Similarly, trusts set up to hold shares in conjunction with the Group's employee share ownership arrangements are also treated as subsidiaries.

### (c) Going concern

The consolidated financial statements have been prepared on the going concern basis.

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 Financial Reporting Council 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.



#### **(d) Acquisitions and goodwill**

Goodwill arising from the purchase of subsidiary undertakings, representing the excess of the fair value of the purchase consideration over the fair values of acquired assets, including intangible assets, is held on the balance sheet and reviewed annually to determine whether any impairment has occurred.

Negative goodwill is written off as it arises.

As permitted by IFRS 1, the Group has elected not to apply IFRS 3 – ‘Business Combinations’ to combinations taking place before its transition date to IFRS (1 October 2004). Therefore any goodwill which was written off to reserves under UK GAAP will not be charged or credited to the profit and loss account on any future disposal of the business to which it relates.

Contingent consideration arising on acquisitions is first recognised in the accounts at its fair value at the acquisition date and subsequently revalued at each accounting date until it falls due for payment or the final amount is otherwise determined.

#### **(e) Cash and cash equivalents**

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

#### **(f) Short-term investments**

Short-term investments are held as part of the liquidity requirement of Paragon Bank PLC. As such they are designated as ‘Available for Sale’, as defined by IAS 39 - ‘Financial Instruments: Recognition and Measurement’ and are consequently measured at their fair value which corresponds to their market value at the balance sheet date.

#### **(g) Leases**

Leases are accounted for as operating or finance leases in accordance with IAS 17 – ‘Leases’. A finance lease is deemed to be one which transfers substantially all of the risks and rewards of the ownership of the asset concerned. Any other lease is an operating lease.

Rental income and costs under operating leases are credited or charged to the profit and loss account on a straight line basis over the period of the leases.

#### **(h) Loans to customers**

Loans to customers are considered to be ‘loans and receivables’ as defined by IAS 39 – ‘Financial Instruments: Recognition and Measurement’. They are therefore accounted for on the amortised cost basis.

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

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

#### **(i) Finance lease receivables**

Finance lease receivables are included within ‘Loans to Customers’ at the total amount receivable less interest not yet accrued, unamortised commissions and provision for impairment.

Income from finance lease contracts is accounted for on the actuarial basis.

#### **(j) Impairment of loans and receivables**

Loans and receivables are reviewed for indications of possible impairment throughout the year and at each balance sheet date in accordance with IAS 39. Where loans exhibit objective evidence of impairment (a ‘loss event’) the carrying value of the loans is reduced to the net present value of their expected future cash flows, including the value of the potential realisation of any security (net of sales costs) discounted at the original EIR.

Within its buy-to-let portfolio the Group utilises a receiver of rent process, whereby the receiver stands between the landlord and tenant and will determine an appropriate strategy for dealing with any delinquency. This strategy may involve the immediate sale of any underlying security or the short or long term letting of the property to cover arrears and principal shortfalls. Where a letting strategy is adopted, a tenant is in place and arrears are reduced or cleared, the account will not necessarily attract an impairment provision. Properties in receivership are eventually either returned to their landlord owners or sold.

Loss events reflect both loans that display delinquency in contractual payments of principal or interest or, for buy-to-let loans in receivership but up to date at the balance sheet date, properties where the receiver adopts a sale strategy, where a shortfall may or may not arise.

In addition to loans where loss events are evident, loans are also assessed collectively, grouped by risk characteristics and account is taken of any impairment arising due to events which are believed to have taken place but have not been specifically identified at the balance sheet date. Collective impairment provisions are calculated for each key portfolio based on recent historical performance, with adjustments for expected changes in losses based on management's judgement. In the receiver of rent portfolio collective provisions are also established for cases where the present strategy might not be sustainable.

For loan portfolios acquired at a discount, the discounts take account of future expected impairments. An impairment charge is only recognised in the income statement if the total receipts from an acquired portfolio are below the original purchase price. Changes to expected cash flows from acquired portfolios are reflected by discounting the future expected cash flows by the original effective interest rate, with any change from the prevailing carrying value being recognised in the income statement.

For financial accounting purposes provisions for impairments of loans to customers when first recognised in the income statement are held in an allowance account. These balances are released to offset against the gross value of the loan when it is written off to profit and loss on the administration system. After this point a salvage balance may be held in respect of any further recoveries expected on the loan.

### (k) Investments in structured entities

Investments in structured entities are intended to be held to maturity and are therefore accounted for on the amortised cost basis. The return from such investments is calculated on the EIR basis.

### (l) Amounts owed by or to group companies

In the accounts of the Company, balances owed by or to other group companies are carried at the current amount outstanding less any provision. Where balances owing between group companies fall within the definition of either financial assets or financial liabilities given in IAS 32 – 'Financial Instruments: Presentation' they are classified as 'Loans and Receivables' or 'Other financial liabilities', respectively.

### (m) Property, plant and equipment

Property, plant and equipment is stated at cost less accumulated depreciation.

Assets held for letting under operating leases are depreciated in equal annual instalments to their estimated residual value over the life of the related lease. This depreciation is deducted in arriving at net lease income and is shown in note 18.

The assets' residual values and useful lives are reviewed by management and adjusted, if appropriate, at each balance sheet date.

Depreciation on operating assets is provided on cost in equal annual instalments over the lives of the assets. Land is not depreciated. The rates of depreciation are as follows:

Freehold premises	2% per annum
Short leasehold premises	over the term of the lease
Computer hardware	25% per annum
Furniture, fixtures and office equipment	15% per annum
Company motor vehicles	25% per annum

### (n) Intangible assets

Intangible assets comprise purchased computer software and other intangible assets acquired in business combinations.

Purchased computer software is capitalised where it has a sufficiently enduring nature and is stated at cost less accumulated amortisation. Amortisation is provided in equal instalments at a rate of 25% per annum.

Other intangible assets acquired in business combinations include brands and business networks and are capitalised in accordance with the requirements of IFRS 3 – 'Business Combinations'. Such assets are stated at attributed cost less accumulated amortisation. Amortisation is provided in equal instalments at a rate determined at the point of acquisition.

### **(o) Investments in subsidiaries**

The Company's investments in subsidiary undertakings are valued at cost less provision for impairment.

### **(p) Own shares**

Shares in Paragon Banking Group PLC held in treasury or by the trustee of the Group's employee share ownership plan are shown on the balance sheet as a deduction in arriving at total equity. Own shares are stated at cost.

### **(q) Retail deposits**

Retail deposits are carried in the balance sheet on the amortised cost basis. The initial fair value recognised represents the cash amount received from the customer.

Interest payable to the customer is expensed to the income statement as interest payable over the deposit term on an EIR basis.

### **(r) Borrowings**

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

Interest and all other costs of the funding are expensed to the income statement as interest payable over the term of the borrowing on an EIR basis.

### **(s) Central bank facilities**

Where central bank facilities are provided at a below market rate of interest, and therefore fall within the definition of government assistance as defined by IAS 20 – 'Accounting for Government Grants and Disclosure of Government Assistance' the liability is initially recognised at the value of its expected cash flows discounted at a market rate of interest for a comparable commercial borrowing. Interest is recognised on this liability on an EIR basis, using the imputed market rate to determine the EIR.

The remaining amount of the advance is recognised as deferred government assistance and released to the profit and loss account through interest payable over the periods during which the arrangement affects profit.

### **(t) Derivative financial instruments**

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

### **(u) Hedging**

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

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

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

## **(v) Taxation**

The charge for taxation represents the expected UK corporation tax and other income taxes arising from the Group's profit for the year. This consists of the current tax which will be shown in tax returns for the year and tax deferred because of temporary differences. This in general, represents the tax impact of items recorded in the current year but which will impact tax returns for periods other than the one in which they are included in the financial statements.

The Group holds a provision for uncertain tax positions at the balance sheet date based on a global assessment of the expected amount that will ultimately be payable.

Tax relating to items taken directly to equity is also taken directly to equity.

## **(w) Deferred taxation**

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

## **(x) Retirement benefit obligations**

The expected cost of providing pensions within the funded defined benefit scheme, determined on the basis of annual valuations by professionally qualified actuaries using the projected unit method, is charged to the income statement. Actuarial gains and losses are recognised in full in the period in which they occur and do not form part of the result for the period, being recognised in the Statement of Comprehensive Income.

The retirement benefit obligation recognised in the balance sheet represents the present value of the defined benefit obligation, as reduced by the fair value of scheme assets at the balance sheet date.

The expected financing cost of the deficit, as estimated at the beginning of the period is recognised in the result for the period within interest payable. Any variances against the estimated amount in the year form part of the actuarial gain or loss.

The charge to the income statement for providing pensions under defined contribution pension schemes is equal to the contributions payable to such schemes for the year.

## **(y) Revenue**

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

## **(z) Fee and commission income**

Other income includes:

- Administration fees charged to borrowers (other than the initial fees included in amortised cost), which are credited when the related service is performed
- Fees charged to third parties for account administration services, which are credited as those services are performed
- Commissions receivable on the sale of insurances, which are taken to profit at the point at which the Group becomes unconditionally entitled to the income
- Maintenance income charged as part of the Group's contract hire arrangements which is recognised as the services are provided. Costs of these services are deducted in other income
- Broker fees receivable on the arrangement of loans funded by third parties, which are taken to profit at the point of completion of the related loan

## **(aa) Share based payments**

In accordance with IFRS 2 – 'Share-based Payments', the fair value at the date of grant of awards to be made in respect of options and shares granted under the terms of the Group's various share based employee incentive arrangements is charged to the profit and loss account over the period between the date of grant and the vesting date.

National Insurance on share based payments is accrued over the vesting period, based on the share price at the balance sheet date.

Where the allowable cost of share based awards for tax purposes is greater than the cost determined in accordance with IFRS 2, the tax effect of the excess is taken to reserves.

## (bb) Dividends

In accordance with IAS 10 – ‘Events after the balance sheet date’, dividends payable on ordinary shares are recognised in equity once they are appropriately authorised and are no longer at the discretion of the Company. Dividends declared after the balance sheet date, but before the authorisation of the financial statements remain within shareholders’ funds.

## (cc) Foreign currency

Foreign currency transactions, assets and liabilities are accounted for in accordance with IAS 21 – ‘The Effects of Changes in Foreign Exchange Rates’. The functional currency of the Group is the pound sterling. Transactions which are not denominated in sterling are translated into sterling at the spot rate of exchange on the date of transaction. Monetary assets and liabilities which are not denominated in sterling are translated at the closing rate on the balance sheet date.

Gains and losses on retranslation are included in interest payable or interest receivable depending on whether the underlying instrument is an asset or a liability, except where deferred in equity in accordance with the cash flow hedging provisions of IAS 39.

## (dd) Segmental reporting

The accounting policies of the segments are the same as those described above for the Group as a whole. Interest payable by each segment includes directly attributable funding and the allocated cost of retail deposit funds utilised. Costs attributed to each segment represent the direct costs incurred by the segment operations.

## 5. FAIR VALUES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

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

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

The Group had no financial assets or liabilities in the year ended 30 September 2017 or the year ended 30 September 2016 valued using level 3 measurements.

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

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

### a) Assets and liabilities carried at fair value

#### *Derivative financial assets and liabilities*

Derivative financial instruments are stated at their fair values in the accounts. The Group uses a number of techniques to determine the fair values of its derivative assets and liabilities, for which observable prices in active markets are not available. These are principally present value calculations based on estimated future cash flows arising from the instruments, discounted using a risk adjusted interest rate. The principal inputs to these valuation models are LIBOR benchmark interest rates for the currencies in which the instruments are denominated, sterling, euros and dollars. The cross-currency basis swaps have a notional principal related to the outstanding currency borrowings and therefore the estimated rate of repayment of these notes also affects the valuation of the swaps. In order to determine the fair values the management applies valuation adjustments to observed data where that data would not fully reflect the attributes of the instrument being valued, such as particular contractual features or the identity of the counterparty. The management reviews the models used on an ongoing basis to ensure that the valuations produced are reasonable and reflect all relevant factors. These valuations are based on market information and they are therefore classified as level 2 measurements. Details of these assets are given in note 38.

#### *Short term investments*

The short term investments described in note 31 are freely traded securities for which a market price quotation is available and are classified as level 1 measurements.

## **b) Assets and liabilities carried at amortised cost**

### ***Cash, bank loans and securitisation borrowings***

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

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

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

### ***Corporate debt***

The Group's retail and corporate bonds are listed on the London Stock Exchange and there is presently a reasonably liquid market in the instruments. It is therefore appropriate to consider that the market price of these borrowings constitutes a fair value. As this valuation is based on a market price, it is considered to be a level 1 measurement.

### ***Retail deposits***

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

### ***Loan assets***

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

### ***Sundry assets and liabilities***

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

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

	<b>2017</b>	<b>2017</b>	2016	2016
	<b>Carrying</b>	<b>Fair</b>	Carrying	Fair
	<b>amount</b>	<b>value</b>	amount	value
	<b>£m</b>	<b>£m</b>	£m	£m
<b>The Group</b>				
<b>Financial assets</b>				
<b>Loans and receivables</b>				
Loans to customers	<b>11,124.1</b>	<b>11,191.9</b>	10,737.5	10,754.4
Cash	<b>1,496.9</b>	<b>1,496.9</b>	1,237.6	1,237.6
	<b>12,621.0</b>	<b>12,688.8</b>	11,975.1	11,992.0
<b>Financial liabilities</b>				
<b>Other liabilities</b>				
Asset backed loan notes	<b>6,475.8</b>	<b>6,475.8</b>	8,374.1	8,374.1
Corporate and retail bonds	<b>444.8</b>	<b>480.4</b>	554.3	573.3
Retail deposits	<b>3,615.4</b>	<b>3,615.1</b>	1,873.9	1,887.2
Secured bank borrowings	<b>1,306.0</b>	<b>1,306.0</b>	1,573.0	1,573.0
	<b>11,842.0</b>	<b>11,877.3</b>	12,375.3	12,407.6
<b>The Company</b>				
<b>Financial assets</b>				
<b>Loans and receivables</b>				
Loans to group companies	<b>59.7</b>	<b>59.7</b>	465.4	465.4
Cash	<b>277.6</b>	<b>277.6</b>	361.3	361.3
	<b>337.3</b>	<b>337.3</b>	826.7	826.7
<b>Financial liabilities</b>				
<b>Other liabilities</b>				
Corporate and retail bonds	<b>444.8</b>	<b>480.4</b>	554.3	573.3
	<b>444.8</b>	<b>480.4</b>	554.3	573.3

## 6. CRITICAL ACCOUNTING ESTIMATES

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

### (a) Impairment losses on loans to customers

Impairment losses on loans are calculated based on statistical models, applied to the present status performance and management strategy for the loans concerned which are used to indicate cases for which a specific provision might be required.

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

Where a letting strategy has been adopted for a buy-to-let case in receivership, with a tenant in place, arrears reduced or cleared and the capital balance potentially reducing, the account will not necessarily attract an impairment provision, dependant on the management strategy adopted.

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

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

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

To illustrate this the impairment provisions were recalculated by changing one factor in the calculation and keeping all others at their current levels. This exercise indicated that:

- Adopting a sale strategy for 5% of currently let buy-to-let properties with a receiver of rent in place would increase impairment provisions by £2.3m (2016: £2.6m)
- 5% of receiver of rent properties currently vacant or for sale becoming fully performing would reduce impairment provisions by £0.3m (2016: £0.4m)
- A 10% reduction in house prices would increase impairment provisions across the first mortgage assets by £2.0m (2016: £3.0m), while a 10% increase would reduce impairment provisions by £1.5m (2016: £2.5m)
- A reduction in cash flows from receiver of rent properties of 10% would increase impairment provision by £0.1m (2016: £0.2m)

It should be noted that all of these changes would, in reality be interrelated so examining them separately may not give reliable guidance to future behaviour.

## **(b) Effective interest rates**

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

To illustrate this the amortised cost values were recalculated by changing one factor in the EIR calculation and keeping all others at their current levels. This exercise indicated that:

- A reduction (or increase) of the assumed average lives of loans secured on residential property by three months would reduce (or increase) balance sheet assets by £2.0m (2016: £1.6m)
- A reduction (or increase) in estimated cash flows from purchased loan assets of 5% would reduce (or increase) balance sheet assets by £15.3m
- An increase of one year in the estimated remaining lives of callable FRN borrowings would increase balance sheet liabilities by an amount between £0.8m and £2.3m

As any of these changes would, in reality, be accompanied by movements in other factors, actual outcomes may differ from these estimates.

## **(c) Impairment of goodwill**

The carrying value of goodwill recognised on acquisitions is verified by use of an impairment test based on the projected cash flows for the cash generating unit, based on management forecasts and other assumptions described in note 42, including a discount factor.

The accuracy of this impairment calculation would therefore be compromised by any differences between these forecasts and the levels of business activity that the cash generating unit is able to achieve in practice. This test will also be affected by the accuracy of the discount factor used.

The sensitivity of the impairment test to reasonably possible movements in these assumptions is discussed in note 42.

## **(d) Retirement benefits**

The present value of the retirement benefit obligation is derived from an actuarial calculation which rests on a number of assumptions relating to inflation, long-term return on investments and mortality. These are listed in note 54. Where actual conditions differ from those assumed the ultimate value of the obligation would be different.

Information on the sensitivity of the valuation to the various assumptions is given in note 54.



## 7. CAPITAL MANAGEMENT

The Group's objectives in managing capital are:

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

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

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

### (a) Dividend policy

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

The distributable reserves of the Company comprise its profit and loss account balance (note 56) and, other than the requirement for the Bank to retain an appropriate level of capital, there are no restrictions preventing profits elsewhere in the Group from being distributed to the parent.

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

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

For the purposes of dividend policy the Group defines dividend cover based on earnings and dividend per share. This is the most common measure used by financial analysts. The expected level of dividend cover in respect of the year, subject to the approval of the final dividend at the Annual General Meeting, is shown below.

	Note	2017	2016
Earnings per share (p)	29	<b>43.1</b>	40.5
Proposed dividend per share in respect of the year (p)	58	<b>15.7</b>	13.5
<b>Dividend cover (times)</b>		<b>2.75</b>	3.00

## (b) Return on tangible equity

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

The Group's consolidated RoTE for the year ended 30 September 2017 is derived as follows:

	Note	2017 £m	2016 £m
Profit for the year after tax		117.2	116.0
Amortisation of intangible assets	20	1.6	1.6
Adjusted profit		118.8	117.6
<b>Divided by</b>			
Opening equity		969.5	969.5
Opening intangible assets	41	(105.4)	(7.7)
Opening tangible equity		864.1	961.8
Closing equity		1,009.4	969.5
Closing intangible assets	41	(104.4)	(105.4)
Closing tangible equity		905.0	864.1
Average tangible equity		884.5	913.0
<b>Return on Tangible Equity</b>		<b>13.4%</b>	<b>12.9%</b>

This table is not subject to audit

## (c) Gearing

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

The debt and equity amounts at 30 September 2017 and at 30 September 2016 were as follows:

	Note	2017 £m	2016 £m
<b>Debt</b>			
Corporate bonds	48	150.0	260.0
Retail bonds	47	297.5	297.5
Bank overdraft		0.6	1.2
Less: Applicable free cash	30	(305.5)	(383.1)
Net debt		142.6	175.6
<b>Equity</b>			
Total equity		1,009.4	969.5
Less: cash flow hedging reserve	56	(2.5)	(2.1)
Adjusted equity		1,006.9	967.4
<b>Total working capital</b>		<b>1,149.5</b>	<b>1,143.0</b>
Debt		12.4%	15.4%
Equity		87.6%	84.6%
<b>Total working capital</b>		<b>100.0%</b>	<b>100.0%</b>

The movements in the proportion of working capital represented by debt and equity during the year ended 30 September 2017, including the scheduled repayment of the £110.0m corporate bond in the year, resulted primarily from the operation of the policy described above.

## (d) Regulatory capital

The Group is subject to supervision by the PRA on a consolidated basis, as a group containing an authorised bank. As part of this supervision the regulator will issue individual capital guidance setting an amount of regulatory capital, which the Group is required to hold relative to its risk weighted assets in order to safeguard depositors from loss in the event of severe losses being incurred by the Group. This is defined by the international Basel III rules, set by the Basel Committee on Banking Supervision ('BCBS') and currently implemented in UK law by EU Regulation 575/2013, referred to as the Capital Requirements Regulation ('CRR').

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

The tables below demonstrate that at 30 September 2017 the Group's regulatory capital of £1,030.5m (2016: £1,005.6m) was comfortably in excess of that required by the regulator.

The Group's regulatory capital differs from its equity as certain adjustments are required by the regulator. A reconciliation of the Group's equity to its regulatory capital determined in accordance with CRD IV at 30 September 2017 is set out below.

	Note	2017 £m	2016 £m
<b>Total equity</b>		<b>1,009.4</b>	969.5
<b>Deductions</b>			
Proposed final dividend	58	(28.9)	(25.5)
Intangible assets	41	(104.4)	(105.4)
<b>Common Equity Tier 1 ('CET1') capital</b>		<b>876.1</b>	838.6
Other Tier 1 capital		-	-
<b>Total Tier 1 capital</b>		<b>876.1</b>	838.6
Corporate bond	48	150.0	260.0
Less: amortisation adjustment	†	-	(97.8)
		<b>150.0</b>	162.2
Collectively assessed credit impairment allowances		<b>4.4</b>	4.8
<b>Total Tier 2 capital</b>		<b>154.4</b>	167.0
<b>Total regulatory capital</b>		<b>1,030.5</b>	1,005.6

† When tier 2 capital instruments have less than five years to maturity the amount eligible as regulatory capital reduces by 20% per annum. As the Group's £110.0m Corporate Bond matured in 2017, this adjustment was required in respect of this instrument at 30 September 2016. No such adjustment is required in respect of the Corporate Bond issued in the year ended 30 September 2016, which matures in 2026.

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

	2017 £m	2016 £m
<b>Credit risk</b>		
Balance sheet assets	<b>4,907.7</b>	4,728.4
Off balance sheet	<b>68.3</b>	51.5
<b>Total credit risk</b>	<b>4,976.0</b>	4,779.9
Operational risk	<b>464.9</b>	445.7
Market risk	-	-
Other	<b>67.8</b>	61.9
<b>Total exposure amount</b>	<b>5,508.7</b>	5,287.5
<b>Solvency ratios</b>	%	%
CET1	<b>15.9</b>	15.9
Total regulatory capital	<b>18.7</b>	19.0

This table is not subject to Audit

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

The table below shows the calculation of the UK leverage ratio, based on the consolidated balance sheet assets adjusted as shown. The PRA has proposed a minimum UK leverage ratio of 3.25% for UK firms.

	Note	2017 £m	2016 £m
Total balance sheet assets		<b>13,682.2</b>	13,518.4
Less: Derivative assets	38	<b>(906.6)</b>	(1,366.4)
Central bank deposits	30	<b>(615.0)</b>	(315.0)
CRDs	39	<b>(1.6)</b>	(0.6)
On-balance sheet items		<b>12,159.0</b>	11,836.4
Less: Intangible assets	41	<b>(104.4)</b>	(105.4)
<b>Total on balance sheet exposures</b>		<b>12,054.6</b>	11,731.0
Derivative assets	38	<b>906.6</b>	1,366.4
Potential future exposure on derivatives		<b>191.3</b>	68.6
<b>Total derivative exposures</b>		<b>1,097.9</b>	1,435.0
Post offer pipeline at gross notional amount		<b>417.9</b>	273.8
Adjustment to convert to credit equivalent amounts		<b>(208.9)</b>	(136.9)
<b>Off balance sheet items</b>		<b>209.0</b>	136.9
Tier 1 capital		<b>876.1</b>	838.6
Total leverage exposure		<b>13,361.5</b>	13,302.9
<b>UK leverage ratio</b>		<b>6.6%</b>	6.3%

This table is not subject to audit

The UK leverage ratio is prescribed by the PRA and differs from the leverage ratio defined by Basel and the CRR due to the exclusion of central bank balances from exposures.

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

## 8. FINANCIAL RISK MANAGEMENT

The principal risks arising from the Group's exposure to financial instruments are credit risk, liquidity risk and market risk (particularly, interest rate risk and currency risk). These risks are discussed in notes 9 to 12 respectively. The Board of Directors has a Risk and Compliance Committee, consisting of the Chairman and the non-executive directors which is responsible for providing oversight and challenge to the Group's risk management arrangements. The Credit Committee and ALCO are executive sub-committees of the Risk and Compliance Committee which monitor performance against the risk appetites set by the Board and make recommendations for changes in risk appetite where appropriate. They also review and, where authorised to do so, agree or amend policies for managing each of these risks, which are summarised in the relevant note. The Corporate Governance Statement in Section B3 (which is not subject to audit) provides further detail on the operations of these committees.

The financial risk management policies have remained unchanged throughout the year and since the year end. The position disclosed below is materially similar to that existing throughout the year.

## 9. CREDIT RISK

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

Primary responsibility for credit risk management across the Group lies with the Credit Committee. The Credit Committee is made up of senior employees, drawn from financial and risk functions independent of the underwriting process. It is chaired by the Chief Risk Officer. Its key responsibilities include setting and reviewing credit policy, controlling applicant quality, tracking account performance against targets, agreeing product criteria and lending guidelines and monitoring performance and trends.

The assets of the Group and the Company which are subject to credit risk are set out below:

	Note	The Group		The Company	
		2017 £m	2016 £m	2017 £m	2016 £m
Loans to customers	32	<b>11,124.1</b>	10,737.5	-	-
Derivative financial assets	38	<b>906.6</b>	1,366.4	-	-
Amounts owed by Group companies	39	-	-	<b>40.1</b>	84.5
Accrued interest income	39	<b>0.2</b>	0.3	-	0.1
CSA assets	39	<b>2.0</b>	3.7	-	-
CRDs	39	<b>1.6</b>	0.6	-	-
Trade receivables	39	<b>4.2</b>	2.4	-	-
Short term investments	31	-	7.1	-	-
Cash	30	<b>1,496.9</b>	1,237.6	<b>277.6</b>	361.3
<b>Maximum exposure to credit risk</b>		<b>13,535.6</b>	13,355.6	<b>317.7</b>	445.9

While this maximum exposure represents the potential loss which might have to be accounted for by the Group, the terms on which a significant proportion of the Group's loan assets are funded, described under Liquidity Risk in note 10, limit the amount of principal repayments on the Group's securitised and warehouse borrowings in cases of capital losses on assets, considerably reducing the effective shareholder value at risk.

### Loans to customers

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

The Group's loan assets at 30 September 2017 are analysed as follows:

	2017 £m	2017 %	2016 £m	2016 %
Buy-to-let mortgages	<b>9,836.5</b>	<b>88.4%</b>	9,621.2	89.6%
Owner-occupied mortgages	<b>19.0</b>	<b>0.2%</b>	19.4	0.2%
<b>Total first charge residential mortgages</b>	<b>9,855.5</b>	<b>88.6%</b>	9,640.6	89.8%
Second charge mortgage loans	<b>490.7</b>	<b>4.4%</b>	526.8	4.9%
<b>Loans secured on residential property</b>	<b>10,346.2</b>	<b>93.0%</b>	10,167.4	94.7%
Development finance	<b>42.3</b>	<b>0.4%</b>	9.1	0.1%
Commercial mortgages	<b>2.7</b>	-	2.9	-
<b>Loans secured on property</b>	<b>10,391.2</b>	<b>93.4%</b>	10,179.4	94.8%
Motor finance loans	<b>163.0</b>	<b>1.5%</b>	95.3	0.9%
Other consumer loans	<b>219.1</b>	<b>2.0%</b>	195.1	1.8%
Asset finance loans	<b>325.0</b>	<b>2.9%</b>	250.4	2.3%
Factoring and discounting balances	<b>23.8</b>	<b>0.2%</b>	16.9	0.2%
Other loans	<b>2.0</b>	-	0.4	-
<b>Total loans to customers</b>	<b>11,124.1</b>	<b>100.0%</b>	10,737.5	100.0%

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

The Group's underwriting philosophy is based on a combination of sophisticated individual credit assessment and the automated efficiencies of a scored decision making process. Information on each applicant is combined with data taken from a credit reference bureau to provide a complete credit picture of the applicant and the borrowing requested. Key information is validated through a combination of documentation and statistical data which collectively provides evidence of the applicant's ability and willingness to pay the amount contracted under the loan agreement. In assessing credit risk, even where the Group would have security on a proposed loan, an applicant's ability and propensity to repay the loan remain the principal factors in the decision to lend.

In considering whether to acquire pools of loan assets, the Group will undertake a due diligence exercise on the underlying loan accounts. Such assets are generally not fully performing and are offered at a discount to their current balance. The Group's procedures may include inspection of original loan documents, verification of security and the examination of the credit status of borrowers. Current and historic cash flow data will also be examined. The objective of the exercise is to establish, to a level of confidence similar to that provided by the underwriting process, that the assets will generate sufficient cash flows to recover the Group's investment and generate an appropriate return without exposing the Group to material operational or conduct risks.

First mortgages and secured loans are secured by charges over residential properties in England and Wales, or similar Scottish or Northern Irish securities. Motor finance loans and asset finance loans are effectively secured by the financed asset. Development finance loans are secured by the development property and various charges over the build.

An analysis of the indexed loan to value ratio ('LTV') for those loan accounts secured on residential property by value at 30 September 2017 is set out below. For acquired accounts the effect of any discount on purchase is allowed for.

	<b>2017</b>	<b>2017</b>	2016	2016
	<b>First mortgages</b>	<b>Secured loans</b>	First mortgages	Secured loans
	%	%	%	%
<b>Loan to value ratio</b>				
Less than 70%	<b>62.1</b>	<b>56.7</b>	60.7	50.9
70% to 80%	<b>25.0</b>	<b>17.5</b>	23.4	17.8
80% to 90%	<b>9.5</b>	<b>11.5</b>	11.3	13.0
90% to 100%	<b>1.3</b>	<b>7.1</b>	2.2	8.9
Over 100%	<b>2.1</b>	<b>7.2</b>	2.4	9.4
	<b>100.0</b>	<b>100.0</b>	100.0	100.0
<b>Average loan to value ratio</b>	<b>66.3</b>	<b>70.0</b>	67.1	72.7
<i>of which</i>				
Buy-to-let	<b>66.4</b>		67.2	
Owner-occupied	<b>30.9</b>		27.5	

The regionally indexed LTVs shown above are affected by changes in house prices, with the Nationwide house price index, for the UK as a whole, registering an annual increase of 2.0% in the year ended 30 September 2017 (2016: 5.3%).

The number of accounts in arrears by asset class, based on the most commonly quoted definition of arrears for the type of asset, at 30 September 2017 and 30 September 2016, compared to the industry averages at those dates published by UK Finance ('UKF') (formerly the CML) and the FLA, was:

	<b>2017</b>	2016
	%	%
<b>First mortgages</b>		
Accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	<b>0.08</b>	0.11
Buy-to-let accounts excluding receiver of rent cases	<b>0.02</b>	0.02
Owner-occupied accounts	<b>3.55</b>	3.23
UKF data for mortgage accounts more than three months in arrears		
Buy-to-let accounts including receiver of rent cases	<b>0.45</b>	0.52
Buy-to-let accounts excluding receiver of rent cases	<b>0.41</b>	0.47
Owner-occupied accounts	<b>0.95</b>	1.03
All mortgages	<b>0.86</b>	0.94
<b>Second charge mortgage loans</b>		
Accounts more than 2 months in arrears		
All accounts	<b>17.55</b>	17.15
Post-2010 originations	<b>0.06</b>	0.00
Legacy cases	<b>16.75</b>	16.33
Purchased assets	<b>19.69</b>	17.86
FLA data for secured loans	<b>10.70</b>	12.40
<b>Car loans</b>		
Accounts more than 2 months in arrears	<b>0.67</b>	0.30
FLA data for point of sale hire purchase	<b>1.70</b>	1.50
<b>Asset finance loans</b>		
Accounts more than 2 months in arrears	<b>0.97</b>	0.82
FLA data for business lease / hire purchase loans	<b>0.60</b>	0.60
<b>Other loans</b>		
Accounts more than 2 months in arrears	<b>96.03</b>	96.35

No published industry data for asset classes comparable to the Group's other books has been identified. Where revised data at 30 September 2016 has been published by the FLA or UKF, the comparative industry figures above have been amended.

Arrears information is not given for development finance or factoring activities as the structure of the products means that such a measure is not relevant.

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

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

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

The payment status of the carrying balances of the Group's live loan assets, at 30 September 2017 and at 30 September 2016 split between those accounts considered as performing and those included in the population for impairment testing, is shown below. Balances for immaterial asset classes are not shown. 'Asset finance loans' below includes other related loan balances. Fully provided non-live accounts are excluded from the tables below.

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

### *First mortgages*

	<b>2017</b>	2016
	<b>£m</b>	£m
Not past due	<b>9,724.2</b>	9,528.1
Arrears less than 3 months	<b>112.6</b>	82.1
Performing accounts	<b>9,836.8</b>	9,610.2
Arrears 3 to 6 months	<b>1.1</b>	2.4
Arrears 6 to 12 months	<b>1.9</b>	2.8
Arrears over 12 months	<b>7.7</b>	11.0
Possessions and similar cases	<b>22.5</b>	31.1
Impairment population	<b>33.2</b>	47.3
<b>Total gross balances</b>	<b>9,870.0</b>	9,657.5
Impairment provision on live cases	<b>(12.7)</b>	(16.4)
Timing adjustments	<b>(1.8)</b>	(0.5)
<b>Carrying balance</b>	<b>9,855.5</b>	9,640.6



## Consumer and asset finance

	Second charge mortgage loans	Motor finance loans	Asset finance loans	Total
	£m	£m	£m	£m
<b>30 September 2017</b>				
Not past due	400.8	158.0	315.3	874.1
Arrears less than 2 months	20.5	5.0	10.0	35.5
Performing accounts	421.3	163.0	325.3	909.6
Arrears 2 to 6 months	14.9	0.7	0.5	16.1
Arrears 6 to 9 months	7.1	0.2	0.7	8.0
Arrears 9 to 12 months	5.4	0.1	-	5.5
Arrears over 12 months	46.2	0.3	0.1	46.6
Specifically impaired asset finance cases	-	-	2.7	2.7
Impairment population	73.6	1.3	4.0	78.9
<b>Total gross balances</b>	<b>494.9</b>	<b>164.3</b>	<b>329.3</b>	<b>988.5</b>
Impairment provision on live cases	(2.1)	(1.2)	(3.1)	(6.4)
Timing adjustments	(2.1)	(0.1)	(1.2)	(3.4)
<b>Carrying balance</b>	<b>490.7</b>	<b>163.0</b>	<b>325.0</b>	<b>978.7</b>

## 30 September 2016

Not past due	415.0	92.7	251.6	759.3
Arrears less than 2 months	33.3	3.0	1.5	37.8
Performing accounts	448.3	95.7	253.1	797.1
Arrears 2 to 6 months	20.3	0.2	1.0	21.5
Arrears 6 to 9 months	8.3	-	0.3	8.6
Arrears 9 to 12 months	7.4	-	-	7.4
Arrears over 12 months	51.0	0.2	0.4	51.6
Specifically impaired asset finance cases	-	-	3.3	3.3
Impairment population	87.0	0.4	5.0	92.4
<b>Total gross balances</b>	<b>535.3</b>	<b>96.1</b>	<b>258.1</b>	<b>889.5</b>
Impairment provision on live cases	(3.4)	(0.6)	(0.5)	(4.5)
Timing adjustments	(5.1)	(0.2)	(3.9)	(9.2)
<b>Carrying balance</b>	<b>526.8</b>	<b>95.3</b>	<b>253.7</b>	<b>875.8</b>

## Other consumer loans

	2017	2016
	£m	£m
Not past due	6.7	4.1
Arrears less than 1 month	0.3	0.3
Performing accounts	7.0	4.4
Arrears 1 to 3 months	0.5	0.4
Arrears 3 to 6 months	0.9	0.7
Arrears 6 to 12 months	2.9	2.3
Arrears over 12 months	223.6	203.5
Impairment population	227.9	206.9
<b>Total gross balances</b>	<b>234.9</b>	<b>211.3</b>
Impairment provision	(15.8)	(16.4)
Timing adjustments	-	-
<b>Carrying balance</b>	<b>219.1</b>	<b>194.9</b>

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

## Acquired assets

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

However, to aid comparability the 84 and 120 month ERC values for the Group's purchased assets, are set out below. These are derived using the same models and assumptions used in the EIR calculations, but the differing bases of calculation lead to different outcomes.

	2017	2017	2017	2016	2016	2016
	Carrying value	84 month ERC	120 month ERC	Carrying value	84 month ERC	120 month ERC
	£m	£m	£m	£m	£m	£m
Loans to customers	503.5	608.9	688.8	533.9	651.3	740.7

Amounts shown as loans to customers above include loans disclosed as first mortgages and other loans (note 32) and are included in the aging tables above at their carrying values.

## Buy-to-let receiver of rent cases

Where a buy-to-let mortgage customer in England or Wales falls into arrears on their account the Group has the power to appoint a receiver of rent under the Law of Property Act. The receiver will then manage the property on behalf of the customer, collecting rents and remitting them to make payments on the account. While the receiver has the power to sell the property, in many cases they will operate it as a buy-to-let on at least a short to medium term basis, potentially longer, depending on the individual circumstances of the case. This causes less disruption to the tenants and may result in the mortgage account returning to performing status and the property being handed back to the customer.

The Group's outstanding exposure to buy-to-let loans with an appointed receiver is set out below.

	2017 Gross £m	2017 Provision £m	2017 Net £m	2016 Gross £m	2016 Provision £m	2016 Net £m
<b>Performing loans</b>						
Let with less than 3 months arrears	113.3	-	113.3	122.9	-	122.9
<b>Impaired loans</b>						
Let with over 3 months arrears	7.0	(2.7)	4.3	10.2	(3.5)	6.7
Vacant or on sale	21.7	(6.8)	14.9	29.5	(7.8)	21.7
Impairment population	28.7	(9.5)	19.2	39.7	(11.3)	28.4
<b>Total gross balances</b>	<b>142.0</b>	<b>(9.5)</b>	<b>132.5</b>	162.6	(11.3)	151.3
Emergency provision	-	(2.4)	(2.4)	-	(2.9)	(2.9)
<b>Carrying balance</b>	<b>142.0</b>	<b>(11.9)</b>	<b>130.1</b>	162.6	(14.2)	148.4

### Development finance

Development finance loans do not require customers to make payments during the life of the loan, therefore arrears and past due measures cannot be used to monitor credit risk. Instead, cases are monitored on an individual basis by management and Credit Risk. At 30 September 2017, this monitoring showed no accounts in default. The average loan to gross development value ratio for the portfolio at year end, a measure of security cover, was 60.6%.

### Institutional exposures

In order to control credit risk relating to counterparties to the Group's derivative financial instruments and cash deposits, ALCO determines which counterparties the Group will deal with, establishes limits for each counterparty and monitors compliance with those limits. Such counterparties are typically highly rated banks and, for all cash deposits and derivative positions held within the Group's securitisation structures, must comply with criteria set out in the financing arrangements, which are monitored externally. Where a derivative counterparty to the Group's cross-currency basis swaps fails to meet the required criteria they are obliged under the terms of the instruments to set aside a cash collateral deposit. The amounts of these cash collateral deposits, which do not form part of the Group's cash position, are given in note 38.

The Group's exposure to credit risk in respect of the counterparties to its derivative financial assets, analysed by their long term credit rating as determined by Fitch is set out below.

	2017 £m	2016 £m
<b>Carrying value of derivative financial assets</b>		
Counterparties rated		
AA-	213.3	218.7
A+	41.8	58.1
A	615.4	969.2
BBB+	36.1	120.4
Gross exposure (note 38)	906.6	1,366.4
Collateral amounts posted	(723.6)	(1,184.2)
<b>Net exposure</b>	<b>183.0</b>	182.2

The Group's cash balances are held in sterling at the Bank of England and at highly rated banks in current accounts and as short fixed term deposits and money market placements. The Group has a large exposures policy to mitigate any concentration risk in respect of its cash deposits. Credit risk on these balances, and the interest accrued thereon, is considered to be minimal.

### Trade debtors

The Group's trade debtors balance represents principally amounts outstanding on unpaid operating lease obligations in the asset finance business, where similar acceptance criteria to those used for finance lease cases apply.

## 10. LIQUIDITY RISK

Liquidity risk is the risk that the Group might be unable to satisfy any payment which is required to be made out of cash available to it at the time.

The Group's principal source of liquidity risk is from its retail deposit funding. Deposit balances raised are typically used to support lending activities where maturity is over a longer period than that of the deposits. This maturity transformation exposes the Group to liquidity risk.

Further liquidity risk in the medium term arises from the Group's corporate and retail bonds which are used to support its general operations and from its participation in central bank funding schemes.

The remaining liquidity risk relates to ensuring that sufficient funding is available to fund the Group's participation in the SPVs, provide capital support for new loans and working capital for the Group. This responsibility rests with ALCO which makes recommendations for the Group's liquidity policy for Board approval and uses detailed cash flow projections to ensure that an adequate level of liquidity is available at all times.

Where assets are funded by non-recourse arrangements, through the securitisation process, liquidity risk is effectively eliminated.

### Retail deposits

The Group retail funding strategy is focused on building a stable mix of deposit products. A high proportion of balances, 98.8%, are protected by the Financial Services Compensation Scheme ('FSCS') which mitigates against the possibility of a retail run.

The cash outflows, including principal and estimated interest, contractually required by the Group's retail deposit balances analysed by the earliest date at which repayment can be demanded are set out below:

	<b>2017</b>	2016
	<b>£m</b>	£m
Payable in less than one year or on demand	<b>2,259.1</b>	1,036.8
Payable in one to two years	<b>795.5</b>	596.0
Payable in two to five years	<b>687.4</b>	312.9
	<b>3,742.0</b>	1,945.7

In order to reduce the liquidity risk inherent in the Group's retail deposit balances, the PRA requires that the Bank, like other regulated banks, maintains a buffer of liquid assets to ensure it has sufficient available funds at all times to protect against unforeseen circumstances. The amount of this buffer is calculated using Individual Liquidity Guidance ('ILG') set by the PRA based on the ILAAP submitted by the Bank. The ILAAP determines the liquid resources that must be maintained in the Bank to meet its Overall Liquidity Adequacy Requirement ('OLAR') and to ensure that it can meet its liabilities as they fall due. It is based on an analysis of its forecast cash requirements and their predicted behaviour in stressed conditions.

At 30 September 2017 the liquidity buffer of High Quality Liquid Assets ('HQLA') comprised the following on and off balance sheet assets, all held within the Bank.

	<i>Note</i>	<b>2017</b>	2016
		<b>£m</b>	£m
Balances with central banks	30	<b>615.0</b>	315.0
Short term investments	31	-	7.1
Total on balance sheet liquidity		<b>615.0</b>	322.1
FLS drawings	49	<b>109.0</b>	108.8
<b>Total HQLA</b>		<b>724.0</b>	430.9

The Bank manages its Liquidity Coverage Ratio ('LCR'), the level of its HQLA relative to its short term forecast net cash outflows. A minimum level of LCR, the Liquidity Coverage Requirement is set through regulation for all regulated financial institutions. As at 30 September 2017, the Bank's LCR was comfortably above the required minimum regulatory standard. The Bank also monitors its Net Stable Funding Ratio ('NSFR') which measures the stability of the funding profile in relation to the composition of its assets and off-balance sheet activities.

Liquidity is not regulated at Group level.

## Borrowings

Set out below is the contractual maturity profile of the Group's and the Company's borrowings at 30 September 2017 and 30 September 2016 based on their carrying values. These are analysed between non-recourse (securitisation) and other funding, representing the liquidity exposure.

	Financial liabilities falling due:				Total £m
	In one year or less, or on demand	In more than one year, but not more than two years	In more than two years but not more than five years	In more than five years	
	£m	£m	£m	£m	
<b>The Group</b>					
<b>30 September 2017</b>					
Secured bank borrowings	-	-	300.3	1,005.7	1,306.0
Asset backed loan notes	-	-	142.4	6,333.4	6,475.8
Total non-recourse funding	-	-	442.7	7,339.1	7,781.8
Bank overdrafts	0.6	-	-	-	0.6
Retail bonds	-	-	184.0	111.7	295.7
Corporate bond	-	-	-	149.1	149.1
Central bank facilities	-	-	700.0	-	700.0
	0.6	-	1,326.7	7,599.9	8,927.2
<b>30 September 2016</b>					
Secured bank borrowings	-	-	486.7	1,086.3	1,573.0
Asset backed loan notes	-	-	136.8	8,237.3	8,374.1
Total non-recourse funding	-	-	623.5	9,323.6	9,947.1
Bank overdrafts	1.2	-	-	-	1.2
Retail bonds	-	-	59.5	235.8	295.3
Corporate bond	110.0	-	-	149.0	259.0
Central bank facilities	-	-	-	-	-
	111.2	-	683.0	9,708.4	10,502.6
<b>The Company</b>					
<b>30 September 2017</b>					
Retail bonds	-	-	184.0	111.7	295.7
Corporate bond	-	-	-	149.1	149.1
	-	-	184.0	260.8	444.8
<b>30 September 2016</b>					
Retail bonds	-	-	59.5	235.8	295.3
Corporate bond	110.0	-	-	149.0	259.0
	110.0	-	59.5	384.8	554.3

IFRS 7 requires the disclosure of future contractual cash flows (including interest) on these borrowings, and these are shown below.

## Non-recourse funding

The Group has historically used securitisation as a principal source of funding, but currently only accesses this market on a strategic basis. In a securitisation an SPV company within the Group will issue asset backed loan notes ('Notes') secured on a pool of mortgage or other loan assets beneficially owned by the SPV in a public offer. The Notes have a maturity date later than the final repayment date for any asset in the pool, typically over thirty years from the issue date. The noteholders are entitled to receive repayment of the Note principal from principal funds generated by the loan assets from time to time, but their right to the repayment of principal is limited to the cash available in the SPV. Similarly, payment of accrued interest to the noteholders is limited to cash generated within the SPV. There is no requirement for any Group company other than the issuing SPV to make principal or interest payments in respect of the Notes. This matching of the maturities of the assets and the related funding substantially reduces the Group's exposure to liquidity risk. Details of Notes in issue are given in note 45 and the assets backing the Notes are shown in notes 33 and 34.

In each case the Group provides funding to the SPV at inception, subordinated to the Notes, which means that the primary credit risk on the pool assets is retained within the Group. The Group receives the residual income generated by the assets. These factors mean that the risks and rewards of ownership of the assets remain with the Group, and hence the loans remain on the Group's balance sheet.

Cash received from time to time in each SPV is held until the next interest payment date when, following payment of principal, interest and the associated costs of the SPV, the remaining balances become available to the Group. Cash balances are also held within each SPV to provide credit enhancement for the particular securitisation, allowing interest and principal payments to be made even if some of the loans default. To provide further credit enhancement in certain SPVs, specific economic trigger events exist which cause additional cash to be retained in the SPV rather than being transferred to the Group. While the Group can, if it chooses, contribute additional cash to cover these requirements, it is under no obligation to do so. No such events occurred in the year ended 30 September 2017 or the year ended 30 September 2016. Whether any such events in any of the Group's other SPVs arise in the future will depend on the performance of the general economy and its impact on mortgage and loan arrears in each SPV. However, if all of the remaining trigger events occurred, a total of £80.5m of additional cash would be retained in the SPV companies (2016: £92.5m). The cash balances of the SPV companies are included within the restricted cash balances disclosed in note 30 as 'securitisation cash'.

Newly originated mortgage loans may be initially funded by a revolving loan facility or 'warehouse' from the point of their origination until their inclusion in a securitisation transaction or other refinancing. A warehouse company functions in a similar way to an SPV, except that funds are drawn down as advances are made, repaid when loans are securitised or refinanced by an internal asset sale and may subsequently be redrawn up to the end of a commitment period.

Repayment of the principal amount of the facilities is not required unless amounts are realised from the secured assets either through repayment, securitisation or asset sales, even after the end of the period. There is no further recourse to other assets of the Group in respect of either interest or principal on the borrowings. The Group has reduced its available warehouse facilities in the period.

As with the SPVs, the Group provides subordinated funding to the warehouse companies and restricted cash balances are held within them. Contributions to the subordinated funding are made each time a drawing on the facility concerned is made. These amounts provide credit enhancement to the warehouse and cover certain fees. This funding is repaid when assets are securitised or refinanced by an internal asset sale. The amount of subordinated funding outstanding in the three active warehouse companies at 30 September 2017 was £71.8m (2016: £118.8m).

Further details of the warehouse facilities are given in note 46 and details of the loan assets within the warehouses are given in note 33.

The final repayment date for all of the securitisation borrowings and the Paragon Second Funding warehouse borrowing is more than five years from the balance sheet date, the earliest falling due in 2033 and the latest in 2050.

The equivalent sterling principal amount outstanding at 30 September 2017 under the SPV and warehouse arrangements, allowing for the effect of the cross currency basis swaps, described under currency risk (note 12), which are net settled with the loan payments, was £6,894.6m (2016: £8,596.3m). The total sterling amount payable under these arrangements, were these principal amounts to remain outstanding until the final repayment date would be £10,576.0m (2016: £13,295.5m). As the principal will, as discussed above, reduce as customers repay or redeem their accounts, the cash flow will be far less than this amount in practice.

## Corporate debt

In February 2013, the Company initiated a Euro Medium Term Note issuance programme, with a maximum issuance of £1,000.0m. The Company had the ability to issue further notes under the programme and has issued three fixed rate bonds for a total of £297.5m, with interest rates ranging from 6.000% to 6.125% and maturities ranging from December 2021 to August 2023, the most recent issue of £112.5m being made in August 2015. This programme offers the Group opportunities to raise further working capital if needed.

During the year ended 30 September 2016 the Group demonstrated its ability to access the capital markets when it issued a £150.0m Tier 2 Bond.

The Group's ability to issue debt is supported by its BBB- credit rating issued by Fitch and renewed in the period.

None of the Group's corporate or retail bond issuance falls due for payment earlier than 2020.

## Central bank facilities

The Group has accessed term facilities under the central bank schemes described in note 49. The Group has prepositioned further assets with the Bank of England which can be used to release more funds for liquidity or other purposes. At 30 September 2017 the amount of drawings available in respect of prepositioned assets was £84.1m.

## Contractual cash flows

The total undiscounted amounts, inclusive of estimated interest, which would be payable in respect of the non-securitisation borrowings of the Group and the Company, should those balances remain outstanding until the contracted repayment date, or the earliest date on which repayment can be required, are set out below.

	Contingent liabilities £m	Corporate bonds £m	Retail bonds £m	Central bank facilities £m	Total £m
<b>a) The Group</b>					
<b>30 September 2017</b>					
Payable in less than one year	2.5	10.9	18.0	2.1	33.5
Payable in one to two years	3.5	10.9	18.0	4.8	37.2
Payable in two to five years	8.1	32.6	228.9	712.6	982.2
Payable in over five years	-	193.5	126.0	-	319.5
	14.1	247.9	390.9	719.5	1,372.4

<b>30 September 2016</b>					
Payable in less than one year	1.9	125.0	18.0	-	144.9
Payable in one to two years	2.5	10.9	18.0	-	31.4
Payable in two to five years	6.6	32.6	111.3	-	150.5
Payable in over five years	5.0	204.4	261.6	-	471.0
	16.0	372.9	408.9	-	797.8

	Corporate bonds £m	Retail bonds £m	Total £m
<b>b) The Company</b>			
<b>30 September 2017</b>			
Payable in less than one year	10.9	18.0	28.9
Payable in one to two years	10.9	18.0	28.9
Payable in two to five years	32.6	228.9	261.5
Payable in over five years	193.5	126.0	319.5
	247.9	390.9	638.8

<b>30 September 2016</b>			
Payable in less than one year	125.0	18.0	143.0
Payable in one to two years	10.9	18.0	28.9
Payable in two to five years	32.6	111.3	143.9
Payable in over five years	204.4	261.6	466.0
	372.9	408.9	781.8

Amounts payable in respect of the 'other accruals' and 'trade creditors' shown in note 50 fall due within one year. The cash flows described above will include those for interest on borrowings accrued at 30 September 2017 disclosed in note 50.

The cash flows which are expected to arise from derivative contracts in place at the year end, estimating future floating rate payments and receipts on the basis of the yield curve at the balance sheet date are as follows:

	<b>2017</b>	2016
	<b>Total cash outflow / (inflow)</b>	Total cash outflow / (inflow)
	<b>£m</b>	£m
<b>On derivative liabilities</b>		
Payable in less than one year	<b>(2.0)</b>	0.4
Payable in one to two years	<b>1.7</b>	0.4
Payable in two to five years	<b>10.9</b>	0.9
Payable in over five years	<b>0.2</b>	0.5
	<b>10.8</b>	2.2
<b>On derivative assets</b>		
Payable in less than one year	<b>(3.9)</b>	(8.0)
Payable in one to two years	<b>(2.3)</b>	(4.1)
Payable in two to five years	<b>(0.7)</b>	(2.3)
Payable in over five years	-	(0.5)
	<b>(6.9)</b>	(14.9)
	<b>3.9</b>	(12.7)

## 11. INTEREST RATE RISK

Interest rate risk is the current or prospective risk to capital or earnings arising from adverse movements in interest rates. The Group's exposure to this risk is a natural consequence of its lending, deposit taking and borrowing activities, as some of its financial assets and liabilities bear interest at rates which float with various market rates while others are fixed, either for a term or for their whole lives. Such risk is referred to as Interest Rate Risk in the Banking Book ('IRRBB'). The Group does not seek to generate income from taking interest rate risk and aims to minimise exposures that occur as a natural consequence of carrying out its normal business activities.

The Group has a dedicated Treasury function which is responsible for the day-to-day management of interest rate risk within Board approved limits. Control and oversight is provided by ALCO which reports to the Risk and Compliance Committee.

The Group's risk management framework for IRRBB has been enhanced over the last year to reflect the BCBS Principles and methods expected to be used by banks for measuring, managing, monitoring and controlling such risks. The Group will continue to develop these processes as interpretation of these standards becomes clearer as they become more widely implemented.

IRRBB is managed through Board approved risk appetite limits and policies. The Group seeks to match the structure of assets and liabilities naturally where possible or by using appropriate financial instruments, such as interest rate swaps.

### IRRBB exposures

Risk exposure in the Group's operations might occur through:

- Gap or re-pricing risk. The risk created when interest rates on assets, liabilities and off-balance sheet items reprice at different times causing them to move by different amounts
- Basis risk. The risk arising where assets and liabilities re-price with reference to different reference interest rates, for example Bank of England base rate and LIBOR. Relative changes in the difference between the reference rates over time may impact earnings
- Option or prepayment risk. The risk that settlement of asset and liability balances at different times from those forecast due to economic conditions or customer behaviour may create a mismatch in future periods

Due to the maturity transformation inherent in the Group's business model it is also exposed to the risk that the relationship of the market rates affecting the shorter term funding balance to those affecting the longer term lending balance will have altered when the funding has to be refinanced.



The Group measures these risks through a combination of economic value and earnings-based measures considering prepayment risk:

- Economic Value of Equity ('EVE') – a range of parallel and non-parallel interest rate stresses are applied to assess the change in market value from assets, liabilities and off-balance sheet items re-pricing at different times
- Net Interest Income ('NII') - impact on earnings from a range of interest rate stresses

### Interest rate sensitivity

To provide a broad indication of the Group's exposure to interest rate movements, the notional impact of a 1.0% change in UK interest rates on the equity of the Group at 30 September 2017, and the notional annualised impact of such a change on the operating profit of the Group, based on the year-end balance sheet have been calculated.

As a simplification this calculation assumes that all relevant UK interest rates move by the same amount in parallel and that all repricing takes place at the balance sheet date.

On this basis, a 1.0% increase in UK interest rates would reduce the Group's equity at 30 September 2017 by £2.1m (2016: £3.1m) and increase profit before tax by £12.3m (2016: increase by £1.9m).

This calculation allows only for the direct effects of any change in UK interest rates. In practice such a change might have wider economic consequences which would themselves potentially affect the Group's business and results.

Although certain of the Group's borrowings have interest rates dependent on US Dollar and Euro LIBOR rates, the effect of the cross currency basis swaps is such that the Group's results have no material exposure to movements in these rates. The effects of independent 1.0% increases in US or Euro interest rates would be to increase the Group's equity by £0.3m (2016: £1.2m) and £1.9m (2016: £2.3m) respectively, however, in reality these movements would be mitigated by movements in UK interest rates and exchange rates.

It should be noted that these sensitivities are illustrative only, and much simplified from those used to manage IRRBB in practice.

### The Company

All the borrowings of the Company have fixed interest rates. Assets and liabilities with other group companies bear interest at floating rates based on LIBOR which reset within three months of the balance sheet date; all other balances are non-interest bearing.

## 12. CURRENCY RISK

The Group has very limited appetite for any uncovered exposure to foreign currency movements.

All of the Group's significant assets and liabilities are denominated in sterling with the exception of the asset backed loan notes denominated in US dollars and euros, which are described in note 45. Although IAS 39 requires that they be accounted for as currency liabilities and valued at their spot rates, a condition of the issue of these notes was that bespoke interest rate and currency swaps ('cross-currency basis swaps') were put in place for the duration of the borrowing, having the effect of converting the liability to a LIBOR linked floating rate sterling borrowing eliminating currency risk for these exposures.

The equivalent sterling principal amounts of notes in issue under the arrangements described above, and their carrying values at 30 September 2017 and 30 September 2016 are:

	<b>2017</b>	<b>2017</b>	2016	2016
	<b>Equivalent sterling principal</b>	<b>Carrying value</b>	Equivalent sterling principal	Carrying value
	<b>£m</b>	<b>£m</b>	£m	£m
US dollar notes	<b>974.7</b>	<b>1,395.9</b>	1,829.5	2,667.6
Euro notes	<b>1,652.7</b>	<b>2,127.3</b>	2,004.1	2,532.5
	<b>2,627.4</b>	<b>3,523.2</b>	3,833.6	5,200.1

Where the asset finance business contracts to purchase assets for leasing in currency these liabilities are hedged by the purchase of appropriate currency balances.

As a result of these arrangements the Group has no material exposure to foreign currency risk, and no sensitivity analysis is presented for currency risk.

None of the assets or liabilities of the Company are denominated in foreign currencies.

### 13. ACQUISITIONS

During the year ended 30 September 2016, the Group acquired two businesses, Paragon Asset Finance ('PAF') (which changed its name from Paragon Bank Asset Finance after the year end) on 3 November 2015 and Premier Asset Finance ('Premier') on 30 September 2016.

No adjustments have been made in the year to the fair values at acquisition for PAF reported in the financial statements for the year ended 30 September 2016 and these values are now therefore final.

Following the agreement of the completion accounts for Premier during the year the cash consideration payable was reduced by £0.3m and the goodwill balance has been adjusted accordingly (note 41). No other fair value balances at acquisition have been revised.

### 14. SEGMENTAL INFORMATION

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

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

Dedicated financing and administration costs of each of these businesses are allocated to the segment. Shared central costs are not allocated between segments, nor is income from central cash balances or the carrying costs of unallocated savings balances.

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

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

Other assets and liabilities are not allocated between segments.

The costs arising in the year ended 30 September 2016 from the PAF and Premier acquisitions of £3.1m have not been allocated as they are not directly related to customer facing activity.

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

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

#### Year ended 30 September 2017

	<b>Mortgages</b>	<b>Commercial Lending</b>	<b>Idem Capital</b>	<b>Total Segments</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
Interest receivable	<b>274.7</b>	<b>33.8</b>	<b>98.9</b>	<b>407.4</b>
Interest payable	<b>(123.6)</b>	<b>(10.6)</b>	<b>(11.4)</b>	<b>(145.6)</b>
Net interest income	<b>151.1</b>	<b>23.2</b>	<b>87.5</b>	<b>261.8</b>
Other operating income	<b>9.6</b>	<b>9.9</b>	<b>0.7</b>	<b>20.2</b>
Total operating income	<b>160.7</b>	<b>33.1</b>	<b>88.2</b>	<b>282.0</b>
Direct costs	<b>(13.7)</b>	<b>(18.9)</b>	<b>(10.8)</b>	<b>(43.4)</b>
Provisions for losses	<b>(3.7)</b>	<b>(0.1)</b>	<b>(1.5)</b>	<b>(5.3)</b>
	<b>143.3</b>	<b>14.1</b>	<b>75.9</b>	<b>233.3</b>

Year ended 30 September 2016

	Mortgages	Commercial Lending	Idem Capital	Total Segments
	£m	£m	£m	£m
Interest receivable	282.2	25.9	101.0	409.1
Interest payable	(139.5)	(8.3)	(13.2)	(161.0)
Net interest income	142.7	17.6	87.8	248.1
Other operating income	7.7	8.4	4.7	20.8
Total operating income	150.4	26.0	92.5	268.9
Direct costs	(12.4)	(16.2)	(11.4)	(40.0)
Provisions for losses	(4.8)	(0.8)	(2.1)	(7.7)
	133.2	9.0	79.0	221.2

The segmental profits disclosed above reconcile to the group results as shown below.

	2017	2016
	£m	£m
Total segmental profit	233.3	221.2
Treasury interest income	1.8	2.3
Unallocated funding costs	(31.0)	(27.2)
Central administration costs	(58.9)	(52.5)
	145.2	143.8
Fair value items	(0.4)	(0.6)
<b>Operating profit</b>	<b>144.8</b>	<b>143.2</b>

The assets and liabilities attributable to each of the segments at 30 September 2017 and 30 September 2016 on the basis described above were:

	Note	Mortgages	Commercial Lending	Idem Capital	Total Segments
		£m	£m	£m	£m
<b>30 September 2017</b>					
<b>Segment assets</b>					
Loans to customers	32	9,953.9	558.8	611.4	11,124.1
Operating lease assets	40	-	23.4	-	23.4
Cross currency basis swaps	38	896.3	-	-	896.3
Securitisation cash	30	543.0	-	31.0	574.0
		11,393.2	582.2	642.4	12,617.8
<b>Segment liabilities</b>					
Allocated deposits		3,401.2	686.9	249.8	4,337.9
Securitisation funding		7,597.1	-	184.7	7,781.8
		10,998.3	686.9	434.5	12,119.7

	Note	Mortgages £m	Commercial Lending £m	Idem Capital £m	Total Segments £m
<b>30 September 2016</b>					
<b>Segment assets</b>					
Loans to customers	32	9,694.7	375.0	667.8	10,737.5
Operating lease assets	40	-	16.0	-	16.0
Cross currency basis swaps	38	1,364.8	-	-	1,364.8
Securitisation cash	30	460.3	-	76.8	537.1
		<b>11,519.8</b>	<b>391.0</b>	<b>744.6</b>	<b>12,655.4</b>
<b>Segment liabilities</b>					
Allocated deposits		1,091.1	494.9	254.6	1,840.6
Securitisation funding		9,668.6	-	278.5	9,947.1
		<b>10,759.7</b>	<b>494.9</b>	<b>533.1</b>	<b>11,787.7</b>

An analysis of the Group's financial assets by type and segment is shown in note 32. All of the assets shown above were located in the UK.

The additions to non-current assets, excluding financial assets, in the year which are included in segmental assets above are investments of £12.9m (2016: £8.7m) in assets held for leasing under operating leases, included in the Commercial Lending segment. No other fixed asset additions were allocated to segments.

The segmental assets and liabilities may be reconciled to the consolidated balance sheet as shown below.

	2017 £m	2016 £m
<b>Total segment assets</b>	<b>12,617.8</b>	12,655.4
Unallocated assets		
Central cash and investments	<b>922.9</b>	707.6
Unallocated derivatives	<b>10.3</b>	1.6
Operational property, plant and equipment	<b>22.8</b>	23.2
Intangible assets	<b>104.4</b>	105.4
Other	<b>4.0</b>	25.2
<b>Total assets</b>	<b>13,682.2</b>	13,518.4
<b>Total segment liabilities</b>	<b>12,119.7</b>	11,787.7
Unallocated liabilities		
Unallocated retail deposits	<b>(722.5)</b>	33.3
Derivative financial instruments	<b>7.1</b>	15.8
Central bank borrowings	<b>1,145.4</b>	555.5
Tax liabilities	<b>22.2</b>	18.7
Retirement benefit obligations	<b>29.8</b>	58.4
Other	<b>71.1</b>	79.5
<b>Total liabilities</b>	<b>12,672.8</b>	12,548.9

## 15. REVENUE

	Note	2017 £m	2016 £m
Interest receivable	16	409.2	411.4
Operating lease income	18	14.4	13.0
Other income	19	17.2	17.8
<b>Total revenue</b>		<b>440.8</b>	<b>442.2</b>
<b>Arising from:</b>			
Mortgages		284.3	289.9
Commercial Finance		55.1	44.3
Idem Capital		99.6	105.7
Total revenue from segments		439.0	439.9
Unallocated revenue		1.8	2.3
<b>Total revenue</b>		<b>440.8</b>	<b>442.2</b>

## 16. INTEREST RECEIVABLE

	2017 £m	2016 £m
<i>Interest receivable in respect of</i>		
Loans and receivables	375.1	377.8
Finance leases	28.8	22.6
Factoring income	2.2	3.0
Interest on loans to customers	406.1	403.4
Other interest receivable	3.1	5.6
Income from structured entities	-	2.4
<b>Total interest on financial assets</b>	<b>409.2</b>	<b>411.4</b>

Interest on loans to customers includes £3.9m (2016: £4.1m) charged on accounts where an impairment provision has been made.

## 17. INTEREST PAYABLE AND SIMILAR CHARGES

	Note	2017 £m	2016 £m
On retail deposits		47.9	29.5
On asset backed loan notes		70.2	103.4
On central bank facilities		1.1	-
On retail bonds		18.6	18.5
On corporate bonds		13.1	4.8
On bank loans and overdrafts		22.7	29.7
Total interest on financial liabilities		173.6	185.9
On pension scheme deficit	54	1.3	0.8
Discounting on contingent consideration	50	0.3	-
Other finance costs		1.4	1.5
		<b>176.6</b>	<b>188.2</b>

## 18. NET OPERATING LEASE INCOME

	Note	2017 £m	2016 £m
<b>Income</b>			
Operating lease rentals		9.7	7.9
Maintenance income		4.7	5.1
<b>Total operating lease income</b>		<b>14.4</b>	13.0
<b>Costs</b>			
Depreciation of lease assets	40	(4.4)	(3.0)
Maintenance salaries	21	(1.7)	(2.0)
Other maintenance costs		(5.3)	(5.0)
<b>Total operating lease costs</b>		<b>(11.4)</b>	(10.0)
<b>Net operating lease income</b>		<b>3.0</b>	3.0

## 19. OTHER INCOME

	2017 £m	2016 £m
Loan account fee income	9.0	7.7
Broker commissions	3.6	1.3
Third party servicing	3.3	7.4
Other income	1.3	1.4
	<b>17.2</b>	17.8

## 20. OPERATING EXPENSES

	Note	2017 £m	2016 £m
Employment costs	21	64.3	58.1
Auditor remuneration	24	1.1	1.2
Amortisation of intangible assets	41	1.6	1.6
Depreciation of operational assets	40	1.9	1.9
Operating lease rentals payable	63	2.6	2.6
Other administrative costs		30.8	27.1
		<b>102.3</b>	92.5

## 21. EMPLOYEES

The average number of persons (including directors) employed by the Group during the year was 1,317 (2016: 1,249). The number of employees at the end of the year was 1,344 (2016: 1,299).

Costs incurred during the year in respect of these employees were:

	2017	2017	2016	2016
	£m	£m	£m	£m
Share based remuneration	4.2		4.4	
Other wages and salaries	51.4		47.8	
<b>Total wages and salaries</b>		<b>55.6</b>		52.2
National Insurance on share based remuneration	1.0		(0.1)	
Other social security costs	5.1		4.5	
<b>Total social security costs</b>		<b>6.1</b>		4.4
Defined benefit pension cost	2.4		1.7	
Other pension costs	1.9		1.8	
<b>Total pension costs</b>		<b>4.3</b>		3.5
<b>Total employment costs</b>		<b>66.0</b>		60.1

Of which

Included in operating expenses (note 20)	64.3	58.1
Included in maintenance costs (note 18)	1.7	2.0
	<b>66.0</b>	<b>60.1</b>

Details of the pension schemes operated by the Group are given in note 54.

The Company has no employees. Details of the directors' remuneration are given in note 22.

## 22. KEY MANAGEMENT REMUNERATION

The remuneration of the directors, who are the key management personnel of the Group and the Company, is set out below in aggregate in accordance with IAS 24 - 'Related Party Transactions'. Further information about the remuneration of individual directors is provided in the Annual Remuneration Report in Section B5.2.2.

	2017	2017	2016	2016
	£m	£m	£m	£m
Salaries and fees	1.6		1.6	
Cash amount of bonus	1.4		1.1	
Social security costs	0.6		0.5	
<b>Short-term employee benefits</b>		<b>3.6</b>		3.2
Post-employment benefits		1.4		0.4
IFRS 2 cost in respect of directors	1.9		1.9	
National Insurance thereon	0.4		0.2	
<b>Share based payment</b>		<b>2.3</b>		2.1
		<b>7.3</b>		5.7

Post-employment benefits shown above are shown as 'pension allowance' in Section B5.2.2. Costs in respect of share awards shown in the Annual Report on Remuneration are determined on a different basis to the IFRS 2 charge shown above.

Social security costs paid in respect of directors are required to be included in this note by IAS 24, but do not fall within the scope of the disclosures in the Directors' Remuneration Report.

## 23. SHARE BASED REMUNERATION

During the year, the Group had various share based payment arrangements with employees. They are accounted for by the Group and the Company as shown below.

The effect of the share based payment arrangements on the Group's profit is shown in note 21.

Further details of share based payment arrangements are given in the Report of the Board to the Shareholders on Directors' Remuneration in Section B5.2.2.

A summary of the number of share awards outstanding under each scheme at 30 September 2017 and at 30 September 2016 is set out below.

	<b>Number 2017</b>	Number 2016
(a) Sharesave Plan	<b>3,113,587</b>	3,236,126
(b) Performance Share Plan	<b>5,103,963</b>	5,834,558
(c) Conditional Share Option Plan	<b>390,746</b>	-
(d) Deferred Bonus Plan	<b>445,252</b>	422,245
(e) Matching Share Plan	-	9,969
(f) Restricted Stock Units	<b>60,115</b>	-
	<b>9,113,663</b>	9,502,898

### (a) Sharesave plan

The Group operates an All Employee Share Option ('Sharesave') plan. Grants under this scheme vest, in the normal course, after the completion of the appropriate service period and subject to a savings requirement.

A reconciliation of movements in the number and weighted average exercise price of Sharesave options over £1 ordinary shares during the year ended 30 September 2017 and the year ended 30 September 2016 is shown below.

	<b>2017 Number</b>	<b>2017 Weighted average exercise price p</b>	2016 Number	2016 Weighted average exercise price p
<b>Options outstanding</b>				
At 1 October 2016	<b>3,236,126</b>	<b>255.27</b>	2,343,499	305.19
Granted in the year	<b>690,540</b>	<b>341.76</b>	2,339,040	249.44
Exercised or surrendered in the year	<b>(637,607)</b>	<b>247.16</b>	(55,827)	105.51
Lapsed during the year	<b>(175,472)</b>	<b>265.03</b>	(1,390,586)	334.95
<b>At 30 September 2017</b>	<b>3,113,587</b>	<b>275.56</b>	3,236,126	255.27
Options exercisable	-	-	-	-

The weighted average remaining contractual life of options outstanding at 30 September 2017 was 28.6 months (2016: 30.8 months). The weighted average market price at exercise for share options exercised in the year was 414.02p (2016: 334.01p).



Options are outstanding under the Sharesave plans to purchase ordinary shares as follows:

Grant date	Period exercisable	Exercise price	Number 2017	Number 2016
20/12/2011	01/02/2017 to 01/08/2017	142.56p	-	138,747
23/12/2013	01/02/2017 to 01/08/2017	276.32p	-	494,575
23/12/2013	01/02/2019 to 01/08/2019	276.32p	<b>153,059</b>	161,309
11/06/2015	01/08/2018 to 01/02/2019	345.68p	<b>130,750</b>	153,079
11/06/2015	01/08/2020 to 01/02/2021	345.68p	<b>10,063</b>	13,881
20/06/2016	01/08/2019 to 01/02/2020	249.44p	<b>1,680,287</b>	1,798,313
20/06/2016	01/08/2021 to 01/02/2022	249.44p	<b>449,765</b>	476,222
28/07/2017	01/09/2020 to 01/03/2021	341.76p	<b>628,762</b>	-
28/07/2017	01/09/2022 to 01/03/2023	341.76p	<b>60,901</b>	-
			<b>3,113,587</b>	3,236,126

A number of the above options were granted to former employees whose rights terminate at the later of twelve months following redundancy or forty-two months after the issue of the options.

The fair value of options granted is determined using a binomial model. Details of the awards over £1 ordinary shares made in the year ended 30 September 2017 and the year ended 30 September 2016, are shown below.

Grant date	28/07/17	28/07/17	20/06/16	20/06/16
Number of awards granted	<b>628,762</b>	<b>61,778</b>	1,855,602	483,438
Market price at date of grant	<b>428.5p</b>	<b>428.5p</b>	297.1p	297.1p
Contractual life (years)	<b>3.5</b>	<b>5.5</b>	3.5	5.5
<b>Fair value per share at date of grant (£)</b>	<b>0.88</b>	<b>0.81</b>	0.50	0.52

#### Inputs to valuation model

Expected volatility	<b>28.49%</b>	<b>27.47%</b>	26.62%	29.47%
Expected life at grant date (years)	<b>3.45</b>	<b>5.44</b>	3.46	5.45
Risk-free interest rate	<b>0.67%</b>	<b>0.88%</b>	0.84%	0.98%
Expected dividend yield	<b>3.24%</b>	<b>3.24%</b>	3.94%	3.94%
Expected annual departures	<b>5.00%</b>	<b>5.00%</b>	5.00%	5.00%

The expected volatility of the share price used in determining the fair value for the three-year schemes is based on the annualised standard deviation of daily changes in price over the three years preceding the grant date. The five-year schemes use share price data for the preceding five years.

## (b) Paragon Performance Share Plan

Awards under this plan comprise a right to acquire ordinary shares in the Company for nil or nominal payment and will vest on the third anniversary of their granting, to the extent that the applicable performance criteria have been satisfied, if the holder is still employed by the Group. The awards will lapse to the extent that the performance condition has not been satisfied on the third anniversary.

Awards are exercisable from the date on which the Remuneration Committee determines the extent to which the performance conditions have been satisfied to the day before the tenth anniversary of the grant date. Clawback provisions apply to awards granted under the PSP as detailed in the remuneration policy.

The conditional entitlements outstanding under this scheme at 30 September 2017 and 30 September 2016 were:

Grant date	Period exercisable	Number	Number
		2017	2016
09/01/2007	09/01/2010 to 08/01/2017 †	-	569
14/06/2007	14/06/2010 to 13/06/2017 †	-	743
26/11/2007	26/11/2010 to 25/11/2017 †	-	3,287
21/05/2009	21/05/2012 to 20/05/2019 †	<b>15,000</b>	400,714
04/01/2010	04/01/2013 to 03/01/2020 †	<b>79,334</b>	79,334
17/12/2010	17/12/2013 to 16/12/2020 †	<b>290,964</b>	292,338
21/12/2011	21/12/2014 to 20/12/2021 †	<b>320,712</b>	624,259
28/02/2013	28/02/2016 to 27/02/2023 ‡	<b>293,546</b>	757,817
10/12/2013	10/12/2016 to 09/12/2023 ‡	<b>317,592</b>	1,211,741
18/12/2014	18/12/2017 to 17/12/2024 ‡	<b>1,028,364</b>	1,029,729
22/12/2015	22/12/2018 to 21/12/2025 §	<b>1,390,247</b>	1,434,027
01/12/2016	01/12/2019 to 30/11/2026 ¶	<b>1,368,204</b>	-
		<b>5,103,963</b>	<b>5,834,558</b>

† These awards, which were conditional on the achievement of performance based criteria, have now vested.

‡ 50% of these awards are subject to a TSR test and 50% are subject to an EPS test. The TSR test compares the rank of the Company's TSR against a comparator group of companies comprising the constituents of the FTSE-250. 25% of the TSR tested awards vest for median performance, increasing on a straight line basis to full vesting for upper quartile performance. The EPS test provides that 25% of EPS tested awards will vest where EPS growth is equal to the increase in the retail price index plus 3%, increasing on a straight line basis to full vesting for EPS growth equal to the increase in the retail price index plus 7% or more. In each case the testing period is the three financial years commencing with the year of grant.

§ 50% of these awards are subject to a TSR test and 50% are subject to an EPS test as described above, except that full vesting of the EPS tested awards takes place where EPS growth is equal to the increase in the retail price index plus 13% or more.

¶ 50% of these awards are subject to a TSR test and 25% are subject to an EPS test as described at ‡ above, except that the comparator group for the TSR test is limited to 13 listed financial service entities rather than the entire FTSE-250. 25% of these awards are subject to risk performance conditions which take in to account factors deemed appropriate by the Remuneration Committee, who will ultimately decide the extent to which the risk condition has been satisfied.

Once the outcomes of these tests have been determined the gross number of awards vesting will be reduced so that the gain to the recipient from the PSP and the CSOP described below is equal to the gain from the gross PSP vesting.

The fair value of awards granted under the PSP is determined using a Monte Carlo simulation model, to take account of the effect of the market based condition. Details of the awards over £1 ordinary shares made in the year ended 30 September 2017 and the year ended 30 September 2016 are shown below:

Grant date	01/12/16	22/12/15
Number of awards granted	<b>1,450,486</b>	1,487,166
Market price at date of grant	<b>369.40p</b>	362.70p
<b>Fair value per share at date of grant</b>	<b>245.73p</b>	204.46p

### Inputs to valuation model

Expected volatility	<b>29.55%</b>	24.99%
Risk-free interest rate	<b>0.76%</b>	1.21%
Expected dividend yield	<b>3.65%</b>	3.03%

For all of the above grants the contractual life and expected life at grant date is three years and no departures are expected.

The expected volatility for awards granted between 18 July 2008 and 30 September 2008 is based on the annualised standard deviation of daily changes in price over the six years preceding the grant date. The expected volatility for awards granted after this date is calculated using the same method but using daily changes in price over the three years preceding the grant date.

The effect of the CSOPs is not allowed for in the IFRS 2 market values of the 2016 grant.

### (c) Company Share Option Plan ('CSOP')

The Company has, in the current year, started to utilise the tax-advantaged element of the PSP under which CSOP options can be granted. The CSOPs may be exercised alongside their accompanying PSPs based upon the exercise price that was set at the grant date. Each member of staff may be granted up to a maximum total value of £30,000 of tax benefitted options.

A reconciliation of movements in the number and weighted average exercise price of CSOP options over £1 ordinary shares during the year ended 30 September 2017 and the year ended 30 September 2016 is shown below.

	2017 Number	2017 Weighted average exercise price p	2016 Number	2016 Weighted average exercise price p
<b>Options outstanding</b>				
At 1 October 2016	-	-	-	-
Granted in the year	<b>404,499</b>	<b>361.88</b>	-	-
Exercised or surrendered in the year	-	-	-	-
Lapsed during the year	<b>(13,753)</b>	<b>361.88</b>	-	-
<b>At 30 September 2017</b>	<b>390,746</b>	<b>361.88</b>	-	-
Options exercisable	-	-	-	-

The conditional entitlements outstanding under this scheme at 30 September 2017 and 30 September 2016 were:

Grant date	Period exercisable	Exercise price	Number 2017	Number 2016
01/12/2016	01/12/2019 to 30/11/2026 <sup>◊</sup>	361.88p	<b>390,746</b>	-
			<b>390,746</b>	-

<sup>◊</sup> 66.7% of these awards are subject to a TSR test and 33.3% are subject to an EPS test. These tests operate in the same manner and with the same conditions as those for the PSP grant of the same date.

To the extent that the CSOP awards vest, the vesting of the PSP award granted at the same time will be abated so that the overall gain to the grantee is the same as would be received on the related PSP award had the CSOP not been in place.

No separate fair value has been attributed to the CSOP options for IFRS 2 purposes as the IFRS 2 market values for the CSOP and PSP combined will equate to that calculated for the PSP without allowing for the CSOP. The benefit from the CSOP is in relation to the employees' tax position, which does not affect the IFRS 2 charge.

### (d) Deferred Bonus awards

Awards under these plans comprise a right to acquire ordinary shares in the Company for nil or nominal payment. The conditional entitlements outstanding under these plans at 30 September 2017 and 30 September 2016 were:

Grant date	Period exercisable	Number 2017	Number 2016
10/12/2013	10/12/2016 to 09/12/2023	<b>92,208</b>	174,519
18/12/2014	18/12/2017 to 17/12/2024	<b>113,202</b>	113,202
22/12/2015	22/12/2018 to 21/12/2025	<b>134,524</b>	134,524
01/12/2016	01/12/2018 to 30/11/2026	<b>105,318</b>	-
		<b>445,252</b>	422,245

The Deferred Bonus shares awarded during 2013 and thereafter can be exercised from the third anniversary of the award date until the day before the tenth anniversary of the date of grant.

The Deferred Bonus shares granted in December 2016 do not accrue dividends over the vesting period unlike earlier grants. The fair value of Deferred Bonus awards issued in the year was determined using a Black-Scholes Merton model. Details of the awards over £1 ordinary shares made in the year ended 30 September 2017 and the year ended 30 September 2016 are shown below.

<b>Grant date</b>	<b>01/12/16</b>	22/12/15
Number of awards granted	<b>105,318</b>	134,524
Market price at date of grant	<b>369.4p</b>	362.7p
<b>Fair value per share at date of grant</b>	<b>331.1p</b>	362.7p

#### Inputs to valuation model

Risk-free interest rate	<b>0.75%</b>	1.21%
Expected dividend yield	<b>3.65%</b>	N/A

#### (e) Matching Share Plan

Awards under this plan comprised a right to acquire ordinary shares in the Company for nil or nominal payment and vested on the third anniversary of their granting to the extent that the applicable performance criteria had been satisfied, if the holder was still employed by the Group.

The entitlements outstanding under this scheme at 30 September 2017 and at 30 September 2016 were:

<b>Grant date</b>	<b>Period exercisable</b>	<b>Number</b>	Number
		<b>2017</b>	2016
02/01/2008	02/01/2011 to 02/01/2018	-	9,969
		-	9,969

The plan lapsed in February 2016 and was not renewed. Therefore no further awards will be made under it.

#### (f) Restricted Stock Units ('RSUs')

The Company, in the current year, has permitted certain employees to elect to receive RSU awards instead of PSP awards. RSU awards have vesting conditions based upon the grantee's personal performance (including a risk element) rather than conditions in the wider business. These conditions are determined to be met to the extent to which the Remuneration Committee deems that to be the case.

The conditional entitlements outstanding under this scheme at 30 September 2017 and 30 September 2016 were:

<b>Grant date</b>	<b>Period exercisable</b>	<b>Number</b>	Number
		<b>2017</b>	2016
01/12/2016	01/12/2019 to 30/11/2026	<b>60,115</b>	-
		<b>60,115</b>	-

The fair value of RSU awards issued in the year was determined using a Black-Scholes Merton model. Details of the awards over £1 ordinary shares made in the year ended 30 September 2017 and the year ended 30 September 2016 are shown below.

<b>Grant date</b>	<b>01/12/16</b>
Number of awards granted	<b>60,115</b>
Market price at date of grant	<b>369.4p</b>
<b>Fair value per share at date of grant</b>	<b>369.4p</b>

#### Inputs to valuation model

Risk-free interest rate	<b>0.75%</b>
Expected dividend yield	<b>3.65%</b>

## 24. AUDITOR REMUNERATION

The analysis of fees payable to the Company's auditors (KPMG LLP) and their associates, excluding irrecoverable VAT, required by the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 is set out below. This analysis includes amounts charged to the profit and loss account or included within the issue costs of debt in respect of fees paid to the Group auditors and their associates.

	<b>2017</b>	2016
	<b>£000</b>	£000
<b>Audit fee of the company</b>	<b>142</b>	119
<b>Other services</b>		
Audit of subsidiary undertakings pursuant to legislation	<b>703</b>	633
<b>Total audit fees</b>	<b>845</b>	752
Audit related assurance services		
Interim review	<b>60</b>	57
Other services	<b>52</b>	103
<b>Total fees</b>	<b>957</b>	912
Irrecoverable VAT	<b>191</b>	182
<b>Total cost to the Group</b>	<b>1,148</b>	1,094
Of which:		
Charged to profit and loss account (note 20)	<b>1,121</b>	1,094
Included in issue costs of debt	<b>27</b>	-
<b>Total cost to the Group</b>	<b>1,148</b>	1,094

Fees paid to the auditors and their associates for non-audit services to the Company are not disclosed because the consolidated accounts of the Group are required to disclose such fees on a consolidated basis.

## 25. PROVISIONS FOR LOSSES

	<b>2017</b>	2016
	<b>£m</b>	£m
Impairment of financial assets (note 35)		
First mortgage loans	<b>3.7</b>	4.8
Second charge mortgage loans	<b>0.4</b>	0.4
Finance lease receivables	-	0.6
Development finance loans	-	-
Other loans	<b>1.2</b>	1.9
	<b>5.3</b>	7.7

## 26. FAIR VALUE NET (LOSSES)

	2017	2016
	£m	£m
Net profit / (loss) on derivatives designated as fair value hedges	14.6	(7.2)
Fair value adjustments from hedge accounting	(13.2)	6.5
Ineffectiveness of fair value hedges	1.4	(0.7)
Ineffectiveness of cash flow hedges	-	-
Net (loss) / gains on other derivatives	(1.8)	0.1
	<b>(0.4)</b>	<b>(0.6)</b>

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

Foreign exchange gains of £468.9m (note 62) on asset backed loan notes denominated in US dollars and euros (2016: losses of £699.9m) have been offset against the movements on the cross currency basis swaps used to hedge these liabilities as part of the cash flow hedge accounting treatment applied.

## 27. TAX CHARGE ON PROFIT ON ORDINARY ACTIVITIES

### (a) Analysis of charge in the year

	2017	2016
	£m	£m
<b>Current tax</b>		
UK Corporation Tax on profits of the period	31.7	28.2
Adjustment in respect of prior periods	(1.3)	(0.6)
Total current tax	30.4	27.6
Deferred tax	(2.8)	(0.4)
<b>Tax charge on profit on ordinary activities</b>	<b>27.6</b>	<b>27.2</b>

### (b) Deferred tax credit for the year

The deferred tax charge in the income statement comprises the following temporary differences:

	2017	2016
	£m	£m
Accelerated tax depreciation	(0.4)	(0.3)
Retirement benefit obligations	0.1	0.1
Impairment and other provisions	(1.5)	0.6
Utilisation of tax losses	-	0.1
Other timing differences	(1.5)	(0.1)
Deferred tax (credit)/charge for the year	(3.3)	0.4
Prior period adjustment	0.5	(0.1)
Change in tax rate	-	(0.7)
<b>Deferred tax (credit) (note 53)</b>	<b>(2.8)</b>	<b>(0.4)</b>

During the year ended 30 September 2015 the UK Government substantively enacted provisions reducing the rate of corporation tax from 20.0% to 19.0% with effect from 1 April 2017 and to 18.0% from 1 April 2020. The tax rate applying from 1 April 2020 was further reduced to 17.0% during the year ended 30 September 2016.

Therefore, the standard rate of corporation tax applicable to the Group for the year ended 30 September 2016 was 20.0%, the rate in the year ended 30 September 2017 was 19.5%, the rate in the years ending 30 September 2018 and 30 September 2019 is expected to be 19.0%, the rate in the year ending 30 September 2020 is expected to be 18.0% and the rate in subsequent years is expected to be 17.0%. The expected impact on deferred tax balances of the changes to 19.0% and 17.0% was accounted for in the year ended 30 September 2016.

### (c) Factors affecting tax charge for the year

The Group operates wholly in the UK and all but a nominal amount of the Group's income arises in UK resident companies. Consequently, it is appropriate to use the prevailing UK corporation tax rate as the comparator to the effective tax rate. As noted in (b) above, the UK Corporation tax rate applicable to the Group for the year was 19.5% (2016: 20.0%).

	<b>2017</b>	2016
	<b>£m</b>	£m
Profit on ordinary activities before taxation	<b>144.8</b>	143.2
Profit on ordinary activities multiplied by the UK standard rate of corporation tax	<b>28.2</b>	28.6
Effects of:		
Permanent differences		
- Disallowable acquisition costs	-	0.3
- Income from structured entities	<b>(0.7)</b>	(0.8)
- Recurring disallowable expenditure and similar items	<b>0.3</b>	0.2
Mismatch in timing differences	<b>0.6</b>	0.3
Change in rate of taxation on deferred tax assets and liabilities	-	(0.7)
Prior year (credit)	<b>(0.8)</b>	(0.7)
<b>Tax charge for the year</b>	<b>27.6</b>	27.2

The income from the Group's investment in structured entities is recognised in the income statement net of taxes incurred by the structured entities and consequently appears as a reconciling item in the tax charge.

The timing difference mismatch arises because tax relief for share based payments is given on a different basis from that on which the accounting charge for the provision of these awards is recognised under IFRS 2.

The expected changes to UK corporation tax rates accounted for in 2016 have reduced the rates at which temporary differences are expected to reverse, resulting in a tax credit.

### (d) Factors affecting future tax charges

As practically all of the Group's profit is subject to UK corporation tax the effective tax rate is expected to fall in line with the reductions in the standard rate described above.

The banking surcharge was introduced with effect from 1 January 2016. This subjects any taxable profits arising in the Group's banking subsidiary, Paragon Bank PLC (and no other Group entity), to an additional 8.0% of tax to the extent these profits exceed £25.0m. The impact of this surcharge is expected to increase the Group's effective tax rate in future periods.

The Group includes a leasing business in PAF. Whilst such businesses do not, in general, have significant permanent differences, the taxable profits in a given accounting period are usually significantly different from the accounting profits due to temporary differences. Consequently, the acquisition will have no material impact on the effective tax rate, but may have on the Group's tax payments.

As a wholly based UK business the Group does not expect to be significantly impacted by the OECD project on Base Erosion and Profit Shifting ('BEPS').

## 28. PROFIT ATTRIBUTABLE TO MEMBERS OF PARAGON BANKING GROUP PLC

The Company's profit after tax for the financial year amounted to £47.4m (2016: £82.4m). A separate income statement has not been prepared for the Company under the provisions of Section 408 of the Companies Act 2006.

The Company has no other items of comprehensive income for the years ended 30 September 2017 or 30 September 2016.

## 29. EARNINGS PER SHARE

Earnings per ordinary share is calculated as follows:

	2017	2016
Profit for the year (£m)	<b>117.2</b>	116.0
Basic weighted average number of ordinary shares ranking for dividend during the year (million)	<b>271.6</b>	286.5
Dilutive effect of the weighted average number of share options and incentive plans in issue during the year (million)	<b>8.0</b>	5.5
Diluted weighted average number of ordinary shares ranking for dividend during the year (million)	<b>279.6</b>	292.0
Earnings per ordinary share		
- basic	<b>43.1p</b>	40.5p
- diluted	<b>41.9p</b>	39.7p

## 30. CASH AND CASH EQUIVALENTS

	2017	2016	2015
	£m	£m	£m
Balances with central banks	<b>615.0</b>	315.0	286.0
Balances with other banks	<b>881.9</b>	922.6	770.0
<b>Cash and cash equivalents</b>	<b>1,496.9</b>	1,237.6	1,056.0

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

Balances with central banks form part of the liquidity buffer of Paragon Bank PLC and are therefore not available for the Group's general purposes.

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

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

	2017	2016	2015
	£m	£m	£m
Free cash	<b>305.5</b>	383.1	237.2
Securitisation cash	<b>574.0</b>	537.1	530.9
Liquidity buffer	<b>615.0</b>	315.0	286.0
ESOP cash	<b>2.4</b>	2.4	1.9
	<b>1,496.9</b>	1,237.6	1,056.0

The 'Cash and Cash Equivalents' amount of £277.6m (2016: £361.3m; 2015: £196.8m) shown in the Company balance sheet is included in 'Free Cash'.

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

## 31. SHORT TERM INVESTMENTS

This amount represented fixed rate securities issued by the UK Government for which a liquid market exists and which were held as part of the liquidity requirement of Paragon Bank PLC. As such they were designated as 'Available for Sale', as defined by IAS 39 - 'Financial Instruments: Recognition and Measurement' and consequently shown at fair value which corresponded to their market value. The Bank's liquidity requirements are currently met through central bank deposits and liquidity facilities and therefore it is no longer necessary to hold treasury bills.

There were no securities held at 30 September 2017. The total nominal value of the securities at 30 September 2016 was £7.0m, the weighted average coupon was 1.75% and their carrying value was £7.1m.



## 32. LOANS TO CUSTOMERS

	Note	2017 £m	2016 £m	2015 £m
Loans and receivables	33	<b>10,636.1</b>	10,391.8	10,019.0
Finance lease receivables	34	<b>488.0</b>	345.7	43.4
Loans to customers		<b>11,124.1</b>	10,737.5	10,062.4
Fair value adjustments from portfolio hedging	36	<b>(8.7)</b>	12.5	5.2
		<b>11,115.4</b>	10,750.0	10,067.6

The movements in the Group's investment in loans to customers in the year ended 30 September 2017 and the year ended 30 September 2016 were:

	2017 £m	2016 £m
<b>Cost</b>		
At 1 October 2016	<b>10,737.5</b>	10,062.4
Acquisitions (note 13)	-	221.7
Additions	<b>1,965.9</b>	1,654.0
Disposals	<b>(18.5)</b>	-
Effective Interest Rate ('EIR') adjustments	<b>85.5</b>	54.9
Other debits	<b>298.5</b>	326.6
Provision charge (note 35)	<b>(5.3)</b>	(7.7)
Repayments and redemptions	<b>(1,939.5)</b>	(1,574.4)
<b>At 30 September 2017</b>	<b>11,124.1</b>	10,737.5

'Other debits' includes primarily interest and fees charged to customers on loans outstanding.

The Group's loan assets at 30 September 2017, analysed between the segments described in note 14 are as follows:

	Mortgages £m	Commercial Lending £m	Idem Capital £m	Total £m
<b>At 30 September 2017</b>				
First mortgages	<b>9,855.5</b>	-	-	<b>9,855.5</b>
Consumer loans	<b>98.4</b>	-	<b>611.4</b>	<b>709.8</b>
Motor finance	-	<b>163.0</b>	-	<b>163.0</b>
Asset finance	-	<b>325.0</b>	-	<b>325.0</b>
Development finance	-	<b>42.3</b>	-	<b>42.3</b>
Other loans	-	<b>28.5</b>	-	<b>28.5</b>
<b>Loans to customers</b>	<b>9,953.9</b>	<b>558.8</b>	<b>611.4</b>	<b>11,124.1</b>
<b>At 30 September 2016</b>				
First mortgages	9,640.6	-	-	9,640.6
Consumer loans	54.1	-	667.8	721.9
Motor finance	-	95.3	-	95.3
Asset finance	-	250.4	-	250.4
Development finance	-	9.1	-	9.1
Other loans	-	20.2	-	20.2
<b>Loans to customers</b>	<b>9,694.7</b>	<b>375.0</b>	<b>667.8</b>	<b>10,737.5</b>

### 33. LOANS AND RECEIVABLES

Loans and receivables at 30 September 2017, 30 September 2016 and 30 September 2015, which are all denominated and payable in sterling, were:

	<b>2017</b>	2016	2015
	<b>£m</b>	£m	£m
First mortgage loans	<b>9,855.5</b>	9,640.6	9,410.8
Second charge mortgage loans	<b>490.7</b>	526.8	387.1
Other unsecured consumer loans	<b>219.1</b>	195.1	221.1
Development finance loans	<b>42.3</b>	9.1	-
Other loans	<b>28.5</b>	20.2	-
	<b>10,636.1</b>	10,391.8	10,019.0

First mortgage loans have a contractual term of up to thirty years, second charge mortgage loans up to twenty five years and other unsecured loans up to ten years. In all cases the borrower is entitled to settle the loan at any point and in most cases early settlement does take place. All borrowers are required to make monthly payments, except where an initial deferred period is included in the contractual terms.

First mortgages are secured on residential property within the UK; second charge mortgage loans enjoy second charges on residential property. The estimated value of the security held against those loans above which are considered to be impaired or past due, representing, for each such account, the lesser of the outstanding balance on the loan and the estimated valuation of the property was:

	<b>2017</b>	2016
	<b>£m</b>	£m
First mortgage loans	<b>22.4</b>	34.2
Second charge mortgage loans	<b>69.4</b>	81.0
	<b>91.8</b>	115.2

The development finance loans have a maximum contractual term of 24 months and an average term of 17 months. Settlement of principal and accrued interest takes place once the development is sold or refinanced following its completion and the customer is not normally required to make payments during the term of the loan. The loans are secured by a legal charge over the site and / or property together with other charges and warranties related to the build.

Other loans include principally invoice factoring, discounted receivables and other short term commercial balances.

The amounts of the loan assets above pledged as collateral under the central bank facilities described in note 49 or under the external funding arrangements described in notes 45 and 46 are shown below. The table also shows assets prepositioned with the Bank of England for use in future drawings.

	First Mortgages £m	Consumer Finance £m	Other £m	Total £m
<b>30 September 2017</b>				
In respect of:				
Asset backed loan notes	5,328.8	270.5	-	5,599.3
Warehouse facilities	1,449.3	-	-	1,449.3
Central bank facilities	1,224.9	-	-	1,224.9
Total pledged as collateral	8,003.0	270.5	-	8,273.5
Prepositioned with Bank of England	122.1	-	-	122.1
Other assets not pledged as collateral	1,730.4	439.3	70.8	2,240.5
	<b>9,855.5</b>	<b>709.8</b>	<b>70.8</b>	<b>10,636.1</b>

### 30 September 2016

In respect of:				
Asset backed loan notes	6,845.8	413.8	-	7,259.6
Warehouse facilities	1,762.1	-	-	1,762.1
Central bank facilities	192.2	-	-	192.2
Total pledged as collateral	8,800.1	413.8	-	9,213.9
Prepositioned with Bank of England	428.1	-	-	428.1
Other assets not pledged as collateral	412.4	308.1	29.3	749.8
	<b>9,640.6</b>	<b>721.9</b>	<b>29.3</b>	<b>10,391.8</b>

## 34. FINANCE LEASE RECEIVABLES

The Group's finance lease receivables are motor finance and asset finance loans. The average contractual life of the motor finance loans is 33 months (2016: 49 months) while that of the asset finance loans was 42 months (2016: 42 months), but it is likely that a significant proportion of customers will choose to settle their obligations early.

The Group's finance leases can be analysed as shown below;

	2017 £m	2016 £m	2015 £m
Motor finance	163.0	95.3	43.4
Asset finance	325.0	250.4	-
<b>Carrying value</b>	<b>488.0</b>	<b>345.7</b>	<b>43.4</b>

The minimum lease payments due under these loan agreements are:

	2017 £m	2016 £m	2015 £m
<b>Amounts receivable</b>			
Within one year	174.9	133.0	12.8
Within two to five years	357.6	255.8	36.1
After five years	17.8	7.6	-
	<b>550.3</b>	<b>396.4</b>	<b>48.9</b>
Less: future finance income	(58.3)	(47.7)	(4.9)
<b>Present value</b>	<b>492.0</b>	<b>348.7</b>	<b>44.0</b>

The present values of those payments, net of provisions for impairment, carried in the accounts are:

	<b>2017</b>	2016	2015
	<b>£m</b>	£m	£m
<b>Amounts receivable</b>			
Within one year	<b>151.9</b>	116.1	11.5
Within two to five years	<b>323.8</b>	225.8	32.5
After five years	<b>16.3</b>	6.8	-
Present value	<b>492.0</b>	348.7	44.0
Allowance for uncollectible amounts	<b>(4.0)</b>	(3.0)	(0.6)
<b>Carrying value</b>	<b>488.0</b>	345.7	43.4

Whilst on motor finance cases the Group has the benefit of the underlying vehicle as security on these loans, no account of this is taken in the allowance for uncollectible amounts shown above. The Group has insufficient information on the current condition of finance leased vehicles to derive a reliable estimate of the value which could be realised from vehicles to offset against arrears accounts. Accordingly, no such disclosure is provided.

For the Group's asset finance loans, estimated valuations of security assets for balances in arrears are undertaken as part of the credit management process. These exercises suggest that the security value of assets under finance leases which are past due or impaired is £12.2m (2016: £6.7m).

The Group's finance lease receivables pledged as collateral for liabilities at 30 September 2017 and 30 September 2016 were:

	<b>2017</b>	2016
	<b>£m</b>	£m
In respect of:		
Asset backed loan notes	-	0.1
Total pledged as collateral	-	0.1
Other assets not pledged as collateral	<b>488.0</b>	345.6
	<b>488.0</b>	345.7

### 35. IMPAIRMENT PROVISIONS ON LOANS TO CUSTOMERS

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

	<b>First mortgages</b>	<b>Other loans and receivables</b>	<b>Finance leases</b>	<b>Total</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
At 1 October 2015	<b>86.0</b>	<b>24.4</b>	<b>0.6</b>	<b>111.0</b>
Amounts provided in the period	<b>4.9</b>	<b>2.7</b>	<b>1.9</b>	<b>9.5</b>
Amounts written off	<b>(2.1)</b>	<b>(4.5)</b>	<b>(1.3)</b>	<b>(7.9)</b>
At 30 September 2016	<b>88.8</b>	<b>22.6</b>	<b>1.2</b>	<b>112.6</b>
Amounts provided in the period	<b>3.8</b>	<b>2.3</b>	<b>2.2</b>	<b>8.3</b>
Amounts written off	<b>(3.5)</b>	<b>(6.6)</b>	<b>(0.2)</b>	<b>(10.3)</b>
<b>At 30 September 2017</b>	<b>89.1</b>	<b>18.3</b>	<b>3.2</b>	<b>110.6</b>

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

	<b>First mortgages</b>	<b>Other loans and receivables</b>	<b>Finance leases</b>	<b>Total</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
At 30 September 2017	<b>76.4</b>	<b>0.3</b>	<b>0.3</b>	<b>77.0</b>
At 30 September 2016	<b>72.4</b>	<b>0.1</b>	<b>0.1</b>	<b>72.6</b>

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

	<b>First mortgages £m</b>	<b>Other loans and receivables £m</b>	<b>Finance leases £m</b>	<b>Total £m</b>
<b>Year ended 30 September 2017</b>				
Amounts provided in the year	3.8	2.3	2.2	8.3
Recovery of amounts previously provided	(0.1)	(0.7)	(2.2)	(3.0)
<b>Net impairment for year (note 25)</b>	<b>3.7</b>	<b>1.6</b>	<b>-</b>	<b>5.3</b>
<b>Year ended 30 September 2016</b>				
Amounts provided in the year	4.9	2.7	1.9	9.5
Recovery of amounts previously provided	(0.1)	(0.1)	(1.6)	(1.8)
<b>Net impairment for year (note 25)</b>	<b>4.8</b>	<b>2.6</b>	<b>0.3</b>	<b>7.7</b>

### 36. FAIR VALUE ADJUSTMENTS FROM PORTFOLIO HEDGING

The Group applies fair value hedge accounting in respect of portfolios of loan assets (note 32) and retail deposits (note 44) where the appropriate criteria are met. In these circumstances the change in the fair value of the hedged items attributable to the hedged risk is shown under this heading next to the carrying value of the hedged assets or liabilities in the appropriate note.

### 37. INVESTMENT IN STRUCTURED ENTITIES

Investments in structured entities represent the Group's contribution made to special purpose vehicle ('SPV') companies established and controlled by unrelated third parties to purchase pools of loan assets. All such investments are denominated in sterling, unlisted and are considered to be debt investments as defined by IFRS. The underlying loans are secured and unsecured consumer loans made to UK borrowers. The Group is under no obligation to make any further contribution to these entities.

The movements in the Group's investment in structured entities in the year ended 30 September 2017 and the year ended 30 September 2016 were:

	<b>2017 £m</b>	2016 £m
<b>Cost</b>		
At 1 October 2016	-	18.1
Additions	-	-
Effective Interest Rate ('EIR') income (note 16)	-	2.4
Payments received	-	(20.5)
<b>At 30 September 2017</b>	<b>-</b>	<b>-</b>

The Group administered the assets of the SPV companies on behalf of the owners. Fee income derived from this activity of £nil (2016: £0.5m) is included within third party servicing fees (note 19) and £nil (2016: £nil) is included in other receivables (note 39) in respect of unpaid fees at the year end.

## 38. DERIVATIVE FINANCIAL ASSETS AND LIABILITIES

### Use of derivative financial instruments

The Group uses derivative financial instruments for risk management purposes. Such instruments are contracts with counterparties and are used only to reduce or eliminate the exposure of the Group to movements in market interest or exchange rates.

It is, and has been throughout the year under review, the Group's policy not to trade in financial instruments, and hence all of the Group's derivative financial instruments are for hedging purposes only. These are used to protect the Group from exposures principally arising from fixed rate lending or borrowing and borrowings denominated in foreign currencies. Hedge accounting is applied where appropriate, though some derivatives, while forming part of an economic hedge relationship, do not qualify for this accounting treatment under the IAS 39 rules, while in other cases hedge accounting has not been adopted either because natural accounting offsets are expected or because complying with the IAS 39 hedge accounting rules would be particularly onerous.

The Group has designated a number of derivatives as fair value hedges for accounting purposes. In particular this treatment is used for:

- (a) hedging the interest rate risk of groups of fixed rate prepayable loan assets with interest rate derivatives on a portfolio basis; and
- (b) hedging the interest rate risk of groups of fixed rate retail deposits with interest rate derivatives on a portfolio basis.

In both cases the Group believes this solution is the most appropriate as it is consistent with the economic hedging approach taken by the Group to these assets and liabilities.

As interest rate swaps are used to hedge pipeline exposures which are not yet recognised on the balance sheet an unmatched fair value cost or credit can arise until both sides of the hedge are recognised, generally a few months after the inception of the derivative contract.

The Group's securitisation borrowings are denominated in sterling, euros and US dollars. All currency borrowings are swapped at inception using bespoke cross-currency basis swaps with principal amortisation and interest rates linked to the underlying borrowing. The currency borrowings therefore have the effect of sterling borrowings.

These swaps provide an effective economic hedge against exchange rate and interest movements, but accounting standards require that they are carried at fair value leading, when exchange rates have moved significantly since the issue of the notes, to large balances for the swaps being carried in the balance sheet. This is currently the case with both euro and US dollar swaps, although the debit balance is compensated for by retranslating the borrowings at the current exchange rate. Cash flow hedging relationships have been designated in respect of these arrangements.

### Analysis of derivative financial instruments

The analysis below splits derivatives between those accounted for as part of the portfolio fair value and cash flow hedges described above and those which, despite representing an economic hedge, do not qualify for this treatment. There were no individual interest rate risk hedging arrangements in place either in the year ended 30 September 2017 or the preceding year.

	2017 Notional amount £m	2017 Assets £m	2017 Liabilities £m	2016 Notional amount £m	2016 Assets £m	2016 Liabilities £m
<b>Derivatives in accounting hedge relationships</b>						
<i>Fair value hedges</i>						
Interest rate swaps	3,213.9	8.8	(6.4)	1,933.9	1.3	(14.5)
<i>Cash flow hedges</i>						
Cross currency basis swaps	2,627.4	896.3	-	3,833.6	1,364.8	-
	<b>5,841.3</b>	<b>905.1</b>	<b>(6.4)</b>	5,767.5	1,366.1	(14.5)
<b>Other derivatives</b>						
Interest rate swaps	507.4	1.5	(0.7)	347.7	0.3	(1.3)
<b>Total recognised derivative assets / (liabilities)</b>	<b>6,348.7</b>	<b>906.6</b>	<b>(7.1)</b>	6,115.2	1,366.4	(15.8)

At 30 September 2017 cash deposits of £723.6m had been pledged as collateral in respect of swaps shown above by the respective swap counterparties (2016: £1,184.2m) as described in note 9.

## 39. SUNDRY ASSETS

### (a) The Group

	2017	2016	2015
	£m	£m	£m
<b>Current assets</b>			
Accrued interest income	0.2	0.3	0.4
Trade receivables	4.2	2.4	-
Prepayments	2.8	2.6	1.9
Bank borrowings	-	-	1.0
CSA Assets	2.0	3.7	0.9
CRDs	1.6	0.6	-
Other tax	0.2	0.8	-
Other receivables	1.7	2.3	2.0
	<b>12.7</b>	<b>12.7</b>	<b>6.2</b>

The Group uses the International Swaps and Derivatives Association ('ISDA') Master Agreement for documenting certain derivative activity within Paragon Bank. For certain counterparties a Credit Support Annex ('CSA') has been executed in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between counterparties to mitigate the market contingent counterparty risk inherent in the outstanding positions. Collateral pledged to such counterparties by the Group is shown in the table above.

Cash ratio deposits ('CRDs') are non-interest bearing deposits lodged with the Bank of England, based on the value of the Bank's eligible liabilities.

Accrued interest income, CSA assets, CRDs and other receivables fall within the definition of financial assets given in IAS 32.

### (b) The Company

	2017	2016	2015
	£m	£m	£m
<b>Current assets</b>			
Amounts owed by Group companies	40.1	84.5	141.2
Accrued interest income	-	0.1	0.1
	<b>40.1</b>	<b>84.6</b>	<b>141.3</b>

Accrued interest income and other debtors fall within the definition of financial assets given in IAS 32.

## 40. PROPERTY, PLANT AND EQUIPMENT

### (a) The Group

	Leased assets £m	Land and buildings £m	Plant and machinery £m	Total £m
<b>Cost</b>				
At 1 October 2015	-	22.9	7.7	30.6
Acquisitions	10.6	-	1.8	12.4
Additions	8.7	0.2	1.3	10.2
Disposals	(0.4)	(0.4)	(0.7)	(1.5)
At 30 September 2016	18.9	22.7	10.1	51.7
Acquisitions	-	-	-	-
Additions	12.9	0.1	1.6	14.6
Disposals	(1.8)	-	(0.8)	(2.6)
<b>At 30 September 2017</b>	<b>30.0</b>	<b>22.8</b>	<b>10.9</b>	<b>63.7</b>
<b>Accumulated depreciation</b>				
At 1 October 2015	-	2.2	6.3	8.5
Charge for the year	3.0	0.6	1.3	4.9
On disposals	(0.1)	(0.4)	(0.4)	(0.9)
At 30 September 2016	2.9	2.4	7.2	12.5
Charge for the year	4.4	0.6	1.3	6.3
On disposals	(0.7)	-	(0.6)	(1.3)
<b>At 30 September 2017</b>	<b>6.6</b>	<b>3.0</b>	<b>7.9</b>	<b>17.5</b>
<b>Net book value</b>				
<b>At 30 September 2017</b>	<b>23.4</b>	<b>19.8</b>	<b>3.0</b>	<b>46.2</b>
At 30 September 2016	16.0	20.3	2.9	39.2
At 30 September 2015	-	20.7	1.4	22.1

Plant and machinery shown above is used within the Group's business. Leased assets includes £16.5m in respect of assets leased under operating leases (2016: £11.4m) and £6.9m of assets available for hire (2016: £4.6m).

### (b) The Company

	Land and buildings £m
<b>Cost</b>	
At 1 October 2015, 30 September 2016 and 30 September 2017	<b>19.9</b>
<b>Accumulated depreciation</b>	
At 1 October 2015	0.6
Charge for the year	0.4
At 30 September 2016	1.0
Charge for the year	0.3
<b>At 30 September 2017</b>	<b>1.3</b>
<b>Net book value</b>	
<b>At 30 September 2017</b>	<b>18.6</b>
At 30 September 2016	18.9
At 30 September 2015	19.3



## 41. INTANGIBLE ASSETS

	Goodwill (note 42) £m	Computer software £m	Other intangible assets £m	Total £m
<b>Cost</b>				
At 1 October 2015	7.6	5.6	8.1	21.3
Acquisitions	96.8	-	1.1	97.9
Additions	-	1.4	-	1.4
At 30 September 2016	104.4	7.0	9.2	120.6
Acquisitions (note 13)	(0.3)	-	-	(0.3)
Additions	-	0.9	-	0.9
<b>At 30 September 2017</b>	<b>104.1</b>	<b>7.9</b>	<b>9.2</b>	<b>121.2</b>
<b>Accumulated amortisation and impairment</b>				
At 1 October 2015	6.0	4.0	3.6	13.6
Amortisation charge for the year	-	0.9	0.7	1.6
At 30 September 2016	6.0	4.9	4.3	15.2
Amortisation charge for the year	-	1.0	0.6	1.6
<b>At 30 September 2017</b>	<b>6.0</b>	<b>5.9</b>	<b>4.9</b>	<b>16.8</b>
<b>Net book value</b>				
<b>At 30 September 2017</b>	<b>98.1</b>	<b>2.0</b>	<b>4.3</b>	<b>104.4</b>
At 30 September 2016	98.4	2.1	4.9	105.4
At 30 September 2015	1.6	1.6	4.5	7.7

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

## 42. GOODWILL

The goodwill carried in the accounts is attributable to two cash generating units, as analysed below:

	2017	2016
	£m	£m
Asset finance	96.5	96.8
TBMC	1.6	1.6
<b>At 30 September 2017</b>	<b>98.1</b>	<b>98.4</b>

### (a) Asset finance

The goodwill carried in the accounts relating to the asset finance cash generating unit was recognised on the acquisitions of PAF and Premier in the year ended 30 September 2016.

An impairment review undertaken at 30 September 2017 indicated that no write down was required.

The recoverable amount of the asset finance cash generating unit used in this impairment testing is determined on a value in use basis using pre-tax cash flow projections based on financial budgets approved by the Board covering a five year period. The pre-tax discount rate applied to the cash flow projection is 15.3% and cash flows beyond the five year budget are extrapolated assuming no lending growth beyond that point.

The key assumptions underlying the value in use calculation for the asset finance cash generating unit are:

- Level of business activity, based on management expectations. Management have concluded that the levels of activity assumed for the purpose of this forecast are reasonable, based on past experience and the current economic environment
- Discount rate, which is based on the Group's cost of capital

As an illustration of the sensitivity of this impairment test to movements in the key assumptions, the Group has calculated that a 10.3% reduction in profit levels coupled with a 1.2% increase in the pre-tax discount rate would eliminate the headroom in the projection.

### (b) TBMC

The goodwill carried in the accounts relating to the TBMC cash generating unit was recognised on the acquisition of The Business Mortgage Company Limited and its subsidiaries ("TBMC") in December 2008 and impaired by £6.0m in 2009.

An impairment review was undertaken at 30 September 2017 which indicated no further impairment. The recoverable amount of TBMC used in this impairment testing is determined on a value in use basis using pre-tax cash flow projections based on financial budgets approved by the Board covering a five year period. The pre-tax discount rate applied to the cash flow projection is 5.4% and cash flows beyond the five year budget are extrapolated using a 2.0% growth rate, being the average long term growth rate in the UK economy over a twenty year period.

The key assumptions underlying the value in use calculation for the TBMC business are:

- Level of business activity, based on management expectations. Management have concluded that the levels of activity assumed for the purpose of this forecast are reasonable, based on past experience and the current economic environment
- Discount rate, which is based on market rates of interest plus a margin appropriate to the risk profile of the TBMC business as an investment.

The directors believe that no reasonably possible change in any of the key assumptions above would cause the carrying value of the unit to exceed its recoverable amount.

### 43. INVESTMENT IN SUBSIDIARY UNDERTAKINGS

	Shares in Group companies £m	Loans to Group companies £m	Loans to ESOP Trusts £m	Total £m
At 1 October 2015	<b>346.5</b>	<b>668.3</b>	<b>3.5</b>	<b>1,018.3</b>
Investments in subsidiaries	<b>174.1</b>	-	-	<b>174.1</b>
Disposal of subsidiaries	-	-	-	-
Loans advanced	-	<b>30.2</b>	<b>9.8</b>	<b>40.0</b>
Loans repaid	-	<b>(246.6)</b>	-	<b>(246.6)</b>
Provision movements	<b>(1.2)</b>	-	<b>0.2</b>	<b>(1.0)</b>
At 30 September 2016	<b>519.4</b>	<b>451.9</b>	<b>13.5</b>	<b>984.8</b>
Investments in subsidiaries	<b>378.6</b>	-	-	<b>378.6</b>
Disposal of subsidiaries	<b>(150.0)</b>	-	-	<b>(150.0)</b>
Loans advanced	-	<b>88.9</b>	<b>4.2</b>	<b>93.1</b>
Loans repaid	-	<b>(494.5)</b>	-	<b>(494.5)</b>
Provision movements	<b>11.4</b>	-	<b>(4.3)</b>	<b>7.1</b>
<b>At 30 September 2017</b>	<b>759.4</b>	<b>46.3</b>	<b>13.4</b>	<b>819.1</b>

Investments in and disposals of subsidiaries represent transactions between the Company and various of its subsidiaries. In the year ended 30 September 2017 these transactions were mostly related to the Group restructuring in September 2017. Crystallisation of provisions as a result of these transfers is the major component of the provision movements in the period.

During the year ended 30 September 2017 the Company received £44.7m in dividend income from its subsidiaries (2016: £82.0m) and £27.0m of interest on loans to Group companies (2016: £33.6m).

The Company's subsidiaries, and the nature of its interest in them, are shown in note 65.

### 44. RETAIL DEPOSITS

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

	<b>2017</b> £m	2016 £m	2015 £m
Fixed rate	<b>2,675.9</b>	1,332.5	508.3
Variable rates	<b>939.5</b>	541.4	200.4
	<b>3,615.4</b>	1,873.9	708.7

The weighted average interest rate on retail deposits at 30 September 2017, analysed by charging method, was:

	<b>2017</b> %	2016 %	2015 %
Fixed rate	<b>1.89</b>	2.11	2.33
Variable rates	<b>1.21</b>	1.65	1.62

The contractual maturity of these deposits is analysed below.

	2017 £m	2016 £m	2015 £m
<b>Amounts repayable</b>			
In less than three months	<b>211.4</b>	55.7	9.1
In more than three months, but not more than one year	<b>1,399.6</b>	690.3	242.6
In more than one year, but not more than two years	<b>770.0</b>	572.9	181.7
In more than two years, but not more than five years	<b>629.7</b>	283.9	188.1
<b>Total term deposits</b>	<b>3,010.7</b>	1,602.8	621.5
<b>Repayable on demand</b>	<b>604.7</b>	271.1	87.2
	<b>3,615.4</b>	1,873.9	708.7
Fair value adjustments for portfolio hedging (note 36)	<b>(3.5)</b>	0.8	-
	<b>3,611.9</b>	1,874.7	708.7

## 45. ASSET BACKED LOAN NOTES

The Group's asset backed loan notes ('notes') are secured on portfolios comprising variable and fixed rate mortgages or personal, retail and car loans. The maturity date of the notes matches the maturity date of the underlying assets (except as noted below). The notes can be prepaid in part from time to time, but such prepayments are limited to the net capital received from borrowers in respect of the underlying assets. There is no requirement for the Group to make good any shortfall on the notes out of general funds. It is likely that a substantial proportion of these notes will be repaid within five years.

For its public issues, the Group has an additional option to repay all of the notes at an earlier date (the 'call date'), at their outstanding principal amount.

Interest is payable at a fixed margin above;

- The London Interbank Offered Rate ('LIBOR') on notes denominated in sterling
- The Euro Interbank Offered Rate ('EURIBOR') on notes denominated in euros
- The London Interbank Offered Rate ('US Dollar LIBOR') on notes denominated in US dollars

All payments in respect of the notes are required to be made in the currency in which they are denominated.

All of the notes are rated and publicly listed, except for those issued by Idem Luxembourg (No. 8), which were issued privately.

The notes outstanding at 30 September 2017 can be analysed as follows:

	2017			2016		
	Listed £m	Not listed £m	Total £m	Listed £m	Not listed £m	Total £m
Secured on first mortgage assets	<b>6,291.1</b>	-	<b>6,291.1</b>	8,095.6	-	8,095.6
Secured on other assets	<b>42.3</b>	<b>142.2</b>	<b>184.7</b>	141.7	136.8	278.5
	<b>6,333.4</b>	<b>142.2</b>	<b>6,475.8</b>	8,237.3	136.8	8,374.1

The Group publishes detailed information on the performance of all of its listed note issues on the Bond Investor Reporting section of its website at [www.paragonbankinggroup.co.uk](http://www.paragonbankinggroup.co.uk). A more detailed description of the securitisation structure under which these notes are issued is given in note 10.

On 20 October 2015, a Group company, Idem Luxembourg (No. 8) entered into an agreement under which sterling floating rate notes have been issued to Citibank NA, from time to time, on a limited recourse basis. These notes bear interest at a rate of one month LIBOR plus 3.50%. During the year £69.8m of new notes were issued under this facility. No additional group funding was required to support these drawings. The new funds were applied to finance portfolios of loan assets purchased from third parties.

Notes in issue at 30 September 2017 and 30 September 2016, net of any held by the Group, were:

Issuer	Maturity date	Call date	Principal outstanding		Average interest margin	
			2017 £m	2016 £m	2017 %	2016 %
<b>Sterling notes</b>						
Paragon Mortgages (No. 7) PLC	15/05/43	15/05/08	-	71.8	-	0.42
Paragon Mortgages (No. 8) PLC	15/04/44	15/10/08	<b>178.1</b>	190.5	<b>0.59</b>	0.59
Paragon Mortgages (No. 9) PLC	15/05/41	15/05/09	<b>108.2</b>	117.4	<b>0.38</b>	0.38
Paragon Mortgages (No. 10) PLC	15/06/41	15/12/09	<b>194.6</b>	214.4	<b>0.46</b>	0.44
Paragon Mortgages (No. 11) PLC	15/10/41	15/04/10	<b>277.9</b>	73.6	<b>0.15</b>	0.29
Paragon Mortgages (No. 12) PLC	15/11/38	15/08/10	<b>106.4</b>	111.1	<b>0.41</b>	0.40
Paragon Mortgages (No. 13) PLC	15/01/39	15/10/10	<b>502.7</b>	541.3	<b>0.27</b>	0.27
Paragon Mortgages (No. 14) PLC	15/09/39	15/03/11	<b>508.7</b>	117.0	<b>0.22</b>	0.31
Paragon Mortgages (No. 15) PLC	15/12/39	15/06/11	<b>138.9</b>	150.6	<b>0.29</b>	0.29
Paragon Mortgages (No. 18) PLC	15/03/41	15/12/16	-	66.4	-	1.54
Paragon Mortgages (No. 19) PLC	15/08/41	15/05/17	-	154.2	-	0.95
Paragon Mortgages (No. 20) PLC	15/11/41	15/08/18	<b>110.1</b>	198.5	<b>0.75</b>	0.72
Paragon Mortgages (No. 21) PLC	15/06/42	15/12/18	<b>86.9</b>	191.4	<b>1.01</b>	0.90
Paragon Mortgages (No. 22) PLC	15/09/42	15/06/19	<b>78.0</b>	163.5	<b>1.02</b>	0.90
Paragon Mortgages (No. 23) PLC	15/01/43	15/10/19	<b>139.3</b>	210.4	<b>1.28</b>	1.22
Paragon Mortgages (No. 24) PLC	15/07/43	15/04/20	<b>218.4</b>	245.9	<b>1.78</b>	1.75
First Flexible No. 5 PLC	01/06/34	01/07/09	<b>55.2</b>	61.6	<b>0.99</b>	0.99
First Flexible No. 6 PLC	01/12/35	01/03/08	<b>55.8</b>	60.6	<b>1.27</b>	1.27
First Flexible No. 7 PLC	15/09/33	15/03/11	<b>16.0</b>	21.2	<b>0.28</b>	0.27
Paragon Personal and Auto Finance (No. 3) PLC	15/04/36	15/04/09	-	35.8	-	0.95
Paragon Secured Finance (No. 1) PLC	15/11/35	15/11/08	<b>42.3</b>	52.7	<b>1.02</b>	0.98
Idem Luxembourg No. 8*	15/10/18	N/A	<b>143.2</b>	137.6	<b>3.50</b>	3.50
<b>US dollar notes</b>						
			<b>\$m</b>	<b>\$m</b>	<b>%</b>	<b>%</b>
Paragon Mortgages (No. 7) PLC	15/05/43	15/05/08	-	207.5	-	0.74
Paragon Mortgages (No. 9) PLC	15/05/41	15/05/09	<b>17.6</b>	19.1	<b>0.36</b>	0.36
Paragon Mortgages (No. 11) PLC †	15/10/41	15/04/10	-	386.8	-	0.10
Paragon Mortgages (No. 12) PLC	15/11/38	15/08/10	<b>804.2</b>	863.3	<b>0.24</b>	0.24
Paragon Mortgages (No. 13) PLC	15/01/39	15/10/10	<b>164.5</b>	179.1	<b>0.18</b>	0.18
Paragon Mortgages (No. 14) PLC †	15/09/39	15/03/11	<b>204.6</b>	1,060.9	<b>0.20</b>	0.20
Paragon Mortgages (No. 15) PLC	15/12/39	15/06/11	<b>668.9</b>	733.2	<b>0.19</b>	0.19
First Flexible No. 6 PLC	01/12/35	01/03/08	<b>8.7</b>	9.4	<b>0.56</b>	0.56

Issuer	Maturity date	Call date	Principal outstanding		Average interest margin		
			2017 €m	2016 €m	2017 %	2016 %	
<b>Euro notes</b>							
Paragon Mortgages (No. 7) PLC	15/05/43	15/05/08	-	211.0	-	0.66	
Paragon Mortgages (No. 8) PLC	15/04/44	15/10/08	<b>238.9</b>	255.7	<b>0.48</b>	0.48	
Paragon Mortgages (No. 9) PLC	15/05/41	15/05/09	<b>168.0</b>	182.1	<b>0.56</b>	0.56	
Paragon Mortgages (No. 10) PLC	15/06/41	15/12/09	<b>256.7</b>	258.7	<b>0.39</b>	0.40	
Paragon Mortgages (No. 11) PLC	15/10/41	15/04/10	<b>229.2</b>	244.5	<b>0.54</b>	0.54	
Paragon Mortgages (No. 12) PLC	15/11/38	15/08/10	<b>340.8</b>	348.8	<b>0.54</b>	0.53	
Paragon Mortgages (No. 13) PLC	15/01/39	15/10/10	<b>313.0</b>	326.2	<b>0.42</b>	0.41	
Paragon Mortgages (No. 14) PLC	15/09/39	15/03/11	<b>350.1</b>	361.7	<b>0.46</b>	0.45	
Paragon Mortgages (No. 15) PLC	15/12/39	15/06/11	<b>260.0</b>	266.1	<b>0.70</b>	0.69	
Paragon Mortgages (No. 22) PLC	15/09/42	15/06/19	<b>58.4</b>	150.8	<b>0.50</b>	0.50	
Paragon Mortgages (No. 23) PLC	15/01/43	15/10/19	<b>60.5</b>	100.1	<b>0.70</b>	0.70	
Paragon Mortgages (No. 24) PLC	15/07/43	15/04/20	<b>104.2</b>	120.7	<b>1.10</b>	1.10	
First Flexible No. 6 PLC	01/12/35	01/03/08	<b>31.4</b>	34.2	<b>1.05</b>	1.05	
Paragon Personal and Auto Finance (No. 3) PLC	15/04/36	15/04/09	-	61.6	-	0.84	

\* Although the maturity date of these notes may be earlier than the potential final redemption date of the underlying loans, repayment cannot be enforced except to the extent that cash can be realised from those assets at that time.

† During the period certain trigger events, specified in the terms and condition of the notes, occurred which meant that all cash flows relating to the class a1 dollar notes issued by Paragon Mortgages (No. 11) PLC and Paragon Mortgages (No. 14) PLC would in future be payable in sterling, as though they had been issued at the equivalent sterling amount (as described in note 10). The swap arrangements in the company mean that this change has no impact on the Group's exposure, but the loans are reported as sterling notes in the table above, whereas in 2016 they had been reported as US dollar notes.

The details of the assets backing these securities are given in notes 33 and 34.

## 46. BANK BORROWINGS

New first mortgage loans may be financed by a secured bank loan, referred to as a 'warehouse facility'. These facilities are drawn on the completion of a mortgage and repayment of the facilities is restricted to the principal cash received in respect of the funded mortgage. Loans originated in warehouse facilities are refinanced in the mortgage backed securitisation market when conditions are appropriate or through internal sales to access retail funding. More information on this process is given in note 10 and details of assets held within the warehouse facilities are given in note 33. Details of the Group's bank borrowings are set out below.

	2017			2016		
	Principal value	Maximum available facility	Carrying value	Principal value	Maximum available facility	Carrying value
	£m	£m	£m	£m	£m	£m
i) Paragon Second Funding	<b>1,005.7</b>	<b>1,005.7</b>	<b>1,005.7</b>	1,086.3	1,086.3	1,086.3
ii) Paragon Fourth Funding	-	-	-	143.0	300.0	143.0
iii) Paragon Fifth Funding	<b>158.0</b>	<b>350.0</b>	<b>157.3</b>	223.0	350.0	221.3
iv) Paragon Seventh Funding	<b>143.0</b>	<b>200.0</b>	<b>143.0</b>	123.0	200.0	122.4
	<b>1,306.7</b>	<b>1,555.7</b>	<b>1,306.0</b>	1,575.3	1,936.3	1,573.0

- i) The Paragon Second Funding warehouse was available for further drawings until 29 February 2008 at which point it converted automatically to a term loan and no further drawings were allowed. This loan is a sterling facility provided to Paragon Second Funding Limited by a consortium of banks and is secured on all the assets of Paragon Second Funding Limited, Paragon Car Finance (1) Limited and Paragon Personal Finance (1) Limited. Its final repayment date is 28 February 2050 but it is likely that substantial repayments will be made within the next five years. Interest on this loan is payable monthly in sterling at 0.675% above LIBOR (2016: 0.675% above LIBOR).
- ii) On 27 September 2010 the Group entered into a £200.0m committed sterling facility provided to Paragon Fourth Funding Limited by Macquarie Bank PLC to provide funding for new lending, which was increased to £250.0m in 2012 and to £300.0m on 8 May 2015. This facility was secured on all the assets of Paragon Fourth Funding Limited, it was available for drawing for a period of two years and had a term of four years. Interest on this loan was payable monthly in sterling at 2.875% above LIBOR until the facility was renewed, on substantially the same terms, with a reduced margin of 1.750% above three month LIBOR, with effect from 12 December 2014 for a further two year period. It was not renewed on the expiry of this period and the outstanding principal amount was repaid in the year.
- iii) On 26 September 2012, the Group entered into a £200.0m committed sterling facility provided to Paragon Fifth Funding Limited by the wholesale division of Lloyds Bank, which was renewed in January 2014. On 15 May 2015 the facility was increased to £350.0m, and certain other changes were made to its terms. The facility was renewed in 2016, but without changes to its terms. This facility is secured on all the assets of Paragon Fifth Funding Limited and is structured with a three year term to permit drawings and re-drawings until June 2018. Interest on this loan was payable monthly in sterling at 2.75% above three month LIBOR until January 2014, when the margin was reduced to 1.75%. As part of the May 2015 amendment to the facility this margin will increase to 2.15% for advances on the facility between £300.0m and £350.0m. The facility had a renewal process that allows the Group to agree a new commitment period prior to the expiry of the existing commitment period.
- iv) On 26 September 2015, a Group company, Paragon Seventh Funding Limited, entered into an additional £200.0m committed sterling facility with Bank of America Merrill Lynch International Limited. This facility is secured on all the assets of Paragon Seventh Funding Limited and is available for drawings and redrawings until 8 October 2017. This facility bears interest at a rate of three month LIBOR plus 1.30%. The facility was not renewed at the end of the commitment period and was repaid after the year end.

The weighted average margin above LIBOR on bank borrowings at 30 September 2017 was 0.873% (2016: 0.974%).

## 47. RETAIL BONDS

On 11 February 2013 the Company inaugurated a £1,000.0m Euro Medium Term Note Programme under which it may issue retail bonds, or other notes, within a twelve month period. The prospectus has been updated from time to time, most recently renewing the programme for a further twelve month period on 15 July 2016, but may be further extended in future.

The terms of issue for each tranche of notes are separately determined. These bonds are listed on the London Stock Exchange and have a fixed term, but are callable at the option of the Company. A summary of the retail bonds outstanding under this programme, shown with their principal values, is set out below.

Maturity date	Interest terms	Issue price	Currency	2017	2016
				£m	£m
5 December 2020	6.000% p.a. fixed	par	GBP	<b>60.0</b>	60.0
30 January 2022	6.125% p.a. fixed	par	GBP	<b>125.0</b>	125.0
28 August 2024	6.000% p.a. fixed	par	GBP	<b>112.5</b>	112.5
				<b>297.5</b>	297.5

The notes are unsubordinated unsecured liabilities of the Company and the amount included in the accounts of the Group and the Company in respect of these bonds is £295.7m (2016: £295.3m).

## 48. CORPORATE BONDS

On 9 September 2016 the Company issued £150.0m of 7.25% Fixed Rate Reset Callable Subordinated Tier 2 Notes at par to provide long term capital for the Group. These bonds bear interest at a fixed rate of 7.25% per annum until 9 September 2021, after which interest will be payable at a fixed rate which is 6.731% over the sterling 5-year mid-market swap rate at that time. These bonds are unsecured and subordinated to any other creditors of the Company. At issue the Notes were rated BB+ by Fitch and this rating was affirmed in the year. Cash received on the issue of these bonds was £149.0m net of issue costs (note 61).

On 20 April 2005 the Company issued £120.0m of 7% Callable Subordinated Notes at an issue price of 99.347% to provide long term capital for the Group. These bonds bore interest at a fixed rate of 7% per annum until 20 April 2012, after which interest was payable at a fixed rate of 3.729% per annum. The bonds were repaid on 20 April 2017. They were unsecured and subordinated to any other creditors of the Company.

A summary of the Company's corporate bonds is set out below:

Maturity date	Current Interest terms	Currency	Principal outstanding		Carrying value	
			2017	2016	2017	2016
			£m	£m	£m	£m
20 April 2017	3.729% p.a. fixed	GBP	-	110.0	-	110.0
9 September 2026	7.250% p.a. fixed	GBP	<b>150.0</b>	150.0	<b>149.1</b>	149.0
			<b>150.0</b>	260.0	<b>149.1</b>	259.0



## 49. CENTRAL BANK FACILITIES

During the year, the Group has utilised facilities provided by the Bank of England including through its Sterling Monetary Framework. These facilities enable either funding or off-balance sheet liquidity to be provided to Paragon Bank on the security of designated pools of the Bank's first mortgage assets, with the amount available based on the value of the security given, subject to a haircut.

Drawings under the FLS are used to provide off balance sheet liquidity and form part of the Bank's HQLA. Fees are charged under the FLS at 0.25% of the market value of the liquidity drawn and are repayable in June 2020.

Drawings under the Indexed Long Term Repo Scheme ('ILTR') have a maturity of six months and a rate of interest set in an auction process. While the Group has accessed this funding in the year, no drawings remained outstanding at the year end.

Drawings under the Term Funding Scheme ('TFS') have a maturity of four years and bear interest at bank base rate. The average remaining maturity of the Group's drawings is 45 months. As these drawings are provided at rates below those available commercially, by a government agency, they are accounted for under IAS 20.

The amounts drawn under these facilities are set out below.

	<b>2017</b>	2016
	<b>£m</b>	£m
TFS	<b>700.0</b>	-
ILTR	-	-
On balance sheet funding	<b>700.0</b>	-
FLS	<b>109.0</b>	108.8
<b>Total central bank facilities</b>	<b>809.0</b>	108.8

Further first mortgage assets of the Bank have been pre-positioned with the Bank of England for future use in such schemes. The assets pledged in support of these drawings are set out in note 33.

The balances arising from central bank facilities carried in the Group accounts are shown below.

	<b>2017</b>	2016
	<b>£m</b>	£m
TFS at IAS 20 carrying value	<b>679.9</b>	-
Deferred government assistance	<b>20.1</b>	-
	<b>700.0</b>	-

## 50. SUNDRY LIABILITIES

### (a) The Group

	2017	2016	2015
	£m	£m	£m
<b>Current liabilities</b>			
Accrued interest	23.6	26.1	23.9
Deferred income	1.1	1.3	0.1
Deferred consideration	-	1.9	-
Trade creditors	3.5	3.8	-
Conduct (note 51)	0.5	1.9	-
Other accruals	21.0	19.6	17.7
Other taxation and social security	1.4	1.7	1.3
	<b>51.1</b>	56.3	43.0
<b>Non-current liabilities</b>			
Accrued interest	7.2	6.5	-
Deferred income	2.1	1.7	0.1
Contingent liabilities	14.0	13.7	-
Other accruals	0.2	0.5	-
	<b>23.5</b>	22.4	0.1
<b>Total sundry liabilities</b>	<b>74.6</b>	78.7	43.1

Accrued interest, contingent liabilities and other accruals fall within the definition of 'other financial liabilities' set out in IAS 32 and IAS 39.

The contingent liability represents consideration payable in respect of corporate acquisitions which is dependent on the performance of the acquired business. Movements in the contingent liability are set out below.

	2017	2016
	£m	£m
At 1 October 2016	13.7	-
Acquisitions	-	13.7
Revaluation of liability	-	-
Unwind of discounting (note 17)	0.3	-
<b>At 30 September 2017</b>	<b>14.0</b>	13.7

### (b) The Company

	2017	2016	2015
	£m	£m	£m
<b>Current liabilities</b>			
Amounts owed to Group companies	36.5	168.5	244.7
Accrued interest	2.9	4.7	4.0
	<b>39.4</b>	173.2	248.7

Accrued interest and other accruals fall within the definition of 'other financial liabilities' set out in IAS 32 and IAS 39.

## 51. CONDUCT

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

In November 2014, the UK Supreme Court handed down its decision in Plevin v Paragon Personal Finance Limited ('Plevin'), which addressed potential liability in respect of PPI claims under Section 140 of the Consumer Credit Act 1974, where commission charged to the customer was particularly high. On 31 March 2017 the FCA introduced rules addressing the handling of PPI cases in the light of the Plevin decision which included a deadline beyond which no further new PPI claims would be required to be considered.

A balance of £0.5m (2016: £1.9m) is recognised in sundry liabilities (note 50) in respect of such claims and other Section 140 related issues.

The Group has reviewed its current exposure to such matters in the light of the Court's judgement in Plevin and the FCA rules and its current expectation is that it will suffer no material additional costs from such claims. However, this assessment is based on our current interpretation of both the Plevin judgement and the rules, which may develop as both the judgement and the rules are implemented. Therefore, it is possible that the maximum possible liability may be greater.

## 52. CURRENT TAX LIABILITIES

Current tax in the Group and the Company represents UK corporation tax owed.

## 53. DEFERRED TAX

### (a) The Group

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

	Note	2017 £m	2016 £m	2015 £m
Net liability at 1 October 2016		2.0	11.3	10.1
Acquisitions	13	-	(3.5)	-
Income statement (credit) / charge	27	(2.8)	(0.4)	1.8
Charge / (credit) to equity		5.6	(5.4)	(0.6)
<b>Net liability at 30 September 2017</b>		<b>4.8</b>	<b>2.0</b>	<b>11.3</b>

The net deferred tax liability for which provision has been made is analysed as follows:

	2017 £m	2016 £m	2015 £m
Accelerated tax depreciation	(4.0)	(4.2)	(0.4)
Retirement benefit obligations	(5.7)	(11.1)	(4.3)
Impairment and other provisions	14.9	16.4	16.6
Tax (losses)	(0.2)	(0.2)	(0.3)
Other timing differences	(0.2)	1.1	(0.3)
<b>Net deferred tax liability</b>	<b>4.8</b>	<b>2.0</b>	<b>11.3</b>

As stated in note 27 legislation has been introduced to reduce the standard rate of UK corporation tax to 17.0% from 1 April 2020. The temporary differences have been provided at the rate prevailing when the Group anticipates the temporary difference to reverse. In the event that the temporary differences actually reverse in different periods a credit or charge will arise in a future period to reflect the difference. The timing of reversal of temporary differences will be affected by both matters within the Group's control (eg the timing and nature of the refinancing of certain portfolios) and matters outside the Group's control (eg the level of redemptions of finance leases).

If temporary differences reverse within Paragon Bank PLC in a period in which it is subject to the banking surcharge, then the impact of the reversal will be at an effective tax rate that includes the surcharge to some extent. The deferred tax numbers above do not include any material temporary differences in Paragon Bank PLC.

In addition, the Group has tax losses of £1.7m (2016: £1.7m) in entities whose current taxable profits are insufficient to support the recognition of a deferred tax asset.

## (b) The Company

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

	2017	2016	2015
	£m	£m	£m
Net liability at 1 October 2016	1.9	1.9	1.8
Income statement charge	(0.1)	-	0.1
<b>Net liability at 30 September 2017</b>	<b>1.8</b>	<b>1.9</b>	<b>1.9</b>

The net deferred tax liability for which provision has been made is analysed as follows:

	2017	2016	2015
	£m	£m	£m
Other timing differences	1.8	1.9	1.9
<b>Net deferred tax liability</b>	<b>1.8</b>	<b>1.9</b>	<b>1.9</b>

## 54. RETIREMENT BENEFIT OBLIGATIONS

### (a) Defined benefit plan - description

The Group operates a funded defined benefit pension scheme in the UK (the 'Plan'). The Plan assets are held in a separate fund, administered by a corporate trustee, to meet long-term pension liabilities to past and present employees. The Trustee of the Plan is required by law to act in the best interests of the Plan's beneficiaries and is responsible for the investment policy adopted in respect of the Plan's assets. The appointment of directors to the Trustee is determined by the Plan's trust documentation. The Group has a policy that one third of all directors of the Trustee should be nominated by active and pensioner members of the Plan.

Employees who are members of the Plan are entitled to receive a pension of 1/60 of their final basic annual salary for every year of eligible service (to a maximum of 2/3). Dependants of members of the Plan are eligible for a dependant's pension and the payment of a lump sum in the event of death in service.

The principal actuarial risks to which the Plan is exposed are:

- **Investment risk** – The risk that income is generated on the Plan's investments at a rate lower than the rate at which the defined benefit liability is calculated, which would cause an increased deficit in the Plan. The Trustee keeps the allocation of the Plan's investments under review to manage this risk on a long term basis
- **Interest risk** – A decrease in bond yields will reduce the discount rate used in valuing the deficit and hence increase the Plan liability
- **Inflation risk** – A rise in inflation will increase the benefits payable to Plan members, which would increase the Plan liability
- **Longevity risk** – The value of the Plan deficit is calculated by reference to the best estimate of the mortality rate among Plan members both during and after employment. An increase in the life expectancy of the members would increase the deficit in the Plan
- **Salary risk** – The valuation of the Plan assumes a level of future salary increases based on a premium over the expected rate of inflation. Should the salaries of Plan members increase at a higher rate then the deficit will be higher

The risks relating to death in service payments are insured with an external insurance company.

As a result of the Plan having been closed to new entrants since February 2002, the service cost as a percentage of pensionable salaries is expected to increase as the average age of active members rises over time. However the membership is expected to reduce so that the service cost in monetary terms will gradually reduce.

The most recent full actuarial valuation of the Plan's liabilities, obtained by the Trustee, was carried out at 31 March 2016, by Aon Hewitt, the Plan's independent actuary. This showed that the value of the Plan's liabilities on a buy-out basis in accordance with Section 224 of the Pensions Act 2004 was £214.0m, with a shortfall against the assets of £118.4m.

Following the 2016 actuarial valuation, the Trustee put in place a revised recovery plan. The Trustee's recovery plan aims to meet the statutory funding objective within six years and ten months from the date of valuation, that is by 31 January 2023.

## (b) Defined benefit plan – financial impact

For accounting purposes the valuation at 31 March 2016 was updated to 30 September 2017 in accordance with the requirements of IAS 19 (revised) by Mercer, the Group's independent consulting actuary.

The major categories of assets in the Plan at 30 September 2017, 30 September 2016 and 30 September 2015 and their fair values were:

	2017	2016	2015
	£m	£m	£m
Cash	0.9	9.7	0.4
Equity instruments	58.7	56.0	56.3
Debt instruments	28.9	29.5	25.7
Real estate	9.8	8.9	8.7
<b>Total fair value of Plan assets</b>	<b>98.3</b>	<b>104.1</b>	<b>91.1</b>
Present value of Plan liabilities	(128.1)	(162.5)	(112.6)
<b>(Deficit) in the Plan</b>	<b>(29.8)</b>	<b>(58.4)</b>	<b>(21.5)</b>

At 30 September 2017 the Plan assets were invested in a diversified portfolio that consisted primarily of equity and debt investments. The majority of the equities held by the Plan are in developed markets. All investments of the Plan are in managed funds for which unit prices are quoted publicly by the fund managers, however they are not openly traded so are considered to be Level 2 financial instruments as defined by IFRS 13.

The movement in the fair value of the Plan assets during the year was as follows:

	2017	2016
	£m	£m
At 1 October 2016	104.1	91.1
Interest on Plan assets	2.3	3.6
Cash flows		
Contributions by Group	3.7	3.2
Contributions by Plan members	0.2	0.2
Benefits paid	(19.0)	(1.3)
Administration expenses paid	(0.4)	(0.4)
Remeasurement gain		
Return on Plan assets (excluding amounts included in interest)	7.4	7.7
<b>At 30 September 2017</b>	<b>98.3</b>	<b>104.1</b>

The actual return on Plan assets in the year ended 30 September 2017 was £9.7m (2016: £11.3m).

Benefits paid includes amounts transferred on the settlement of the Plan's commitments to certain members with large accrued benefits. No gain or loss arose on these transfers, which will reduce the Plan's exposure to future volatility. These transfers are described further in the Directors' Remuneration Report in Section B5.

The movement in the present value of the Plan liabilities during the year was as follows:

	2017	2016
	£m	£m
At 1 October 2016	162.5	112.6
Current service cost	2.4	1.7
Funding cost	3.6	4.4
Cash flows		
Contributions by Plan members	0.2	0.2
Benefits paid	(19.0)	(1.3)
Remeasurement (gain) / loss		
Arising from demographic assumptions	(6.7)	-
Arising from financial assumptions	(10.7)	44.9
Arising from experience adjustments	(4.2)	-
<b>At 30 September 2017</b>	<b>128.1</b>	<b>162.5</b>

The liabilities of the Plan are measured by discounting the best estimate of future cash flows to be paid out by the Plan using the Projected Unit method. This amount is reflected in the liability in the balance sheet. The Projected Unit method is an accrued benefits valuation method in which the Plan liabilities are calculated based on service up until the valuation date allowing for future salary growth until the date of retirement, withdrawal or death, as appropriate. The future service rate is then calculated as the contribution rate required to fund the service accruing over the next year again allowing for future salary growth. The major weighted average assumptions used by the actuary were (in nominal terms):

	<b>30 September 2017</b>	30 September 2016	30 September 2015
In determining net pension cost for the year			
Discount rate	<b>2.40%</b>	3.90%	4.10%
Rate of compensation increase	<b>3.50%</b>	3.55%	3.65%
Rate of price inflation	<b>3.00%</b>	3.05%	3.15%
Rate of increase of pensions	<b>2.95%</b>	3.00%	3.05%
In determining benefit obligations			
Discount rate	<b>2.70%</b>	2.40%	3.90%
Rate of compensation increase	<b>3.60%</b>	3.50%	3.55%
Rate of price inflation	<b>3.10%</b>	3.00%	3.05%
Rate of increase of pensions	<b>2.90%</b>	2.95%	3.00%
Further life expectancy at age 60			
Male member aged 60	<b>29</b>	29	29
Female member aged 60	<b>30</b>	31	31
Male member aged 40	<b>30</b>	32	32
Female member aged 40	<b>32</b>	34	34

The amounts charged in the consolidated income statement in respect of the Plan are:

	Note	<b>2017</b>	2016
		<b>£m</b>	£m
Current service cost	21	<b>2.4</b>	1.7
Administration expenses		<b>0.4</b>	0.4
Included within operating expenses		<b>2.8</b>	2.1
Funding cost of Plan liabilities		<b>3.6</b>	4.4
Interest on Plan assets		<b>(2.3)</b>	(3.6)
Net interest expense	17	<b>1.3</b>	0.8
<b>Components of defined benefit costs recognised in profit or loss</b>		<b>4.1</b>	2.9

The amounts recognised in the consolidated statement of comprehensive income in respect of the Plan are:

	<b>2017</b>	2016
	<b>£m</b>	£m
Return on Plan assets (excluding amounts included in interest)	<b>7.4</b>	7.7
Actuarial gains / (losses)		
Arising from demographic assumptions	<b>6.7</b>	-
Arising from financial assumptions	<b>10.7</b>	(44.9)
Arising from experience adjustments	<b>4.2</b>	-
<b>Total actuarial gain / (loss)</b>	<b>29.0</b>	(37.2)
Tax thereon	<b>(5.5)</b>	6.8
<b>Net actuarial gain / (loss)</b>	<b>23.5</b>	(30.4)

Of the remeasurement movements reflected above:

- The return on plan assets represents better than expected investment performance
- The change in demographic assumptions reflects the adoption of new mortality assumptions, in line with those adopted by the Trustee in the triennial valuation, which predict lower life expectancy among members
- The change in financial assumptions reflects principally the impact of increased inflation expectations on discount rates
- The experience adjustments relate to the trueing up of the IAS 19 valuation to reflect changes in Plan members' positions and salaries over the three year period between triennial valuations

### (c) Defined benefit plan – future cash flows

The sensitivity of the valuation of the defined benefit obligation to the principal assumptions disclosed above at 30 September 2017, calculating the obligation on the same basis as used in determining the IAS 19 value, is as follows:

<b>Assumption</b>	<b>Increase in assumption</b>	<b>Impact on scheme liabilities</b>
Discount rate	0.1% p.a.	Decrease by 2.2%
Rate of inflation*	0.1% p.a.	Increase by 2.2%
Rate of salary growth	0.1% p.a.	Increase by 0.4%
Rates of mortality	1 year of life expectancy	Increase by 2.5%

\*maintaining a 0.5% assumption for real salary growth

The sensitivity analysis presented above may not be representative of an actual future change in the defined benefit obligation as it is unlikely that changes in assumptions would occur in isolation as some of the assumptions will be correlated. There has been no change in the method of preparing the analysis from that adopted in previous years.

In conjunction with the Trustee, the Group has continued to conduct asset-liability reviews of the Plan. These studies are used to assist the Trustee and the Group to determine the optimal long-term asset allocation with regard to the structure of liabilities within the Plan. The results of the studies are used to assist the Trustee in managing the volatility in the underlying investment performance and risk of a significant increase in the scheme deficit by providing information used to determine the investment strategy of the Plan. There have been no changes in the processes by which the Plan manages its risks from previous periods.

The target asset allocations for the year ending 30 September 2018 are 60% growth assets (primarily equities), 30% bonds and 10% real estate.

The rate of employee contributions to the Plan is 5.0% of pensionable salaries. Before 1 April 2017 the agreed rate of employer contributions was 27.0% of gross salaries for participating employees with additional contributions of £1.5m per annum for deficit reduction and £0.4m per annum to cover administration and life cover costs, payable monthly. After 1 April 2017, following the finalisation of the March 2016 valuation, employer contributions increased to 32.0% of gross salaries and the additional contribution for deficit reduction increased to £2.5m per annum. The £0.4m per annum contribution in respect of costs remained in place.

The present best estimate of the contributions to be made to the Plan by the Group in the year ending 30 September 2018 is £4.4m.

The average duration of the benefit obligations in the Plan at the year end are shown in the table below:

	<b>2017</b>	2016
	<b>Years</b>	Years
<b>Category of member</b>		
Active members	<b>24</b>	26
Deferred pensioners	<b>23</b>	26
Current pensioners	<b>16</b>	16
<b>All members</b>	<b>22</b>	24

#### (d) Defined contribution arrangements

The Group sponsors a defined contribution (Worksave) pension scheme, open to all employees who are not members of the Plan. The Group successfully completed the auto-enrolment process mandated by the UK Government in November 2013, using this scheme.

The PAF business also sponsors a number of defined contribution pension plans and makes contributions to these schemes in respect of employees.

The assets of these schemes are not Group assets and are held separately from those of the Group, under the control of independent trustees. Contributions made by the Group to these schemes in the year ended 30 September 2017, which represent the total cost charged against income, were £1.9m (2016: £1.8m) (note 21).

## 55. CALLED-UP SHARE CAPITAL

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

Movements in the issued share capital in the year were:

	<b>2017</b>	2016
	<b>Number</b>	Number
<b>Ordinary shares</b>		
At 1 October 2016	<b>295,852,094</b>	309,349,316
Shares issued	<b>637,607</b>	218,872
Shares cancelled	<b>(15,000,000)</b>	(13,716,094)
<b>At 30 September 2017</b>	<b>281,489,701</b>	295,852,094

During the year the Company issued 637,607 shares (2016: 55,827) to satisfy options granted under sharesave schemes for a consideration of £1,575,925 (2016: £68,070). In the year ended 30 September 2016, the Company had also issued 163,045 shares at par to the trustees of its Employee Share Ownership Plan ('ESOP') Trust in order that they could fulfil their obligations under the Group's share based award arrangements.

On 1 June 2017 15,000,000 shares held in treasury were cancelled by the Company (2016: 13,716,094 shares).

## 56. RESERVES

### (a) The Group

	<b>2017</b>	2016	2015
	<b>£m</b>	£m	£m
Share premium account	<b>65.5</b>	64.6	64.6
Capital redemption reserve	<b>28.7</b>	13.7	-
Merger reserve	<b>(70.2)</b>	(70.2)	(70.2)
Cash flow hedging reserve	<b>2.5</b>	2.1	(1.9)
Profit and loss account	<b>784.5</b>	725.9	767.7
	<b>811.0</b>	736.1	760.2



**(b) The Company**

	<b>2017</b>	2016	2015
	<b>£m</b>	£m	£m
Share premium account	<b>65.5</b>	64.6	64.6
Capital redemption reserve	<b>28.7</b>	13.7	-
Merger reserve	<b>(23.7)</b>	(23.7)	(23.7)
Profit and loss account	<b>384.0</b>	415.5	456.6
	<b>454.5</b>	470.1	497.5

The merger reserve arose, due to the provisions of UK company law at the time, on a group restructuring on 12 May 1989 when the Company became the parent entity of the Group.

The cash flows to which amounts included in the cash flow hedging reserve relate result from the cross currency basis swaps described in note 12. The contractual life of these swaps, over which cash flows might take place and affect profit, extend over the next 27 years (2016: 28 years). However the cash flows in respect of these swaps will only continue for as long as the related notes remain outstanding, which is expected to be a much shorter period.

**57. OWN SHARES**

	<b>The Group</b>		<b>The Company</b>	
	<b>2017</b>	2016	<b>2017</b>	2016
	<b>£m</b>	£m	<b>£m</b>	£m
<b>Treasury shares</b>				
At 1 October 2016	<b>46.2</b>	89.2	<b>46.2</b>	89.2
Shares purchased	<b>65.5</b>	51.0	<b>65.5</b>	51.0
Shares cancelled	<b>(45.1)</b>	(94.0)	<b>(45.1)</b>	(94.0)
At 30 September 2017	<b>66.6</b>	46.2	<b>66.6</b>	46.2
<b>ESOP shares</b>				
At 1 October 2016	<b>16.3</b>	10.8	-	-
Shares purchased	<b>4.2</b>	8.9	-	-
Shares subscribed for (note 55)	-	0.3	-	-
Options exercised	<b>(4.0)</b>	(3.7)	-	-
At 30 September 2017	<b>16.5</b>	16.3	-	-
<b>Balance at 30 September 2017</b>	<b>83.1</b>	62.5	<b>66.6</b>	46.2
Balance at 1 October 2016	<b>62.5</b>	100.0	<b>46.2</b>	89.2

At 30 September 2017 the number of the Company's own shares held in treasury was 15,693,643 (2016: 15,348,714). These shares had a nominal value of £15,693,643 (2016: £15,348,714). These shares do not qualify for dividends.

The ESOP shares are held in trust for the benefit of employees exercising their options under the Company's share option schemes and awards under the Paragon Performance Share Plan, Matching Share Plan and Deferred Bonus Plan. The trustees' costs are included in the operating expenses of the Group.

At 30 September 2017, the trusts held 3,180,661 ordinary shares (2016: 3,594,175) with a nominal value of £3,180,661 (2016: £3,594,175) and a market value of £13,975,824 (2016: £11,267,738). Options, or other share-based awards, were outstanding against all of these shares at 30 September 2017 (2016: all). The dividends on all of these shares have been waived (2016: all).

## 58. EQUITY DIVIDEND

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

	<b>2017</b>	2016	<b>2017</b>	2016
	<b>Per share</b>	Per share	<b>£m</b>	£m
<b>Equity dividends on ordinary shares</b>				
Final dividend for the year ended 30 September 2016	<b>9.2p</b>	7.4p	<b>25.5</b>	21.7
Interim dividend for the year ended 30 September 2017	<b>4.7p</b>	4.3p	<b>12.5</b>	12.2
	<b>13.9p</b>	11.7p	<b>38.0</b>	33.9

Amounts paid and proposed in respect of the year:

	<b>2017</b>	2016	<b>2017</b>	2016
	<b>Per share</b>	Per share	<b>£m</b>	£m
Interim dividend for the year ended 30 September 2017	<b>4.7p</b>	4.3p	<b>12.5</b>	12.2
Proposed final dividend for the year ended 30 September 2017	<b>11.0p</b>	9.2p	<b>28.9</b>	25.5
	<b>15.7p</b>	13.5p	<b>41.4</b>	37.7

The proposed final dividend for the year ended 30 September 2017 will be paid on 19 February 2018, subject to approval at the Annual General Meeting, with a record date of 5 January 2018. The dividend will be recognised in the accounts when it is paid.

## 59. NET CASH FLOW FROM OPERATING ACTIVITIES

### (a) The Group

	<b>2017</b>	2016
	<b>£m</b>	£m
<b>Profit before tax</b>	<b>144.8</b>	143.2
Non-cash items included in profit and other adjustments:		
Depreciation of operating property, plant and equipment	<b>1.9</b>	1.9
Profit on disposal of operating property, plant and equipment	<b>(0.1)</b>	(0.1)
Amortisation of intangible assets	<b>1.6</b>	1.6
Foreign exchange movement on borrowings	<b>(468.9)</b>	699.9
Other non-cash movements on borrowings	<b>6.4</b>	14.3
Impairment losses on loans to customers	<b>5.3</b>	7.7
Charge for share based remuneration	<b>4.2</b>	4.4
Net (increase) / decrease in operating assets:		
Operating lease assets	<b>(7.4)</b>	(5.4)
Loans to customers	<b>(391.9)</b>	(443.0)
Derivative financial instruments	<b>459.8</b>	(706.3)
Fair value of portfolio hedges	<b>21.2</b>	(7.3)
Other receivables	-	(2.1)
Net increase / (decrease) in operating liabilities:		
Retail deposits	<b>1,741.5</b>	1,165.2
Derivative financial instruments	<b>(8.7)</b>	9.1
Fair value of portfolio hedges	<b>(4.3)</b>	0.8
Other liabilities	<b>(1.8)</b>	4.9
Cash generated by operations	<b>1,503.6</b>	888.8
Income taxes (paid)	<b>(28.9)</b>	(23.6)
	<b>1,474.7</b>	865.2

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

**(b) The Company**

	<b>2017</b>	2016
	<b>£m</b>	£m
<b>Profit before tax</b>	<b>44.6</b>	82.9
Non-cash items included in profit and other adjustments:		
Depreciation of property, plant and equipment	<b>0.3</b>	0.4
Non-cash movements on borrowings	<b>0.5</b>	0.4
Impairment (release) / provision on investments in subsidiaries	<b>(8.1)</b>	1.0
Charge for share based remuneration	<b>4.2</b>	4.4
Net decrease in operating assets:		
Other receivables	<b>45.5</b>	56.7
Net (decrease) in operating liabilities:		
Other liabilities	<b>(133.8)</b>	(75.5)
Cash (utilised) / generated by operations	<b>(46.8)</b>	70.3
Income taxes received / (paid)	<b>2.3</b>	(2.7)
	<b>(44.5)</b>	67.6

**60. NET CASH FLOW FROM INVESTING ACTIVITIES**

	<b>The Group</b>		<b>The Company</b>	
	<b>2017</b>	2016	<b>2017</b>	2016
	<b>£m</b>	£m	<b>£m</b>	£m
Proceeds from sales of operating property, plant and equipment	<b>0.3</b>	0.4	-	-
Purchases of operating property, plant and equipment	<b>(1.7)</b>	(1.5)	-	-
Purchases of intangible assets	<b>(0.9)</b>	(1.4)	-	-
Decrease in short term investments	<b>7.1</b>	34.0	-	-
Movement in loans to subsidiary undertakings	-	-	<b>401.4</b>	206.6
Acquisitions (Note 13)	<b>(1.6)</b>	(310.1)	-	-
Investment in subsidiary undertakings	-	-	<b>(378.6)</b>	(174.1)
Disposal of subsidiary undertakings	-	-	<b>150.0</b>	-
<b>Net cash generated / (utilised) by investing activities</b>	<b>3.2</b>	(278.6)	<b>172.8</b>	32.5

## 61. NET CASH FLOW FROM FINANCING ACTIVITIES

	The Group		The Company	
	2017	2016	2017	2016
	£m	£m	£m	£m
Shares issued (note 55)	1.5	-	1.5	0.3
Dividends paid (note 58)	(38.0)	(33.9)	(38.0)	(33.9)
Issue of asset backed floating rate notes	69.8	531.0	-	-
Repayment of asset backed floating rate notes	(1,503.0)	(1,137.2)	-	-
Issue of corporate bonds	-	149.0	-	149.0
Repayment of corporate bonds	(110.0)	-	(110.0)	-
Movement on central bank facilities	700.0	-	-	-
Movement on other bank facilities	(268.6)	145.5	-	-
Purchase of shares (note 57)	(69.7)	(59.9)	(65.5)	(51.0)
<b>Net cash (utilised) / generated by financing activities</b>	<b>(1,218.0)</b>	<b>(405.5)</b>	<b>(212.0)</b>	<b>64.4</b>

## 62. RECONCILIATION OF NET DEBT

### (a) The Group

	Cash flows			Non-cash movements			Closing debt
	Opening debt	Debt issued	Others	Acquisition	Foreign exchange	Other	
	£m	£m	£m	£m	£m	£m	£m
<b>30 September 2017</b>							
Asset backed loan notes	8,374.1	69.8	(1,503.0)	-	(468.9)	3.8	6,475.8
Bank borrowings	1,573.0	-	(268.6)	-	-	1.6	1,306.0
Bank borrowing debits	-	-	-	-	-	-	-
Corporate bonds	259.0	-	(110.0)	-	-	0.1	149.1
Retail bonds	295.3	-	-	-	-	0.4	295.7
Central bank borrowings	-	700.0	-	-	-	-	700.0
Bank overdrafts	1.2	-	(0.6)	-	-	-	0.6
Gross debt	10,502.6	769.8	(1,882.2)	-	(468.9)	5.9	8,927.2
Cash	(1,237.6)	(769.8)	510.5	-	-	-	(1,496.9)
<b>Net debt</b>	<b>9,265.0</b>	<b>-</b>	<b>(1,371.7)</b>	<b>-</b>	<b>(468.9)</b>	<b>5.9</b>	<b>7,430.3</b>
<b>30 September 2016</b>							
Asset backed loan notes	8,274.6	531.0	(1,137.2)	-	699.9	5.8	8,374.1
Bank borrowings	1,425.4	-	145.5	-	-	2.1	1,573.0
Bank borrowing debits	(1.0)	-	-	-	-	1.0	-
Corporate bonds	110.0	149.0	-	-	-	-	259.0
Retail bonds	294.9	-	-	-	-	0.4	295.3
Central bank borrowings	-	-	-	-	-	-	-
Bank overdrafts	0.7	-	-	0.5	-	-	1.2
Gross debt	10,104.6	680.0	(991.7)	0.5	699.9	9.3	10,502.6
Cash	(1,056.0)	(680.0)	504.0	(5.6)	-	-	(1,237.6)
<b>Net debt</b>	<b>9,048.6</b>	<b>-</b>	<b>(487.7)</b>	<b>(5.1)</b>	<b>699.9</b>	<b>9.3</b>	<b>9,265.0</b>

Other non-cash changes shown above represent EIR adjustments relating to the spreading of initial costs of the facilities concerned.

(b) The Company

	Cash flows			Non-cash movements		Closing debt £m
	Opening debt £m	Debt issued £m	Other £m	Foreign exchange £m	Other £m	
<b>30 September 2017</b>						
Corporate bonds	259.0	-	(110.0)	-	0.1	149.1
Retail bonds	295.3	-	-	-	0.4	295.7
Gross debt	554.3	-	(110.0)	-	0.5	444.8
Cash	(361.3)	-	83.7	-	-	(277.6)
<b>Net debt</b>	<b>193.0</b>	<b>-</b>	<b>(26.3)</b>	<b>-</b>	<b>0.5</b>	<b>167.2</b>
<b>30 September 2016</b>						
Corporate bonds	110.0	149.0	-	-	-	259.0
Retail bonds	294.9	-	-	-	0.4	295.3
Gross debt	404.9	149.0	-	-	0.4	554.3
Cash	(196.8)	(149.0)	(15.5)	-	-	(361.3)
<b>Net debt</b>	<b>208.1</b>	<b>-</b>	<b>(15.5)</b>	<b>-</b>	<b>0.4</b>	<b>193.0</b>

Other non-cash changes shown above represent EIR adjustments relating to the spreading of initial costs of the bonds.

### 63. OPERATING LEASE ARRANGEMENTS

(a) As Lessor

The Group, through its asset finance business, leases assets under operating leases. In respect of certain of these assets, the Group also provides maintenance services to the lessee.

Assets subject to these arrangements are shown in note 40 and the income from these activities is shown in note 18.

The future minimum lease payments under these arrangements may be analysed as follows:

	The Group		The Company	
	2017 £m	2016 £m	2017 £m	2016 £m
<b>Amounts falling due:</b>				
Within one year	3.0	2.5	-	-
Between two and five years	7.5	4.7	-	-
After more than five years	0.3	-	-	-
	<b>10.8</b>	<b>7.2</b>	<b>-</b>	<b>-</b>

**(b) As Lessee**

	The Group		The Company	
	2017	2016	2017	2016
	£m	£m	£m	£m
<b>Minimum lease payments under operating leases recognised in operating expenses for the year</b>				
Office buildings	2.1	2.1	-	-
Motor vehicles	0.3	0.3	-	-
Office equipment	0.2	0.2	-	-
	2.6	2.6	-	-

At 30 September 2017 the Group had outstanding commitments for future minimum lease payments under non-cancellable operating leases, which fall due as follows:

	The Group		The Company	
	2017	2016	2017	2016
	£m	£m	£m	£m
<b>Amounts falling due:</b>				
Within one year	2.4	2.3	-	-
Between two and five years	6.8	3.4	-	-
After more than five years	3.8	-	-	-
	13.0	5.7	-	-

Operating lease payments represent rents payable by the Group in respect of certain of its office premises and lease payments on company vehicles and equipment. The average term of the current building leases from inception or acquisition is 6 years (2016: 5 years) with rents subject to review every five years, while the average term of the vehicle leases and office equipment is 3 years (2016: 3 years).

## 64. RELATED PARTY TRANSACTIONS

**(a) The Group**

Mr A K Fletcher, an independent non-executive director of the Company, is a director of Paragon Pension Plan Trustees Limited, which acts as the corporate trustee of the Paragon Pension Plan ('the Plan'). Mr Fletcher was appointed a trustee of the Plan on 27 May 2010, and a director of Paragon Pension Trustees Limited on 7 November 2011. The Plan moved to corporate trusteeship in the first quarter of 2013 at which point all individuals ceased to be trustees of the Plan on their own account. In respect of this appointment he was paid £10,000 in the year ended 30 September 2017 by Paragon Finance PLC, the sponsoring company of the Plan (2016: £10,000).

The Plan is a related party of the Group. Transactions with the Plan are described in note 54.

The Group had no other transactions with related parties other than the key management compensation disclosed in note 22.

**(b) The Company**

During the year the parent company entered into transactions with its subsidiaries, which are related parties. Management services were provided to the Company by one of its subsidiaries and the Company granted awards under the share based payment arrangements described in note 23 to employees of subsidiary undertakings.

Details of the Company's investments in subsidiaries and the income derived from them are shown in notes 43 and 65.

Outstanding current account balances with subsidiaries are shown in notes 39 and 50.

During the year the Company incurred interest costs of £10.2m in respect of borrowings from its subsidiaries (2016: £8.9m).

## 65. DETAILS OF SUBSIDIARY UNDERTAKINGS

Subsidiary undertakings of the Group at 30 September 2017, where the share capital is held within the Group are shown below. The holdings shown are those held within the Group. The shareholdings of the Company in the direct subsidiaries listed below are the same as those held by the Group, except that:

- For the shareholdings marked \* the Company holds only 74% of the share capital
- For the shareholdings marked † the Company holds only 66.7% of the share capital

In these cases the remainder is held by other group companies.

The issued share capital of all subsidiaries consists of ordinary share capital, except those companies marked § which have additional preference share capital held within the Group.

Company	Holding	Principal activity
<b>Direct subsidiaries of Paragon Banking Group PLC</b>		
Paragon Car Finance Limited	100%	Vehicle finance
Idem Capital Holdings Limited	100%	Intermediate holding company
Moorgate Servicing Limited	100%	Intermediate holding company
Paragon Bank PLC	100%	Deposit taking, residential mortgages and loan and vehicle finance
SPV Securities Limited	100%	Asset investment
The Business Mortgage Company Limited	100%	Mortgage broker
Paragon Fourth Funding Limited	100%	Residential mortgages
Paragon Mortgages (No. 7) PLC	100%	Residential mortgages
Paragon Mortgages (No. 8) PLC	100%	Residential mortgages
Paragon Mortgages (No. 9) PLC	100% *	Residential mortgages
Paragon Mortgages (No. 10) PLC	100% *	Residential mortgages
Paragon Mortgages (No. 11) PLC	100% *	Residential mortgages
Paragon Mortgages (No. 12) PLC	100% *	Residential mortgages
Paragon Mortgages (No. 13) PLC	100% *	Residential mortgages
Paragon Mortgages (No. 14) PLC	100% *	Residential mortgages
Paragon Mortgages (No. 15) PLC	100% *	Residential mortgages
Paragon Mortgages (No. 16) PLC	100%	Residential mortgages
Paragon Mortgages (No. 17) PLC	100%	Residential mortgages
Paragon Personal and Auto Finance (No. 3) PLC	100%	Loan and vehicle finance
Paragon Secured Finance (No. 1) PLC	100%	Loan finance
First Flexible (No. 7) PLC	100% *	Residential mortgages
Collateralised Mortgage Securities (No. 12) PLC	100%	Non-trading
Colonial Finance (UK) Limited	100%	Non-trading
Earlswood Finance Limited	100% *	Non-trading
Earlswood Finance (No. 2) Limited	100%	Non-trading
Finance for People (No. 3) Limited	100%	Non-trading
Finance for People (No. 4) PLC	100% §	Non-trading
Herbert (1) PLC	100%	Non-trading
Herbert (2) PLC	100%	Non-trading
Herbert (4) PLC	100%	Non-trading
Herbert (5) PLC	100%	Non-trading
Herbert (6) PLC	100%	Non-trading
Herbert (7) PLC	100%	Non-trading
Herbert (8) PLC	100%	Non-trading
Herbert (9) PLC	100%	Non-trading
Herbert (10) PLC	100%	Non-trading
Highlands Loan Servicing Limited	100%	Non-trading
Homeloans (No. 4) PLC	100% §	Non-trading
Homer Funding Limited	100%	Non-trading



Company	Holding	Principal activity
<b>Direct subsidiaries of Paragon Banking Group PLC</b>		
Idem Luxembourg (No. 4) ‡	100%	Non-trading
Idem Luxembourg (No. 5) ‡	100%	Non-trading
Idem Luxembourg (No. 9) ‡	100%	Non-trading
Mortgage Funding Corporation PLC	100%	Non-trading
NHL Second Funding Corporation PLC	100%	Non-trading
NHL Third Funding Corporation PLC	100%	Non-trading
Paragon Car Finance (1) Limited	100%	Non-trading
Paragon Dealer Finance Limited	100%	Non-trading
Paragon Finance Holdings Limited	100%	Non-trading
Paragon Lending Limited <i>(formerly Paragon Mortgages (No. 31) Limited)</i>	100%	Non-trading
Paragon Loan Finance (No. 1) Limited	100% §	Non-trading
Paragon Loan Finance (No. 2) Limited	100% §	Non-trading
Paragon Mortgages (No. 1) PLC	100% §	Non-trading
Paragon Mortgages (No. 2) PLC	100% §	Non-trading
Paragon Mortgages (No. 4) PLC	100%	Non-trading
Paragon Mortgages (No. 5) PLC	100%	Non-trading
Paragon Mortgages (No. 26) Limited	100% *	Non-trading
Paragon Mortgages (No. 27) Limited	100%	Non-trading
Paragon Mortgages (No. 33) Limited	100%	Non-trading
Paragon Mortgages (No. 34) Limited	100%	Non-trading
Paragon Mortgages (No. 36) Limited	100%	Non-trading
Paragon Mortgages (No. 37) Limited	100%	Non-trading
Paragon Mortgages (No. 38) Limited	100%	Non-trading
Paragon Pension Investments GP Limited	100%	Non-trading
Paragon Pension Plan Trustees Limited	100%	Non-trading
Paragon Personal Finance (1) Limited	100%	Non-trading
Paragon Servicing Limited <i>(formerly Paragon Mortgages (No. 32) Limited)</i>	100%	Non-trading
Paragon Third Funding Limited	100%	Non-trading
Paragon Vehicle Contracts Limited	100%	Non-trading
PGC Capital Limited	100%	Non-trading
Plymouth Funding Limited	100%	Non-trading
Redbrick Real Estate Services Limited	100%	Non-trading
Sancopia Capital Limited	100%	Non-trading
Sancopia Limited	100%	Non-trading
TBMC (2) Limited	100%	Non-trading
Tegic Capital Limited	100%	Non-trading
Tegic Limited	100%	Non-trading
Townend Farm (Easington) Management Company Limited <i>(formerly (formerly Paragon Mortgages (No. 35) Limited)</i>	100%	Non-trading
Universal Credit Limited	100%	Non-trading
Yorkshire Freeholds Limited	100%	Non-trading
Yorkshire Leaseholds Limited	100%	Non-trading

Company	Holding	Principal activity
<b>Direct and indirect subsidiaries of Paragon Bank PLC</b>		
Paragon Finance PLC	100%	Residential mortgages and asset administration
Mortgage Trust Limited	100%	Residential mortgages
Paragon Mortgages Limited	100%	Residential mortgages
Paragon Mortgages (2010) Limited	100%	Residential mortgages
Paragon Asset Finance Limited <i>(formerly Paragon Bank Asset Finance Limited)</i>	100%	Holding company and portfolio administration
City Business Finance Limited	100%	Asset finance
Paragon Business Finance PLC <i>(formerly Paragon Bank Business Finance PLC)</i>	100%	Asset finance
Paragon Commercial Finance Limited <i>(formerly Dash Commercial Finance Limited)</i>	80%	Asset finance
Paragon Technology Finance Limited <i>(formerly Paragon Bank Technology Finance Limited)</i>	100%	Asset finance
Premier Asset Finance Limited	100%	Asset finance broker
Specialist Fleet Services Limited	100%	Asset finance and contract hire
Capital Professions Finance Limited	100%	Non-trading
Collett Transport Services Limited	100%	Non-trading
Fineline Holdings Limited	100%	Non-trading
Fineline Media Finance Limited	100%	Non-trading
Homer Management Limited	100%	Non-trading
Lease Portfolio Management Limited	100%	Non-trading
PBAF Acquisitions Limited <i>(formerly Print Finance Limited)</i>	100%	Non-trading
PBAF (No. 1) Limited	100%	Non-trading
State Securities Holdings Limited	100%	Non-trading
State Security Limited	100%	Non-trading

Company	Holding	Principal activity
<b>Direct and indirect subsidiaries of Idem Capital Holdings Limited</b>		
Moorgate Loan Servicing Limited	100%	Asset administration
Idem (No. 3) Limited	100%	Asset investment
Idem Capital Securities Limited	100%	Asset investment
Idem First Finance Limited	100%	Asset investment
Paragon Personal Finance Limited	100%	Consumer loan finance
Idem (No. 5) Limited	100%	Non-trading
Idem (No. 6) Limited	100%	Non-trading
Idem Asset Management Limited	100%	Non-trading
Idem Capital Acquisitions Limited	100%	Non-trading
Idem Capital Limited	100%	Non-trading
Idem Consumer Loans Limited	100%	Non-trading
Idem Luxembourg (No. 10) ‡	100%	Non-trading
Sancopia Portfolios Limited	100%	Non-trading

Company	Holding	Principal activity
<b>Other indirect subsidiary undertakings</b>		
First Flexible No. 6 PLC	100% §	Residential mortgages
Mortgage Trust Services PLC	100%	Residential mortgages and asset administration
Paragon Second Funding Limited	100%	Residential mortgages and loan and vehicle finance
Redbrick Survey and Valuation Limited	100%	Surveyors and property consulting
Buy to Let Direct Limited <i>(formerly Landlordcentre.co.uk Limited)</i>	100%	Non-trading
LOM Recoveries Limited	100%	Non-trading
Moorgate Asset Administration Limited	100%	Non-trading
Paragon Options PLC	100%	Non-trading
TBMC Group Limited	100%	Non-trading
The Business Mortgage Company Services Limited	100%	Non-trading
Tidford Cottages Management Limited	100%	Non-trading

The financial year end of all of the Group's subsidiary companies is 30 September. They are all registered in England and Wales and operate in the UK except:

- Those entities marked ‡ which are registered in the Grand Duchy of Luxembourg
- Paragon Pension Investments GP Limited, which is registered in Scotland and operates in the UK

20% of the equity of Paragon Commercial Finance Limited is subject to a call option agreed as part of the acquisition of the company by PAF. No material minority interest attaches to this holding.

As part of the Group's financing arrangements certain mortgage and consumer loans originated by Paragon Mortgages (2010) Limited and Mortgage Trust Limited or acquired by Idem Capital Securities Limited have been sold to special purpose entity companies, which had raised non-recourse finance to fund these purchases. The shares of these companies are ultimately beneficially owned through independent trusts and are considered to be controlled by the Group, as defined by IFRS 10 and hence they are considered to be subsidiaries of the Group.

The principal companies party to these arrangements at 30 September 2017 comprise:

Company	Principal activity
First Flexible No. 4 PLC	Residential mortgages
First Flexible No. 5 PLC	Residential mortgages
Idem Capital Securities (No. 1)	Asset investment
Idem Luxembourg (No. 8)	Asset investment
Paragon Fifth Funding Limited	Residential mortgages
Paragon Sixth Funding Limited	Residential mortgages
Paragon Seventh Funding Limited	Residential mortgages
Paragon Mortgages (No. 18) Holdings Limited	Holding company
Paragon Mortgages (No. 18) PLC	Residential mortgages
Paragon Mortgages (No. 19) Holdings Limited	Holding company
Paragon Mortgages (No. 19) PLC	Residential mortgages
Paragon Mortgages (No. 20) Holdings Limited	Holding company
Paragon Mortgages (No. 20) PLC	Residential mortgages
Paragon Mortgages (No. 21) Holdings Limited	Holding company
Paragon Mortgages (No. 21) PLC	Residential mortgages
Paragon Mortgages (No. 22) Holdings Limited	Holding company
Paragon Mortgages (No. 22) PLC	Residential mortgages
Paragon Mortgages (No. 23) Holdings Limited	Holding company
Paragon Mortgages (No. 23) PLC	Residential mortgages
Paragon Mortgages (No. 24) Holdings Limited	Holding company
Paragon Mortgages (No. 24) PLC	Residential mortgages
Paragon Mortgages (No. 25) Holdings Limited	Holding company
Paragon Mortgages (No. 25) PLC	Residential mortgages
Arianty Holdings Limited	Holding company
Arianty No. 1 Limited	Non-trading
Arianty Services Limited	Non-trading
First Flexible No. 1 Limited	Non-trading
First Flexible No. 2 Limited	Non-trading
First Flexible No. 3 Limited	Non-trading

All of these companies are registered and operate in the UK except Idem Capital Securities (No. 1) and Idem Luxembourg (No.8) which are registered in the Grand Duchy of Luxembourg.

Homeloans (No. 7) LLP and Homeloans (No. 8) LLP are limited liability partnerships, established under English law, in which all of the members are Group companies. They are therefore considered to be subsidiary entities. Both are registered in England and Wales and operate in the UK.

Earlswood Finance (No. 3) Limited, a company limited by guarantee, is registered in England and Wales and operates in the UK. It is included in the consolidation as it is ultimately controlled by the parent company.

The Group accounts include the results of two Jersey companies, which are ultimately beneficially owned by a charitable trust, but are considered to be controlled by the Group, using the definition contained in IFRS 10 'Consolidated Financial Statements'. These companies, Idem Jersey (No. 1) Limited and Idem Jersey (No. 2) Limited are registered in the Bailiwick of Jersey and operate in the UK.

The share capital of Idem Jersey (No. 1) Limited is divided into A shares and B shares. All of the 600 B shares are held by Group companies 100 by the parent company and 500 by other Group companies.

The registered office of each of the entities listed in this note is the same as that of the Company (note 1), except that:

- The registered office of The Business Mortgage Company Limited, TBMC (2) Limited, Buy to Let Direct Limited, TBMC Group Limited, and The Business Mortgage Company Services Limited is Greenmeadow House, 2 Village Way, Greenmeadow Springs Business Park, Cardiff, CF15 7NE
- The registered office of State Security Limited is Burlington House, Botleigh Grange Office Campus, Grange Drive, Hedge End, Southampton, SO30 2AF
- The registered office of the Scottish company is Citypoint, 65 Haymarket Terrace, Edinburgh, Scotland, EH12 5HD
- The office of the Luxembourg entities is 8-10, Avenue de la Gare, L-1610 Luxembourg
- The registered office of the Jersey companies is 13 Castle Street, St Helier, Jersey, JE4 5UT

All of the entities listed in this note are included in the consolidated accounts of the Group.

## 66. COUNTRY-BY-COUNTRY REPORTING

The Capital Requirements (Country-by-Country Reporting) Regulations 2013 came into effect on 1 January 2014 and place certain reporting obligations on financial institutions that are within the scope of CRD IV. The objective of the country-by-country reporting requirements is to provide increased transparency regarding the source of the financial institution's income and the locations of its operations.

Paragon Banking Group PLC is a UK registered entity. Details of its subsidiaries are given in note 65 and the activities of the Group are described in Section A2.1.

The activities of the Group, described as required by the Regulations for the year ended 30 September 2017 were:

	<b>United Kingdom</b>
	<b>£m</b>
<hr/>	
<b>Year ended 30 September 2017</b>	
Total operating income	<b>252.8</b>
Profit before tax	<b>144.8</b>
Corporation tax paid	<b>28.9</b>
Public subsidies received	-
Average number of full time equivalent employees	<b>1,229</b>
<hr/>	
	<b>United Kingdom</b>
	<b>£m</b>
<hr/>	
<b>Year ended 30 September 2016</b>	
Total operating income	<b>244.0</b>
Profit before tax	<b>143.2</b>
Corporation tax paid	<b>23.6</b>
Public subsidies received	-
Average number of full time equivalent employees	<b>1,175</b>

The Group's participation in Bank of England funding schemes is set out in note 49.

E.

# APPENDICES TO THE ANNUAL REPORT

Additional financial information supporting amounts shown in the Strategic Report (Section A), but not forming part of the Statutory Accounts

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## A. INCOME STATEMENT RATIOS

The average net interest margin is calculated as follows:

	Note	2017 £m	2016 £m
Opening loans to customers	32	<b>10,737.5</b>	10,062.4
Closing loans to customers	32	<b>11,124.1</b>	10,737.5
Average loans to customers		<b>10,930.8</b>	10,400.0
Net interest		<b>232.6</b>	223.2
<b>Net interest margin</b>		<b>2.13%</b>	2.15%
Impairment provision	25	<b>5.3</b>	7.7
<b>Impairment as a percentage of average loan balance</b>		<b>0.05%</b>	0.07%

## B. COST:INCOME RATIO

Cost:income ratio is derived as follows:

	Note	2017 £m	2016 £m
Cost – operating expenses	20	<b>102.3</b>	92.5
Total operating income		<b>252.8</b>	244.0
<b>Cost / Income</b>		<b>40.5%</b>	37.9%



## C. UNDERLYING PROFIT

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

	<b>2017</b>	2016
	<b>£m</b>	£m
Profit on ordinary activities before tax	<b>144.8</b>	143.2
Add back: Fair value adjustments	<b>0.4</b>	0.6
<b>Underlying profit</b>	<b>145.2</b>	143.8

## D. NET ASSET VALUE

	<i>Note</i>	<b>2017</b>	2016
Total equity (£m)		<b>1,009.4</b>	969.5
Outstanding issued shares (m)	55	<b>281.5</b>	295.8
Treasury shares (m)	57	<b>(15.7)</b>	(15.3)
Shares held by ESOP schemes (m)	57	<b>(3.2)</b>	(3.6)
		<b>262.6</b>	276.9
Net asset value per £1 ordinary share		<b>£3.84</b>	£3.50
Tangible equity (£m)	7	<b>905.0</b>	864.1
<b>Tangible net asset value per £1 ordinary share</b>		<b>£3.45</b>	£3.12

F.

# USEFUL INFORMATION

Information which may be helpful to shareholders and other users of the Annual Report and Accounts

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## GLOSSARY

<b>AGM</b>	Annual General Meeting	<b>EAD</b>	Exposure at Default
<b>ALCO</b>	Asset and Liability Committee	<b>ECL</b>	Expected Credit Loss
<b>BCBS</b>	Basel Committee on Banking Supervision	<b>EIR</b>	Effective Interest Rate
<b>BEIS</b>	Department for Business, Energy and Industrial Strategy	<b>EPS</b>	Earnings per Share
<b>BEPS</b>	Base Erosion and Profit Shifting	<b>EQA</b>	External Quality Assessment
<b>BS 18001</b>	British Standard 18001:2007, 'Occupational Health and Safety Management Systems'	<b>ERC</b>	Estimated Remaining Collections
<b>CAGR</b>	Compound Annual Growth Rate	<b>ESOP</b>	Employee Share Ownership Plan
<b>CAP</b>	CAP Automotive Limited	<b>ESOS</b>	Energy Savings and Opportunities Scheme
<b>CBTL</b>	Consumer Buy-to-Let requirements	<b>EU</b>	European Union
<b>CEO</b>	Chief Executive Officer	<b>EURIBOR</b>	Euro Interbank Offered Rate
<b>CET1</b>	Core Equity Tier 1	<b>EVE</b>	Economic Value of Equity
<b>CGU</b>	Cash Generating Unit	<b>FCA</b>	Financial Conduct Authority
<b>CIIA</b>	Chartered Institute of Internal Audit	<b>FLA</b>	Finance and Leasing Association
<b>CIPD</b>	Chartered Institute of Personnel and Development	<b>FLS</b>	Funding for Lending Scheme
<b>CMI</b>	Chartered Management Institute	<b>FPC</b>	Financial Policy Committee (of the Bank of England)
<b>CML</b>	Council of Mortgage Lenders	<b>FRC</b>	Financial Reporting Council
<b>CO<sub>2</sub></b>	Carbon Dioxide	<b>FSC</b>	Forest Stewardship Council
<b>Code</b>	UK Corporate Governance Code (2016 version)	<b>FSCS</b>	Financial Services Compensation Scheme
<b>CONC</b>	FCA Consumer Credit Regime	<b>GDPR</b>	General Data Protection Regulation
<b>COREP</b>	Common Reporting	<b>GHG</b>	Greenhouse Gases
<b>CPI</b>	Consumer Price Index	<b>HA</b>	Hampton-Alexander
<b>CRDs</b>	Cash Ratio Deposits	<b>HMOs</b>	Homes in Multiple Occupation
<b>CRD IV</b>	Capital Requirements Regulation and Directive	<b>HMRC</b>	Her Majesty's Revenue and Customs
<b>CRO</b>	Chief Risk Officer	<b>HQLA</b>	High Quality Liquid Assets
<b>CRR</b>	Capital Requirements Regulation EU Regulation 575/2013	<b>HVAC</b>	Heating, Ventilation and Cooling System
<b>CSA</b>	Credit Support Annex	<b>IAS</b>	International Accounting Standard(s)
<b>CSOP</b>	Company Share Option Plan	<b>IASB</b>	International Accounting Standards Board
<b>DEFRA</b>	Department for Environment, Food and Rural Affairs	<b>ICAAP</b>	Internal Capital Adequacy Assessment Process
<b>Deloitte</b>	Deloitte LLP	<b>ICG</b>	Individual Capital Guidance
<b>DSBP</b>	Deferred Share Bonus Plan	<b>ICR</b>	Interest Cover Ratio
		<b>IFRS</b>	International Financial Reporting Standard(s)
		<b>ILAAP</b>	Internal Liquidity Adequacy Assessment Process
		<b>ILG</b>	Individual Liquidity Guidance

<b>ILTR</b>	Indexed Long Term Repo Scheme	<b>PRS</b>	Private Rented Sector
<b>IMLA</b>	Intermediary Mortgage Lenders Association	<b>PSP</b>	Performance Share Plan
<b>IRB</b>	Internal Ratings Basis	<b>RIDDOR</b>	Reporting of Incidents, Disease and Dangerous Occurrences Regulation 2013
<b>IRRBB</b>	Interest Rate Risk in the Banking Book	<b>RNS</b>	The Regulatory News Service of the London Stock Exchange
<b>ISA</b>	Individual Savings Account	<b>RoTE</b>	Return on Tangible Equity
<b>ISDA</b>	International Swaps and Derivatives Association	<b>RPI</b>	Retail Price Index
<b>KPMG</b>	KPMG LLP, the Group's auditor	<b>RSUs</b>	Restricted Stock Units
<b>LCR</b>	Liquidity Coverage Ratio	<b>SA</b>	Standardised Approach
<b>LGD</b>	Loss Given Default	<b>Schedule 7</b>	Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008
<b>LIBOR</b>	London Interbank Offered Rate	<b>SDLT</b>	Stamp Duty Land Tax
<b>Ltd</b>	Limited (company)	<b>SFS</b>	Specialist Fleet Service
<b>LTI</b>	Long Term Incentive	<b>SME</b>	Small and/or Medium-sized Enterprise(s)
<b>LTV</b>	Loan To Value	<b>SMR</b>	Senior Managers Regime
<b>MCA</b>	Management Consultancies Association Ltd	<b>SPV</b>	Special Purpose Vehicle company
<b>MCoB</b>	Mortgage Conduct of Business	<b>TBMC</b>	The Business Mortgage Company
<b>MMR</b>	Mortgage Market Review	<b>TFS</b>	Term Funding Scheme
<b>MRC</b>	Model Risk Committee	<b>The Articles</b>	The Articles of Association of the Company
<b>MSP</b>	Matching Share Plan	<b>The Bank</b>	Paragon Bank PLC
<b>NI</b>	National Insurance	<b>The Company</b>	Paragon Banking Group PLC
<b>NII</b>	Net Interest Income	<b>The Group</b>	The Company and all of its subsidiary undertakings
<b>NIM</b>	Net Interest Margin	<b>The Order</b>	The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014
<b>NSFR</b>	Net Stable Funding Ratio	<b>The Plan</b>	The Paragon Pension Plan
<b>OHSMS</b>	Occupational Health and Safety Management System	<b>TSR</b>	Total Shareholder Return
<b>OLAR</b>	Overall Liquidity Adequacy Requirement	<b>UK</b>	United Kingdom
<b>ORCC</b>	Operational Risk and Compliance Committee	<b>UKF</b>	UK Finance
<b>PAYE</b>	Pay As You Earn	<b>US</b>	United States of America
<b>PAF</b>	Paragon Asset Finance (formerly Paragon Bank Asset Finance)	<b>US Dollar LIBOR</b>	The London Interbank Offered Rate on balances denominated in US dollars
<b>PD</b>	Probability of default	<b>VAT</b>	Value Added Tax
<b>PIDA</b>	Public Interest Disclosure Act 1998	<b>WEEE</b>	Waste Electrical and Electronic Equipment
<b>PLC</b>	Public Limited Company		
<b>PPI</b>	Payment Protection Insurance		
<b>PRA</b>	Prudential Regulation Authority (of the Bank of England)		
<b>Premier</b>	Premier Asset Finance Limited		

## Want more information or help?

The Company's share register is maintained by our Registrars, Computershare, who you should contact directly if you have questions about your shareholding or wish to update your address details.

**Computershare Investor Services PLC**  
**The Pavilions**  
**Bridgwater Road**  
**Bristol BS99 6ZZ**

**Telephone: 0370 707 1244\***

**and outside the UK +44 (0)370 707 1244**

**Online: [www.investorcentre.co.uk](http://www.investorcentre.co.uk)**

\*Calls are charged at the standard geographic rate and will vary by provider. Calls outside the UK will be charged at the applicable international rate. Lines are open 8:30am to 5:30pm, Monday to Friday, excluding UK public holidays.

## Electronic communications

You can view and manage your shareholding online by registering with Computershare's Investor Centre Service. To register:

- Visit [www.computershare.com](http://www.computershare.com)
- Go to 'Manage my shareholdings'
- Register using your Shareholder Reference Number and your postcode

We actively encourage our shareholders to receive communications via email and view documents electronically on our website, including our Annual Report and Accounts, as this has significant environmental and cost benefits. Should you wish to receive electronic documents please contact Computershare by telephone or online.

## Website

You can find further useful information on our website, [www.paragonbankinggroup.co.uk](http://www.paragonbankinggroup.co.uk), including:

- Regular updates about our business
- Comprehensive share price information
- Financial results and reports
- Historic dividend dates and amounts

## Shareholder fraud warning

Shareholders are advised to be very wary of any suspicious or unsolicited advice or offers, whether over the telephone, through the post or by email. If you receive any such unsolicited communication please check the company or person contacting you is properly authorised by the Financial Conduct Authority ('FCA') before getting involved. You can check at [www.fca.org.uk/consumers/protect-yourself](http://www.fca.org.uk/consumers/protect-yourself) and can report calls from unauthorised firms to the FCA by calling 0800 111 6768.

## Duplicate documents and communications

If you receive more than one copy of shareholder documents, it is likely that you have multiple accounts on the share register, perhaps with a slightly different name or address. To combine your shareholdings, please contact Computershare and provide your Shareholder Reference Numbers.

### Financial calendar

**January 2018**

Trading update

**July / August 2018**

Trading update

**22 May 2018**

Half year results

**November 2018**

Full year results

### Dividend calendar

**4 January 2018**

Ex-dividend date for 2017 final dividend

**5 July 2018**

Ex-dividend date for 2018 interim dividend

**5 January 2018**

Record date for 2017 final dividend

**6 July 2018**

Record date for 2018 interim dividend

**19 February 2018**

Payment date for 2017 final dividend

**27 July 2018**

Payment date for 2018 interim dividend

### Annual General Meeting

**15 February 2018**

To be held at 9:00am at the offices of Jefferies International Limited at Vintners Place, 68 Upper Thames Street, London, EC4V 3BJ

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## OTHER PUBLIC REPORTING

In addition to its annual financial reporting the Group has published, or will publish, the following documents in respect of the year ended 30 September 2017, as required by legislation or regulation, relating to the Group or its constituent entities.

- Pillar III disclosures required by Part 8 of the CRR
- Tax Strategy Statement
- Modern Slavery Statement
- Gender pay gap information

These documents are made available on the Group's website at [www.paragonbankinggroup.co.uk](http://www.paragonbankinggroup.co.uk).

All of these statements are required to be published annually. In addition, for the year ending 30 September 2018, the Group will be required to publish bi-annual statements on supplier payments. It will also be making its first report against its Women in Finance charter commitments in January 2018.





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## CONTACTS

### Registered and head office

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Solihull  
West Midlands B91 3QJ

Telephone: 0121 712 2323

### London office

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[investor.relations@paragonbank.co.uk](mailto:investor.relations@paragonbank.co.uk)

### Company Secretariat

[company\\_secretary@paragonbank.co.uk](mailto:company_secretary@paragonbank.co.uk)

### Internet

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### Consulting actuaries

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Four Brindleyplace  
Birmingham B1 2JQ



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