PARAGON BANKING GROUP PLC

Half Year Financial Report

For the six months ended 31 March 2023

Under Stock Exchange embargo until 7.00 a.m. Tuesday 6 June 2023

Strong financial and operational performance, with further balance sheet growth

Paragon Banking Group PLC ('Paragon' or 'the Group'), the specialist banking group, today announces its half-year results for the six months ended 31 March 2023

Nigel Terrington, Chief Executive of Paragon said:

"We are delighted to deliver another strong financial and operational performance, achieving record interim operating profits, alongside robust growth in our loan book.

New mortgage lending increased by 19.1% due to our focus on supporting professional landlords, who continue to see strong portfolio growth and tenant demand. Our commercial lending loan book increased by 13.9%, supporting Paragon's diversification strategy. The Group has a high quality loan book, 99% of which is secured, virtually all on low LTV properties. Notwithstanding the more volatile and disruptive environment, our portfolios are performing resiliently.

Savings balances grew by 20.5% year-on-year, underpinning our strong liquidity and supporting improvements to our net interest margin, which we now expect to be around 3% this financial year.

Our capital ratios are strong and liquidity levels remain high which enabled us to announce today a further increase in our share buy-back programme from £50 million to £100 million.

We are well placed to continue to support our customers and deliver strong returns for our shareholders as we look to capitalise on the opportunities that the environment will inevitably produce."

Financial highlights:

- Underlying profit increased 22.2% to £128.9 million (2022 H1: £105.5 million)*
- Underlying EPS increased 28.0% to 42.5 pence (2022 H1: 33.2 pence)*
- Statutory profit before tax down 67.7% at £46.4 million (2022 H1: £143.6 million) reflecting the unwinding of £82.5 million of the £191.9 million of fair value gains recognised in 2022, with statutory EPS decreased 63.1% to 16.4 pence (2022 H1: 44.4 pence)
- Continued NIM enhancement to 2.95% (2022 H1: 2.57%). Guidance increased to circa 3.00% for full year
- Cost:income ratio reduced to 38.1% (2022 H1: 41.2%)
- Capital base remains strong – CET1 15.6% (31 March 2022: 15.4%)
- Underlying RoTE 18.7% (2022 H1: 15.5%)*
- Interim dividend up 17.0% at 11.0 pence (2022 H1: 9.4 pence)
- Additional £50.0 million share buy-back announced for H2

- Deposit base grew to £11.9 billion (2022 H1: £9.9 billion). 94%+ FSCS insured, no disruption to deposit gathering from the events in the US

* For underlying basis, see Appendix A

Operational highlights:

- Total new lending increased 6.9% to £1.59 billion (2022 H1: £1.49 billion) driving a 4.6% year-on-year growth in the loan book

- New mortgage lending of £1.02 billion was 19.1% higher than the £0.86 billion achieved in 2022 H1, with a continued focus on professional landlords who represented 98.6% of completions in the period

- New commercial lending totalled £0.57 billion, 9.4% down on 2022 H1 with outperformance in the SME and motor divisions being offset, as expected, by lower net completions in development finance

- Buy-to-let pipeline stood at £0.81 billion compared to £1.34 billion a year earlier, reflecting strong completions and weak application flows in the post mini-budget period. Recent application flows are stronger, with the pipeline up nearly 20% from its intra-period low and continuing to increase after the period end

- As expected, the development finance pipeline reflects the national picture on housing development, with developer caution regarding prices, cost inflation and supply chain reliability. The pipeline at 31 March 2023 stood at £0.71 billion compared to £0.86 billion a year earlier

- Buy-to-let redemptions ran at an annualised rate of 10.7% for 2023 H1, compared to 6.9% in the comparable period in 2022. The rate was particularly high in the disrupted environment in Q1, at an annualised 13.5%, but has since moderated to a more normal level of 7.8% in Q2

- Continued progress being made with the PRA on IRB accreditation, but timetable remains dependent on PRA requirements and its resource availability

- Paragon has responded to the PRA Basel 3.1 consultation paper. Impact of proposals as drafted would be a reduction of 2.3% of CET1 if IRB accreditation was delayed beyond the proposed Basel 3.1 implementation date of 1 January 2025

Guidance summary:

Updated guidance is given below for mortgage lending volumes, net interest margin and share buy-backs.

2023 FY metric	Original guidance	Updated guidance
Mortgage Lending advances	£1.6bn - £1.9bn	Upgraded to £1.75bn - £1.9bn
Commercial Lending advances	£1.1bn - £1.3bn	Unchanged
Net Interest Margin	Increase to at least 289 bp	Increase to circa 300bp
Operating expenses	circa £170m	Unchanged
Buy-back	Up to £50m	Increase to up to £100m

<u>For further information, please contact:</u>

Paragon Banking Group PLC
Nigel Terrington, Chief Executive
Richard Woodman, Chief Financial Officer
Tel: 0121 712 2505

Headland Consultancy
Lucy Legh / Charlie Twigg
Email: paragon@headlandconsultancy.com
Tel: 020 3805 4822

The Group will be holding a results presentation for sell-side analysts on Tuesday 6 June 2023 at 9:30am at UBS, 5 Broadgate, London EC2M 2QS.

This will be webcast live at: https://secure.emincote.com/client/paragon/half-year-results

The presentation material will be available on the Group's website at www.paragonbankinggroup.co.uk/investors from 7:00am, with a webcast replay available from 2:00pm.

Cautionary statement

Your attention is drawn to the cautionary statement set out at the end of this document.

Interim Management Report

1 OVERVIEW

During the six months ended 31 March 2023, the Group has continued to provide the lending and savings products its customers expect, delivering 4.6% year-on-year loan book growth, maintaining strong liquidity by increasing the savings deposit base, improving customer retention and increasing returns, with underlying profit rising 22.2% compared to the first half in 2022 and underlying return on tangible equity standing at an annualised 18.7%. This is despite material market volatility and substantial increases in market interest rates in the period, which opened with the impacts of the September 2022 mini-budget in the UK and closed with the repercussions of the collapses of Credit Suisse, Silicon Valley Bank and other US lenders.

LENDING ACTIVITY

Buy-to-let application flows were slow at the start of the period, when fixed rate pricing was elevated following the negative impacts of the mini-budget. Strong pipeline conversions have seen the value of new advances reach £1.02 billion, an increase of over 19% when compared to the first half of 2022. The disruption to application flows at the start of the period, coupled with this conversion rate, saw the pipeline reduce to £0.81 billion, rebuilding from a low point in early February 2023. Customer retention rates remain strong, with over 70% of maturing fixed rate business being retained during the period and portfolio-wide redemptions running at an annualised 10.7%, with redemption activity strongest on the legacy, variable rate portfolio.

Our original guidance for Mortgage Lending volumes for 2023 was a range from £1.60 billion to £1.90 billion – we now expect the result for the year to be in the range of £1.75 billion to £1.90 billion.

The four sub-divisions in the Commercial Lending segment have seen differing levels of market demand and performance during the first half. At £0.22 billion (31 March 2022: £0.18 billion), SME lending advances were 21.0% up on the equivalent period last year and motor finance lending also grew, by 13.9% to £0.09 billion (31 March 2022: £0.08 billion). The development finance business saw activity levels depressed, in line with the national housebuilding market, with drawdowns down 15.6% and new enquiry levels more subdued, particularly in the final calendar quarter of 2022. The structured lending portfolio saw modest net redemptions in the period. The net new business flows, however, resulted in the net book value for the segment increasing by 13.9% year-on-year, finishing the first half at £1.96 billion (31 March 2022: £1.72 billion).

We retain our guidance for Commercial Lending completions in 2023, with the expected level staying in the £1.1 billion to £1.3 billion range.

1 OVERVIEW (CONTINUED)

MARGINS

The Group's diversification strategy and legacy mortgage portfolio run-off combine to give a structural asset-side margin accretion over time. The overall net interest margin is also positively geared to higher interest rates, generating higher returns on the Group's net assets. The rate of increase in base rates over the past year has also resulted in a favourable movement in the Group's cost of funds, which has supported the growth in the overall NIM to 295 basis points in the period, and resulted in funding costs moving below the SONIA reference rate. With rates now being towards the top of the expected cycle, our updated guidance for the full year outturn is for margins to be around 300 basis points.

CREDIT AND COSTS

We have updated our IFRS 9 macro-economic scenarios, for loss provisioning purposes, with the GDP and house price outlook deteriorating when compared to the 2022 year-end estimates. The weighted average fall in GDP across the Group's four economic scenarios in the year ending 30 September 2023, is now forecast at 1.7%, rather than the 1.1% forecast at 30 September 2022. At the same time, the weighted average of house price falls across the scenarios over the same period is 12.5%, rather than the 8.2% fall included in the year end scenarios. The increases in base rates and inflation seen in the last six months have also been reflected in the opening position.

Scenario weightings have been left unchanged at the interim but £5.0 million of the £15.0 million of judgemental overlay included at the year-end has been released, as portfolio performance remains robust, while models begin to recognise some of the losses anticipated in the brought forward adjustment, as credit performance data emerges. There has been limited evidence of increasing arrears, with what little there has been being confined to the legacy, variable rate buy-to-let portfolio, where rate increases are passed straight through to customers on these tracker products. The overall impairment charge represented an annualised cost of risk of 10 basis points. While this is higher than the 2 basis points reported in the first half of 2022, it is in line with the full year outturn.

Operating expenses were in line with expectations at £83.8 million for the first half (2022 H1: £74.9 million), as we continue to focus on our digitalisation programme, and reflecting the inflationary effects being felt across the economy. Various technology-led projects are currently in train, with the most recent, a servicing portal for the buy-to-let portfolio, having delivered its first release shortly after the half year.

Our 2023 cost guidance remains unchanged at around £170 million.

As anticipated at the previous financial year end, the strong fair value gains seen in 2022 have reversed in part in the first half of 2023, as interest rate expectations have cooled. These are non-cash fair value postings and are reported below underlying profit as they will reverse over time, and do not impact the Group's operational activity. However, they must be reflected in the Group's statutory profit and capital disclosures and can give rise to substantial swings, as in the most recent periods.

Interim Management Report (Continued)

1 OVERVIEW (CONTINUED)

CAPITAL AND DISTRIBUTIONS

The Group's capital ratios remained strong at the end of March, with CET1 of 15.6% and a Total Capital Ratio ('TCR') of 17.7%. The Group's capital resources remain significantly above its regulatory requirement (CET1 10.2%, TCR 12.3%. including CRD IV buffers). We continue to progress our IRB accreditation, with an ongoing and productive engagement with the Prudential Regulation Authority ('PRA'). However, the eventual accreditation date will depend on PRA resource availability as we progress with the modular approach.

During the period the PRA published a consultation paper detailing its proposed approach to implementing the Basel 3.1 capital requirements. Along with a great many other industry participants, we have responded to the consultation, and anticipate feedback from the regulator in the second half of calendar year 2023. Our initial estimates suggest a 2.3% reduction in the Group's CET1 ratios if the proposals are adopted as drafted, should the Group not receive its IRB accreditation by the target implementation date of 1 January 2025.

At the 2022 financial year end we announced a £50.0 million share buy-back for 2023. This was completed in February and we will undertake a further buy-back of up to £50.0 million in the second half of the financial year, taking the potential full year share buy-back to £100.0 million.

Our liquidity levels remain strong, both in absolute and contingent terms. Despite the market backdrop we have seen strong deposit inflows, with balances having increased by 20.5% since March 2022 with a £1.2 billion increase in the first six months of the 2023 financial year. Pricing continues to be attractive relative to SONIA levels and has supported the Group's progress on Net Interest Margin ('NIM') expansion. Deposit balances stood at £11.9 billion at 31 March 2023.

The impacts of Covid on the earnings profile in recent years has meant the interim / final dividend splits might become skewed if we follow the simple approach of each year's interim dividend being 50% of the prior year's final dividend. To smooth this effect in 2023 we are increasing the interim pay-out on a one-off basis to 11.0 pence per share, where policy would indicate 9.6 pence per share. Our total dividend for the financial year will still be based on around 40% of underlying basic EPS, in line with the Group's stated policy, except in exceptional circumstances.

CONCLUSION

The Group continues to trade profitably, with strong capital and liquidity ratios. We remain well placed to continue to compete strongly, supporting our customers and taking market share in our chosen specialist markets. Whilst the absolute rate environment may affect aggregate demand levels in these markets, and the adverse headwinds in the UK economy continue to impact our customers, the strength of our business model allows us to face these challenges with confidence.

Interim Management Report (Continued)

2 BUSINESS REVIEW

For reporting purposes the Group's operations are organised into two divisions, based on product types, origination and servicing capabilities. This classification was adopted for the first time in the Group's annual accounts for the year ended 30 September 2022, and amounts reported below for the six months ended 31 March 2022 have been restated for consistency.

Customer loan balances at 31 March 2023 and advances in the period for those divisions are summarised below:

	Advances in the period			Loans to customers at the period end		
	Six months ended 31 March 2023 £m	Six months ended 31 March 2022 £m	Year ended 30 September 2022 £m	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Mortgage Lending	1,018.4	855.3	1,910.0	12,593.3	12,193.4	12,328.7
Commercial Lending	574.4	634.2	1,304.7	1,961.6	1,721.5	1,881.6
	1,592.8	1,489.5	3,214.7	14,554.9	13,914.9	14,210.3

The half year period has seen a 2.4% growth in the total loan book with a 4.6% year-on-year increase. Excluding legacy first and second mortgage balances and the unsecured portfolio, which was disposed of in the second half of the 2022 financial year, the portfolio grew by 13.7%, year-on-year.

Total advances for the six months grew 6.9%, year-on-year, but this performance represented a reduction from the strong performance in the second half of the 2022 financial year, as the Group managed its new lending activity in the face of economic and political disruption in the UK. New business activity also varied across the Group's business lines, depending on the impact of building UK economic headwinds on their respective customer bases.

2.1 MORTGAGE LENDING

The Group's Mortgage Lending division principally provides buy-to-let mortgages secured on UK residential property to specialist landlords. The Group has a wealth of experience in this market, built up over more than a quarter of a century, through a variety of economic environments. This gives the Group an unparalleled understanding of both this form of lending and the landlord customer base it targets.

During the period the Group also offered loans to non-specialist landlords, however, these form a minor part of its operations. The segment also includes legacy assets from discontinued product lines, principally second charge mortgages.

In all its offerings, the Group targets niche markets where its focus on detailed case-by-case underwriting and its robust and informed approach to property risk differentiate it from both mass market lenders and other specialists.

2 BUSINESS REVIEW (CONTINUED)

Housing and mortgage market

The recent trend of increasing volumes in the UK housing market was sharply reversed in the period, following the impact of the autumn mini-budget and associated pressures on affordability. Data published by HMRC shows 575,000 transactions in the six months ended 31 March 2023, a reduction of 1.7% from the first half of the last financial year, but a fall of 8.1% compared to the second half. This trend was particularly strong towards the end of the period with the level in the second quarter some 25% lower than the first. This reflects, in part, a hiatus in the mortgage market in September / October 2022 where many lenders withdrew offers and reduced product availability, with the number of available buy-to-let products in the market reported by Moneyfacts falling to 988 in October 2022, from a peak of 3,484 in June 2022. By the period end this had recovered somewhat to 2,628 products across different lenders.

In the face of these market conditions house prices continued the downward movement which had commenced in September, with the Nationwide House Price Index ending the period 6.1% below its peak, having fallen 5.6% in the six months. However, this only returned prices to levels seen in February 2022, and data published by the Nationwide in April 2023 suggested the downward trend may be abating and confidence returning if only gradually.

UK mortgage approvals reported by the Bank of England were significantly lower than in previous periods, following the events of late 2022. £100.9 billion of new mortgages were approved in the six-month period, a reduction of 34.1% from the £153.0 billion recorded a year earlier, and 39.9% from the level recorded in the six months ended 30 September 2022. The proportion of the total represented by remortgages remained broadly similar to previous periods at 57%.

While the issues posed by the cost-of-living crisis have increased pressure on borrowers, arrears and possessions reported by UK Finance (‘UKF’) remained at low levels, although numbers were building towards the end of the period. In the second quarter of the financial year the number of arrears cases was only 1% higher than a year earlier, with the majority of this increase concentrated in the lightest arrears bands. Possessions continued their upward trend, but remain far below pre-Covid levels. This would indicate that the current economic headwinds have yet to impact significantly on UK mortgage borrowers’ ability to meet their monthly payments, but it remains too early to judge what the longer-term impact of the recent sharp rise in interest rates will be.

2 BUSINESS REVIEW (CONTINUED)

The Private Rented Sector ('PRS') and the buy-to-let mortgage market

The Group's target customers in the buy-to-let sector are specialist landlords. These landlords will typically let out four or more properties, or operate with more complex properties. They will generally run their portfolio as a business and have both a strong understanding of their local lettings market and a high level of personal day-to-day involvement. The Group is one of the leaders amongst a small number of specialist lenders addressing this sector, which is underserved by many of the larger financial institutions.

The Group considers that its target customers' level of experience, involvement in day-to-day letting activities and diversification of income streams across properties make them less vulnerable to cash flow shocks in the event of a downturn and therefore better able to cope when faced with economic pressures facing their business or their tenants.

In recent years the PRS has consistently represented around one fifth of UK housing stock, as reported by UK Government data. This provision is crucial to meeting the country's housing needs, particularly in a downturn, where accessing, or remaining within, the owner-occupied sector may be challenging for some households.

The UK Government is proposing reform of the PRS through its Renters (Reform) Bill, which was introduced into Parliament in May 2023. The Group has monitored the development of the legislation to date and is largely comfortable with the reforms, which balance the needs of tenants and landlords. However, there are concerns over the impact on the student lending market in particular and, more generally, the level of new regulation being applied to landlords. The Group would also urge the UK Government to ensure that the introduction of the new framework is adequately resourced to prevent disruption to both tenants and landlords. Overall, the Group does not believe its business model will be significantly impacted by the new legislation, and feels that its customer base may be better prepared to face these changes than some other parts of the PRS.

Volumes of new buy-to-let mortgages in the UK were affected by economic pressures, but less severely than the wider mortgage market. New advances reported by UKF, at £22.0 billion for the six months ended 31 March 2023, were only 9.8% lower than in the same period in the previous year, but significantly reduced from the final six months of that period (2022 H1: £24.4 billion, 2022 H2: £28.7 billion). This reduction affected both mortgages for new house purchases and remortgages, with remortgages continuing to represent around two thirds of cases. Some of this reduction will be due to the impact of lenders withdrawing offers already made, which the Group was able to avoid as a result of its pre-hedging strategy, but the broadly downward trend continued throughout the six months.

There is also evidence of increasing numbers of borrowers transferring to new products offered by their existing lender, which are not recorded as new cases in the data. Information published by UKF showed that 63% of landlords refinancing their mortgage in the period switched to a new product with the same lender, rather than remortgaging, compared to 59% in the preceding six months.

2 BUSINESS REVIEW (CONTINUED)

The residential rental market in the UK remains strong, with Royal Institution of Chartered Surveyors ('RICS'), in its March 2023 UK Residential Market Survey, reporting tenant demand rising through the period, but falling instructions from landlords. These factors are putting upward pressure on rents, with around 60% of agents expecting near-term rent increases, and an average expectation of a 4% increase in rental yields over the next twelve months. This is supported by research from Propertymark in its March 2023 survey, where 58% of members reported increasing rents in their area. This strength in the market should support both cash flows and affordability for landlord customers, even in the face of interest rate increases and other inflationary pressures.

These national trends are supported by research carried out with the Group's customers and mortgage brokers in the first months of 2023. In the Group's landlord market survey for the second quarter of the financial year, 67% of respondents reported increased tenant demand, meaning that new tenant demand is at its highest level in five years, coupled with an expectation of rising rents. However, there are clear adverse impacts from the economic situation, with landlords reporting pressures on profitability and increasing incidence of arrears, and confidence metrics remaining depressed, albeit slightly improving from the previous quarter.

A clear majority of mortgage intermediaries remained optimistic about the outlook for their own businesses, with 85% stating they were confident or very confident (2022 H2: 91%). However their levels of confidence in the outlook more generally had fallen since the survey carried out six months earlier. Only 46% were that confident of the prospects for the mortgage industry (2022 H2: 91%), falling to 43% for buy-to-let (2022 H2: 79%). The principal causes for concern reported were rising interest rates, the UK cost of living and the prospect of a UK economic downturn more generally.

The UKF analysis of arrears and possessions for the first quarter of the calendar year, published in May 2023, showed numbers of arrears cases for buy-to-let growing more steeply than for owner-occupied cases, but remaining at relatively low levels historically, and with growth focussed on the lightest arrears bands. Arrears in the buy-to-let market remained significantly lower than for owner-occupied loans. Buy-to-let possessions also continued to grow, while remaining below historic averages. This data might indicate that economic factors are beginning to impact performance, but any overall trend is yet to be firmly established.

Overall, current research shows the buy-to-let market remaining strong, albeit with significant headwinds in the economic outlook of market participants not yet clearly demonstrated in the quantitative measures.

2 BUSINESS REVIEW (CONTINUED)

Mortgage Lending activity

The total amounts of the division's lending in the six-month period are set out below.

	Six months ended 31 March 2023 £m	Six months ended 31 March 2022 £m	Year ended 30 September 2022 £m
Specialist buy-to-let	1,004.5	838.8	1,869.5
Simple buy-to-let	13.9	15.8	39.5
Total buy-to-let	1,018.4	854.6	1,909.0
Owner-occupied	-	0.7	1.0
	1,018.4	855.3	1,910.0

Total lending in the segment increased by 19.1% compared to the same period in the previous financial year, continuing the strong performance seen towards the end of the 2022 financial year.

Overall buy-to-let lending continued to increase, building on the momentum established in the second half of 2022. Total completions in the six months were 19.2% higher than in the first half of the 2022 financial year with specialist business up by 19.8%, with completions from the September 2022 new business pipeline supported by the hedging arrangements already in place.

Applications in the first part of the period were impacted by market disruption around the financial year end and general levels of economic uncertainty, causing the pipeline to reduce through the early months of the period before beginning to recover after January 2023, reaching £810.9 million by 31 March 2023 (30 September 2022: £1,256.0 million, 31 March 2022: £1,337.8 million). While the closing pipeline was 39.4% lower than a year earlier, it was continuing to increase, enhancing prospects for the second half of the financial year.

The majority of the Group's mortgage lending products offer fixed rates for an initial period, with many customers choosing a new product, either with the Group or elsewhere, at the end of this fixed period. A market shift in 2017 saw five-year fixed rate offerings become the dominant product and the early tranches of that lending are now coming to the end of the five-year period. Retaining such customers as their fixed rates expire has been a priority for the mortgage business in the period, with this focus ensuring that over 70% of such customers whose deals expired in the period were retained.

Specialist intermediaries are the principal source of the Group's buy-to-let business, and it continues to develop its service proposition to ensure its business partners receive the service levels that they deserve. The Group continues to monitor satisfaction levels amongst its brokers, with 72% of those surveyed in the period saying that the Group provided better service than other lenders (2022 H1: 66%, 2022 FY: 66%).

Interim Management Report (Continued)

2 BUSINESS REVIEW (CONTINUED)

This research also showed that 93% of brokers were satisfied with the ease of obtaining a response from the Group (2022 H1: 89%, 2022 FY: 88%), delivering a net promoter score at offer stage of +58 (2022 H1: +46, 2022 FY: +43). The Group was also named 'Best Professional Buy-to-Let Mortgage Lender' at the 2022/23 Your Mortgage Awards, its tenth victory in this category, further underlining its customer service credentials.

The Group's long-term programme of reengineering its mortgage business continued through the period. This includes a thorough review and upgrading of all systems and operational processes to align them with the Group's strategy for the division and the overarching plan of digitalising the business.

The value of the work completed in the previous period to improve the redemption and retention process is demonstrated by results in this area in the period. The six months ended 31 March 2023 saw the completion of another major phase of the project, with the first release of a new landlord portal readied for implementation. This new portal, which went live in May 2023, offers a better user experience and increased self-serve opportunities, and will continue to be enhanced going forward. The overall project continues and will provide additional service upgrades and new opportunities for interaction between the Group and its customers and intermediaries as further phases are rolled out.

Environmental impacts

The Group understands the potential for climate change to impact its mortgage business and seeks to mitigate risk through careful consideration of the properties on which it will lend. It also continues to develop systems and refine data to allow its overall position to be measured and the behaviour of its security portfolio under climate-related stresses to be better understood.

As part of its response to climate change, the Group offers a range of green buy-to-let mortgages on all properties within the Group's lending criteria. These products offer lower interest rates for energy efficient properties with EPC ratings of C or higher, the currently accepted benchmark for energy-efficient properties.

The Group, together with other UK banking entities, has been working with the UK Government to develop a more consistent approach to the definition of green activities in the housing market and the housing finance sectors. It is unlikely that significant progress can be made in greening the UK housing stock until all market participants have a shared concept of what that should mean in detail.

Interim Management Report (Continued)

2 BUSINESS REVIEW (CONTINUED)

The Group's new lending volumes on green buy-to-let products in the six months ended 31 March 2023, which increased by 30.1% compared to the same period in 2022, are set out below.

	2023 H1	**2022 H1**	**2022 FY**
	£m	**£m**	**£m**
New lending on properties with:			
EPC rated A or B	93.1	77.9	169.0
EPC rated C	364.7	273.9	663.2
Total rated A to C	457.8	351.8	832.2
Percentage with available data (England and Wales)	*99.9%*	*99.4%*	*99.6%*

The Group's latest analysis identified EPC grades for 93.8% of its mortgage book by value at 31 March 2023 (30 September 2022: 92.8%, 31 March 2022: 90.8%). Of these 99.1% were graded E or higher (30 September 2022: 98.9%, 31 March 2022: 98.7%) with 40.3% rated A, B or C (30 September 2022: 39.3%, 31 March 2022: 38.2%). This continuing improvement results from the new lending described above, with 46.3% of new originations in the year in England and Wales having one of the top three grades (99.9% coverage).

The Group's quarterly survey of landlord attitudes for the first part of the 2023 calendar year assessed awareness of the EPC framework for the first time. The Group was pleased to note that 97% of landlords were aware of the current EPC requirements for rental property, with 85% saying that they fully understood the rules. 97% of landlords were already aware of the EPC gradings of their properties, although one in five landlords had at least some properties with grade E or lower. 68% of landlords intended to bring their properties up to standard and 80% had already carried out some work to upgrade their properties. The progress of these works will help to mitigate the Group's transition risk on climate change, as well as offering business opportunities to support its customer base with their progress towards net zero.

While the Group monitors EPC performance, it is also conscious of the need to avoid unintended consequences by focussing lending solely on this. Although upgrading existing properties is beneficial to overall emissions, the demolition and replacement of properties may be less so.

The Group also monitors the potential physical risks to security values arising from climate change. This includes assessing a property's flood risk as part of the underwriting process, and analysing the overall portfolio exposure to flood risk on an ongoing basis. The latest data, at 31 March 2023, showed approximately 3.0% by number of properties securing the Group's buy-to-let mortgages in England and Wales were considered to be at medium or high risk of flooding (30 September 2022: 3.0%, 31 March 2022: 3.2%).

The business is currently working to develop products to support existing customers to make their properties more energy efficient. Given that the majority of properties in the PRS require some form of upgrade to meet the Government targets, this kind of support will be vital to achieving net zero.

2 BUSINESS REVIEW (CONTINUED)

Performance

The outstanding first and second charge mortgage balances in the segment at 31 March 2023 are set out below, analysed by business line. Legacy second charge mortgage assets and other consumer loans at 31 March 2022 were disclosed as part of the Idem Capital segment.

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Post-2010 assets			
Buy-to-let	9,142.8	7,992.8	8,536.4
Owner-occupied	26.3	31.5	28.0
Second charge	88.6	124.5	104.4
	9,257.7	8,148.8	8,668.8
Legacy assets			
Buy-to-let	3,240.5	3,840.3	3,549.6
Owner-occupied	6.2	10.1	8.4
Second charge	88.9	117.4	101.9
Other consumer lending	-	76.8	-
	12,593.3	12,193.4	12,328.7

Balances within the mortgage portfolio have continued to increase steadily, a result of lending volumes and successfully retaining existing customers. At 31 March 2023, loan balances in the division were 3.3% higher than a year earlier. Within this balance, the overall buy-to-let portfolio increased 4.6% year-on-year to £12,383.3 million (30 September 2022: £12,086.0 million, 31 March 2022: £11,833.1 million), with post-2010 originated assets representing 73.8% of the total at the end of the period (30 September 2022: 70.6%, 31 March 2022: 67.5%).

The annualised redemption rate on buy-to-let mortgage assets in the six months to 31 March 2023 was comparable to that seen towards the end of the previous financial year at 10.7% (2022 H1: 6.9%, 2022 FY: 9.8%). This is despite the potential impact of rising rates on customers whose interest charges are linked to reference rates, and the increasing numbers of five-year products now reaching the end of their terms. The management of this figure has been a priority for the mortgage business, with significant operational and systems focus placed on customer retention.

Although arrears on the buy-to-let book increased in the period in response to the economic environment, they remained modest at 31 March 2023, at 0.25% (30 September 2022: 0.15%, 31 March 2022: 0.15%). The Group's buy-to-let arrears remain very low compared to performance in the national buy-to-let market, with UKF reported arrears of 0.46% across the sector at 31 March 2023 (30 September 2022: 0.41%, 31 March 2022: 0.44%), highlighting the Group's asset quality.

2 BUSINESS REVIEW (CONTINUED)

The Group's approach to buy-to-let business is focussed on rigorous assessment of the credit quality and financial capability of its customers, underpinned by its assessment of the available security. It relies on a detailed and thorough assessment of the value and suitability of the property as security, including the use of a specialist in-house valuation team covering the whole country, and this robust approach to valuation, not just at inception, but through the life of the loan, provides it with significant security even in times of economic stress.

The loan-to-value ratio in the Group's buy-to-let book, at 62.5%, reflects the impacts of new lending activity and of house price falls in the period on existing accounts (30 September 2022: 57.9%, 31 March 2022: 59.2%). However, security coverage remains substantial. Levels of interest cover and stressed affordability also remain good, despite the rising rate environment in recent months, indicating that the Group's customers are well placed to cope with adverse economic impacts.

Arrears on the closed second charge mortgage books increased marginally to 22.59% (30 September 2022: 21.33%, 31 March 2022: 20.13%). These arrears levels remain higher than the average for the sector, but this reflects the history and seasoning of the balances, while the continuing upward trend reflects the redemption of performing accounts. This portfolio contains a significant number of accounts which are currently making full monthly payments, but which had missed payments at some point in the past, which inflates the arrears rate. Performance in the period is considered satisfactory and the Group enjoys substantial security on these assets, with an average loan-to-value ratio of 53.1% (30 September 2022: 50.6%, 31 March 2022: 53.2%) providing a significant mitigant to credit risk.

For accounting purposes, 6.8% of the segment's gross balances were considered as having a significant increase in credit risk ('SICR') at the period end (30 September 2022: 16.4%, 31 March 2022: 14.5%), including 1.2% which were credit impaired (30 September 2022: 1.1%, 31 March 2022: 2.0%). This reduction was driven mainly by the impact of more stable, albeit more adverse, forecast short-term economics on modelled probabilities of default, generating a more focussed Stage 2 population. However, the impact of reduced security values meant that provision coverage was stable, at 33 basis points (30 September 2022: 31 basis points, 31 March 2022: 28 basis points), with coverage on fully performing accounts also broadly stable at 5 basis points (30 September 2022: 6 basis points, 31 March 2022: 5 basis points).

The Group's receiver of rent process for buy-to-let assets helps to reduce the level of loss by giving it direct access to the rental flows from the underlying properties, while allowing tenants to stay in their homes. At 31 March 2023, 491 properties were managed by a receiver on the customer's behalf. The year-on-year reduction was principally attributable to the resolution of a large legacy portfolio in the second half of the 2022 financial year, with the upward movement in the six months being an impact of the tightening economic position (30 September 2022: 475 properties, 31 March 2022: 558 properties). Almost all the current receiver of rent arrangements relate to pre-2010 lending, with cases being resolved on a long-term basis to ensure the best outcome for the Group, its customers and their tenants. There were relatively low numbers of cases entering the receiver of rent process in the period.

2 BUSINESS REVIEW (CONTINUED)

Outlook

The Group's mortgage lending operation has a strong presence in the professional landlord buy-to-let market, based on established relationships with customers and brokers, careful underwriting and rigorous security assessment. These factors mean that it is well placed both to deliver a profitable loan book and to protect the value in its assets in the face of adverse economic headwinds.

2.2 COMMERCIAL LENDING

The Group's Commercial Lending division includes four key specialist business streams lending to, or through, commercial organisations, mostly on a secured basis. The development of this division has been a major strategic focus for the Group over recent years and remains fundamental to the success of the Group.

The four business lines address:

- Development finance, funding smaller, mostly residential, property development projects
- SME lending, providing leasing for business assets and unsecured cash flow lending for professional services firms, amongst other products
- Structured lending, providing finance for niche non-bank lenders
- Motor finance, focussed on specialist parts of the market

Each of these businesses is led by a managing director, supported by a specialist team with a strong understanding of their market. The principal competitors for each are small banks and non-bank lenders. The Group operates principally in markets where the largest lenders have little presence, creating both a credit availability issue for customers and significant opportunities for the Group.

The Group's strategy for Commercial Lending is to target niches (either product types or customer groups) where its skill sets and customer service culture can be best applied, and its capital effectively deployed to optimise the relationship between growth, risk and return.

Commercial Lending activity

Aggregate new business in the division reduced by 9.4%, compared to the same period in 2022, with the general economic backdrop impacting customer demand and completion levels. However, the extent and nature of this impact varied across the division's four principal business lines. In the development finance business, where the levels of economic and political uncertainty in the UK caused developers to delay potential activity, the impact was more severe. In contrast, the motor finance business had a strong operating period, recording year-on-year growth.

2 BUSINESS REVIEW (CONTINUED)

Activity levels across the operations varied through the period. The new lending activity in the segment during the period is set out below, analysed by principal business line. As the structured lending business comprises revolving credit facilities, the net movement in the period is shown below.

	Six months ended 31 March 2023 £m	Six months ended 31 March 2022 £m	Year ended 30 September 2022 £m
Development finance	273.1	323.7	632.2
SME lending	220.0	181.8	446.4
Structured lending	(4.9)	53.0	59.9
Motor finance	86.2	75.7	166.2
	574.4	634.2	1,304.7

These advances increased the Commercial Lending loan book by 4.3% in the six months, to a total of £1,961.6 million, its highest level to date (31 March 2022: £1,721.5 million, 30 September 2022: £1,881.6 million).

Development finance

Activity levels in the Group's development finance business have been significantly impacted by the political uncertainty in the UK around the previous financial year end. This in turn led to uncertainties for developers relating to prices achievable on completion, build costs and funding costs, reducing their appetite to launch new projects. This resulted in a reduced level of enquiries towards the end of the previous financial year and the low level of the lending pipeline reported at 30 September 2022.

As expected, this led to reduced new business levels at the beginning of the period, and the negative headwinds continued to affect activity throughout the half year, although there were signs of recovery towards the end of the period, with March seeing increased levels of new enquiries and feedback from customers more positive. Overall advances reduced by 15.6% compared to the first six months of the 2022 financial year.

The short-term prospects for future lending are stronger than at the previous financial year end, with a more stable economic outlook leading to increasing numbers of proposals in the system. While undrawn balances on current facilities had reduced to £459.9 million (31 March 2022: £596.4 million, 30 September 2022: £556.0 million), the new business pipeline had recovered to £250.0 million from its low point in September (31 March 2022: £266.7 million, 30 September 2022: £188.4 million). A significant amount of these balances would be expected to be drawn in the second half of the financial year providing a stronger base for lending in this period.

2 BUSINESS REVIEW (CONTINUED)

The Group encourages the development of more energy efficient housing stock by offering green finance options. Projects developing energy-efficient properties, those with an EPC A grade, can receive beneficial funding terms. In the six-month period, £18.0 million of new drawings related to projects with an expected A grade on completion, compared to £11.9 million advanced in the whole of the previous financial year. With a developing pipeline, this will be an area of focus for the Group going forward, as developers increasingly factor these discounts into their project planning.

The regional spread of the Group's lending has continued to gradually broaden, with the proportion of the portfolio located in London and the South-East of England falling to 53.7% from 56.8% at 30 September 2022. Activity increased particularly in the East Midlands and South West.

The Group's investment in systems for this business has continued to show benefits through this period, enhancing process efficiency and customer service. This drive towards digitalisation will continue, providing a solid platform for the growth of the business and supporting the transition over time to an internal ratings based approach to capital management.

Despite the short-term disruption in the pipeline of developments during the period, the long-term fundamentals of the business remain sound, with the increased level of enquiries towards the end of the period a positive sign. The UK continues to provide fewer new homes than government forecasts suggest are necessary, offering significant opportunities for smaller developers to expand and for the Group to support them. The Group's proposition is strong and attractive and continues to provide healthy returns for the capital invested and opportunities for growth.

SME lending

Compared to the first six months of 2022, new lending in the SME lending business grew by 21.0%. However, when compared to the second half of the 2022 financial year new business fell by 16.9% as the economic and political instability in the latter part of the 2022 calendar year impacted on SME confidence levels, making customers reluctant to enter long-term commitments, although confidence was slowly returning towards the end of the period.

Asset leasing volumes for the six months, excluding government-backed loans, increased by 41.2% to £133.0 million compared to the same period twelve months earlier (2022 H1: £94.2 million, 2022 FY: £276.9 million). Total asset finance lending, excluding cars and high value items, reported by the Finance and Leasing Association ('FLA') increased by a much smaller amount, only 12.6%. Investment in operating leases has also continued with £6.4 million of assets being acquired (2022 H1: £9.7 million, 2022 FY: £14.5 million).

The Group continued to provide loans under the UK Government-sponsored British Business Bank's Recovery Loan Scheme ('RLS') programme to support SMEs potentially affected by the Covid pandemic. The reduction in the guarantee from December 2021, and the general emergence from Covid saw a marked drop-off in take-up of the scheme. The first half of 2023 saw £2.9 million advanced under schemes backed by government guarantees (2022 H1: £23.8 million, 2022 FY: £32.2 million), of which £2.3 million was asset leasing business.

Interim Management Report (Continued)

2 BUSINESS REVIEW (CONTINUED)

The Group continues to closely monitor the government-guaranteed portfolio for any adverse indications, particularly in view of the performance issues with such loans reported by other lenders, which have principally focussed on Bounce Back Loans Scheme ('BBLS') lending. However, it has yet to encounter such problems in its own portfolio. The Group expects to offer these loans to SME customers until the scheme closes.

Short-term lending to professional services firms outside the government supported schemes reached £77.4 million in the period, 35.6% more than the comparable period in 2022, and 12.7% up on the second half of 2022 (2022 H1: £57.1 million, 2022 FY: £125.8 million). These loans are often used to spread the impact of tax payments, and in previous periods the availability of tax deferrals, together with the availability of the Coronavirus Business Interruption Scheme ('CBILS') and similar loans amongst this customer group had seriously depressed demand. However, these arrangements have been phased out, and the underlying requirement for this form of finance remains for the longer-term, with performance continuing to move back towards pre-Covid levels.

While the SME lending operation is seeing more green propositions than in previous periods, the environmental impact of investment decisions is currently not a major priority for many SMEs, particularly in the face of economic pressures on their businesses. The Group will continue to support UK SMEs with green propositions, as they transition their businesses towards net zero, and these types of initiatives are expected to increase going forward.

The Group's investment in the technology of its SME lending systems has continued to deliver improvements in internal efficiency and service to brokers and customers, providing an important point of differentiation against competitors. Agile and modular delivery enables individual improvements to go into the live system as they are completed, providing incremental enhancements, rather than waiting for a complex 'big bang'.

The new broker portal launched in the previous financial year continues to provide benefits as its use is rolled out. Take-up has continued to grow with over 70% of standard SME lending applications now being received through the portal. This interface is designed as an additional service to brokers, and the division's business support team remains fundamental to ensuring brokers and customers receive the standard of service they deserve. In a survey conducted by the Group, 75% of users were satisfied with the new portal, with 79% considering it to be as good as or better than other lenders' offerings. Feedback from the survey will be used to drive further enhancements to the portal.

More widely, the division's ongoing broker satisfaction survey reported that 78% of respondents were likely to do further business with the Group and the overall NPS for the period was +25, significantly positive. The strength of the Group's relationships with the broker community is a key strength for the business going forward.

The FLA Outlook Survey for the first quarter of 2023, released in May 2023, showed the majority of members expecting further worsening of economic conditions over the following twelve months with 11% of all members and 14% of asset finance members expecting significant worsening from the early 2023 position. Almost 80% of respondents expected worsening arrears performance over the next twelve months and over 90% expected higher corporate insolvencies. The majority of members felt that trading conditions would become tougher over the next twelve months, but not significantly so, while expecting a small growth in business volumes.

2 BUSINESS REVIEW (CONTINUED)

The Group's own quarterly research among SME leaders, conducted in the early part of 2023, also saw evidence of some fragility in the sector. Just over half of SMEs were confident of the prospects for their own business with the remainder unsure or negative, with similar results for their views on the sector more generally. Equal numbers reported improving and worsening cash flows over the most recent quarter and only 50% expected improving cashflows looking forward, with substantial numbers expecting deterioration, particularly in the short term. Despite this, the numbers of SMEs expecting to increase investment showed a significant increase, albeit from a low level in late 2022.

Overall, the picture is very mixed, with some SMEs becoming more confident, especially for the longer term, but significant numbers still with a more negative outlook.

The operating environment for SMEs in the UK, while more stable than six months ago, still presents significant threats, with the pessimistic outlook likely to impact near-term volume growth in the division. However, the division has robust resources in place to manage any decline in portfolio performance and has enhanced its technology further to support recoveries.

Structured lending

Activity in the structured lending business stream was broadly stable in the six months, in response to the prevailing economic conditions. Drawn balances fell marginally from £178.7 million at 30 September 2022 to £174.2 million at the end of March 2023. All facilities continued to be managed in line with their agreements.

These facilities generally fund non-bank lenders of various kinds, providing the Group with increased product diversification. The facilities are constructed to provide a buffer for the Group in the event of default in the ultimate customer population. The Group's experienced account managers receive regular reporting on the performance of the security assets, and maintain a high level of contact with clients to safeguard its position. To date the Group has recorded no losses on any of its structured lending facilities.

The Group is currently examining a number of potential further facilities which would broaden the range of products and industries supported. In the current economic climate these evaluations have a significant focus on the viability of the underlying customer activity. The Group continues to seek new opportunities in this field, which would extend the range of asset classes covered and dilute the concentration risk inherent in such lending.

Interim Management Report (Continued)

2 BUSINESS REVIEW (CONTINUED)

Motor finance

The Group's motor finance business is a focussed operation targeting propositions not addressed by mass-market lenders, including specialist makes and vehicle types, such as light commercial vehicles, motorhomes and caravans, including static caravans.

Performance was strong in the period with new lending growing 13.9% to £86.2 million (2022 FY: £166.2 million, 2022 H1: £75.7 million). This was despite a broadly flat performance in the consumer car leasing market as a whole, with the FLA reporting a 3.0% decline in new car finance business for the six months compared to the same period a year earlier.

The Group's expansion of lending on battery-powered electric vehicles ('BEVs') continued in the period, as the take up of BEVs in the UK continued to grow, with the Society of Motor Manufacturers and Traders reporting the highest ever level of BEV registrations in March 2023. The Group advanced £4.8 million of loans on BEVs in the period, 77.8% greater than the lending in the same period in the previous year (2022 FY: £6.0 million, 2022 H1: £2.7 million). With the business' focus on used car finance, the proportion of BEV lending will lag the growth in new registrations, however, good progress has been made with over 5% of new motor finance business related to these products and around 10% relating to electric vehicles more broadly. The Group is well placed to support the green aspirations of its customers, as electric vehicles become a more widely viable and popular option and increasing numbers enter the used car market.

Performance

The loans within the Commercial Lending division, analysed by product type are set out below.

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Asset leasing	551.6	457.0	532.5
Professions finance	65.4	49.5	60.9
CBILS, BBLS and RLS	76.3	94.3	88.0
Invoice finance	24.4	24.1	25.7
Unsecured business lending	17.6	14.0	14.6
Total SME lending	735.3	638.9	721.7
Development finance	765.8	672.9	719.9
Structured lending	174.2	171.7	178.7
Motor finance	286.3	238.0	261.3
	1,961.6	1,721.5	1,881.6

The size of the Commercial Lending book increased by 4.3% in the six months, as activity amongst the Group's SME customer base began to increase following the pandemic.

2 BUSINESS REVIEW (CONTINUED)

Credit quality in the development finance book remained largely excellent. Accounts are regularly monitored for project progress and credit quality and graded on a case-by-case basis by the Credit Risk function. At 31 March 2023, only eight accounts were identified as at risk of loss, although the number of watchlist cases increased in the period. The average loan to gross development value for the portfolio at the period end, a measure of security cover, was 62.0% (30 September 2022: 62.1%, 31 March 2022: 62.1%). This gives the Group a significant credit buffer if any of the projects encounter issues. No write-offs were recognised in the period.

Arrears metrics in the division's originated finance leasing portfolios remain stable, despite the economic pressures in the UK. Arrears on asset leasing business at 31 March 2023 stood at 0.17% (30 September 2022: 0.08%, 31 March 2022: 0.21%) and those on the motor finance book at 1.34% (30 September 2022: 1.58%, 31 March 2022: 2.20%). Despite this, the Group has reviewed its potential responses to credit issues across the operation and is ready to support any customers encountering problems.

Whilst some lenders have reported significant issues with their CBILS, BBLS and RLS lending related to either credit quality or fraud, the Group is yet to see any significant impacts. The portfolio at 31 March 2023 contained only £1.9 million of Stage 2 accounts at gross carrying value and only £0.9 million of credit impaired cases. The Group has so far had to make claims against the government guarantee on £2.2 million of loans, out of the £125.6 million advanced since the schemes began, with £1.6 million of this balance already settled and the remainder still being processed by the guarantor. The majority of the Group's government-backed lending was to its existing customers, which contributed to the credit quality of this lending and has enabled it to avoid the issues seen elsewhere.

For structured lending accounts, the Group carefully monitors the performance of the underlying asset pool on a monthly basis, to ensure its security is adequate. Performance issues have been identified on two facilities, but these are being carefully managed and no significant losses are expected.

In terms of the Group's impairment procedures, 8.0% of the segment's gross balances were considered as having an SICR, a little higher than seen in previous periods, principally due to the increased number of watchlist cases in development finance and structured lending noted above (30 September 2022: 4.7%, 31 March 2022: 3.0%). This included 1.5% which were credit impaired (30 September 2022: 0.7%, 31 March 2022: 1.0%). Provision coverage remained broadly similar to the year end position, at 136 basis points (30 September 2022: 134 basis points, 31 March 2022: 118 basis points) although coverage on fully performing accounts had reduced from 108 basis points at 30 September 2022 to 86 basis points at the period end as the model began to differentiate better between Stage 1 and Stage 2 accounts.

2 BUSINESS REVIEW (CONTINUED)

Outlook

While the Commercial Lending division's business lines have responded differently to the economic pressures of the past six months, they all remain strong and are benefitting from the investment in systems made over recent years. Despite the level of challenge, business trends towards the end of the period were more positive and the Group's careful approach to credit and strong customer relationship management have strongly protective characteristics.

In the longer term the prospects for the sector appear brighter and the positioning of the Commercial Lending division's operations will enable them to develop positively and contribute further to the Group's overall growth and progress.

Interim Management Report (Continued)

3 FUNDING REVIEW

The majority of the Group's funding is raised through its retail savings operation. It also has substantial central bank facilities and is able to access a variety of other wholesale funding sources.

The Group's diversified funding sources allow it to adapt to changes in both business requirements and the operating environment in a timely, sustainable and cost effective manner. In addition, the Group's status as a debt issuer is supported by its credit rating which was confirmed by Fitch during February 2023.

During the six-month period the Group's deposit book has continued to grow, despite pressure on household savings from increasing UK living costs, which was mitigated by the increasing attractiveness of term deposits to customers, compared with other forms of saving. This growth in term deposits has generated a flow of funds from clearing banks to smaller deposit takers, such as the Group, whose market strength has historically focussed on these products.

The Group's funding at 31 March 2023 is summarised below.

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Retail deposit balances	11,875.9	9,853.7	10,669.2
Securitised and warehouse funding	631.6	1,348.4	995.3
Central bank facilities	2,750.0	2,850.0	2,750.0
Tier-2 and retail bonds	261.6	261.3	261.5
Repurchase agreements	-	-	-
Total on balance sheet funding	15,519.1	14,313.4	14,676.0
Other off balance sheet liquidity facilities	150.0	150.0	150.0
	15,669.1	14,463.4	14,826.0

The Group's funding balance has continued its long-term movement towards the retail savings market in the period, with an increase of 11.3% in retail deposits. At the end of the period retail deposits represented 76.5% of all on balance sheet funding (30 September 2022: 72.7%, 31 March 2022: 68.8%).

At 31 March 2023, the proportion of easy access deposits, which are repayable on demand, was 25.1% of total on-balance sheet funding, similar to the position at the start of the period (30 September 2022: 27.0%, 31 March 2022: 25.2%). This percentage remains low compared to the rest of the banking sector.

Interim Management Report (Continued)

3 FUNDING REVIEW (Continued)

The Group has continued to build its liquidity balance during the six months, in part to facilitate the refinancing of the Paragon Mortgages (No. 25) securitisation, which was announced in May 2023, after the period end. £2,165.8 million of cash was available for liquidity purposes at 31 March 2023 (30 September 2022: £1,689.1 million, 31 March 2022: £1,342.4 million). The appropriate level of cash reserves is monitored on an ongoing basis as part of the Group's capital and liquidity strategy, which continues to be based on a conservative view of the economic outlook, and allows for the developing needs of the business and the medium-term requirement to refinance its central bank borrowings by October 2025.

Derivative assets and liabilities continue to be used to hedge interest rate risk arising from fixed rate loans and deposits. The Group pre-hedges its lending pipeline, which results in derivative positions being established before loans are completed.

While this strategy has not materially changed in the period, the movements in interest rate expectations over the most recent financial periods have resulted in large derivative asset balances being carried on the balance sheet at fair value, although the 31 March 2023 position was somewhat reduced from the previous financial year end. The size of these balances and the volatility in rates has also led to significant profit and loss account impacts. However, any such gains or losses, which tend to zero over time, are ancillary to the Group's lending and deposit-taking activities and it undertakes no trading in derivatives.

3.1 RETAIL FUNDING

The Group's savings operation is central to its funding position. The UK savings market provides a funding channel which is reliable, liquid, scalable and cost-effective. The main focus of the Group's operation is on offering sterling deposits to UK households, through a streamlined online presence, supported by an outsourced administration function, although this has become more diversified over recent periods. Products offered include cash ISAs, term and notice deposits, and easy access accounts, with the substantial majority of balances insured by the Financial Services Compensation Scheme ('FSCS').

The Group's strategy in the retail deposit market is to generate and retain customer accounts by providing competitive interest rates, attractive and innovative products and high quality customer service. The protection provided to depositors by the FSCS both incentivises larger savers to divide their deposits between several institutions and reduces the perceived risk for customers in using less familiar institutions, providing market opportunities for the Group's offering. At 31 March 2023, this FSCS protection covered over 94% of the Group's deposit balances.

The Group's customer deposits continued to increase faster than the overall market, with an 11.3% increase in balances over the six-month period, reflecting the attractiveness of the Group's proposition and its continuing programme of business and systems development. This was achieved despite the complexities inherent in more volatile market pricing as different deposit takers responded to base rate increases in different ways and over differing time frames, and customers' savings preferences moved towards fixed rate products.

Interim Management Report (Continued)

3 FUNDING REVIEW (Continued)

During the six months, UK household savings balances reported by the Bank of England remained broadly stable, despite the pressure on household budgets from the cost-of-living crisis. Balances at 31 March 2023 reached £1.66 trillion, an increase of 0.8% in the period and an increase of 3.4% year-on-year. Given the recent trend of household incomes diminishing in real terms, it is possible that overall UK savings balances may contract in the coming year, before returning to growth thereafter.

Within the savings market there was a strong move towards fixed-term and notice deposits, with the Bank of England reporting a 34.5% increase in such deposits from individuals over the six-month period, despite the stable position of the overall savings base. This is attributable to the increasing opportunity cost to consumers of leaving excess savings in current accounts or low yielding deposit accounts as rates rise. As many of these fixed-term products are offered on a fixed rate basis, this market shift also increased the proportion of the market represented by such products.

The Group benefitted from this market shift, with increasing demand for its core products. Specialist savings providers, such as the Group, typically have stronger product offerings in the fixed term, notice and ISA markets, with the current account and easy access markets dominated by the major clearing banks. Therefore, a market where fixed-term products are more attractive offers opportunities for the Group, evidenced by the increased proportion of the savings book represented by fixed rate products.

Increasing diversification and the FSCS guarantee are likely to reduce the potential for liquidity impacts and the Group's profiling of its target customers suggests they may be more resilient than average in the event of future economic stresses.

The Group's savings balances at the period end are analysed below.

	Average interest rate		**Proportion of deposits**	
	31 March 2023 %	**30 September 2022 %**	**31 March 2023 %**	**30 September 2022 %**
Fixed rate deposits	2.93	1.74	63.8	58.1
Variable rate deposits	2.70	1.55	36.2	41.9
All balances	2.84	1.66	100.0	100.0

The increase in funding costs is driven by market movements, where, following increases in the Bank of England base rate, savings rates have moved sharply upwards in the period. However, market savings rates rose less quickly than benchmark interest rates, resulting in the Group's funding cost falling below SONIA. The Bank of England reported average rates for easy access accounts increasing from 0.6% to 1.48% over the six months, while the rate for two year deposits rose from 2.63% to 4.05%. The average initial term of the Group's fixed rate deposits at 31 March 2023 remained stable at 21 months (30 September 2022: 22 months), with such products representing a higher proportion of the portfolio, reflecting market level trends.

Interim Management Report (Continued)

3 FUNDING REVIEW (Continued)

The Group's presence on third party investment platforms and digital banks' savings marketplaces provides an important part of the Group's savings base. These channels provide access to a different customer demographic to the Group's mainstream customers, with the more diversified sourcing offering enhanced opportunities to manage inflows and costs. The difference in profile of the platform customers is highlighted by their average account balances, which is far lower than that seen on direct business. The Group now has nine such relationships, compared to eight at 30 September 2022. These channels represent around 18% of the total deposit base (30 September 2022: 13%) and the Group has the systems and control framework in place to further increase its reach through these channels, if appropriate and cost-effective.

The Group's strategy in the savings market relies on providing a high quality customer offering and it conducts insight surveys throughout the customer journey. The results of this research in the period maintained the strongly positive position previously reported.

For customers opening a savings account with the Group in the period, 89% of those who provided data stated that they would 'probably' or 'definitely' take a second product (2022 H1: 88%, 2022 FY: 88%). The net promoter score for new customers in the period was +62, an improvement on results in recent periods (2022 H1: +58, 2022 FY: +52), and significantly positive.

Of customers with maturing savings balances in the period, 88% stated that they would 'probably' or 'definitely' consider taking out a replacement product with the Group (2022 H1: 86%, 2022 FY: 87%) with a net promoter score at maturity of +53, compared to +50 for the first half of the 2022 financial year (2022 FY: +52).

These responses show that the quality of the Group's customer interaction operations position it well to retain customers and deposits in an active and competitive market.

The Group's savings offering continues to win recognition from industry experts, winning 'Best Multi-Channel Savings Provider' at the 2023 Savings Champion awards and 'Cash ISA Provider of the Year' at the 2023 Moneynet awards, endorsing the Group's diversified approach as well as one of its key products.

The Group's retail deposit base continues to provide a stable foundation for its funding strategy, allowing volumes and rates to be effectively and flexibly managed. The Group will continue to develop the business on a strategic basis, broadening its product range, addressing wider demographics and expanding its presence on third party platforms. It will also continue to develop its systems to ensure it is able to address the increasingly sophisticated needs of savers.

3 FUNDING REVIEW (Continued)

3.2 CENTRAL BANK FACILITIES

The largest part of the Group's wholesale funding balance relates to Bank of England facilities, principally those introduced to support SME lending during the Covid pandemic. The Group also has access to other facilities offered by the Bank, which it utilises from time to time as part of its overall funding strategy.

The largest part of the Group's central bank funding relates to the Bank of England Term Funding scheme for SMEs ('TFSME'), with borrowings under this scheme at 31 March 2023 of £2,750.0 million (31 March 2022: £2,750.0 million, 30 September 2022: £2,750.0 million). Interest is payable on these drawings at the Bank of England base rate, and the relative cost-effectiveness of this form of borrowing as rates rise is being kept under review.

The Group retains access to other Bank of England funding channels, including the Indexed Long-Term Repo ('ILTR') scheme, for liquidity purposes but has made no drawings in the period.

The Group expects to continue to make use of Bank of England facilities from time to time where this is appropriate and cost-effective. Mortgage loans have been pre-positioned with the Bank to be available to act as collateral for future drawings, if and when required.

3.3 WHOLESALE FUNDING

The Group's wholesale borrowings from other institutions include securitisation funding, warehouse bank debt and retail and Tier-2 corporate bonds. The Group's Long-Term Issuer Default Rating, a measure of its strength as an issuer, was confirmed at BBB+ by Fitch in February 2023, with a stable outlook.

Capital markets in the UK suffered from increased levels of volatility during the period, particularly during the earlier months following the mini-budget in the UK. However, sentiment was calmer towards the close of the period, despite issues in the global banking sector. Markets were resilient under pressure and funding remained available, if not at very attractive prices.

Over recent periods the availability of central bank funding has reduced the Group's reliance on other wholesale funding sources, in common with other UK banks. This has resulted in a significant reduction in securitisation funding, which reduced further after the period end, when the Paragon Mortgages (No. 25) PLC ('PM 25') note issue, representing £250.2 million of funding at 31 March 2023, was repaid.

The Group also retains access to a £450.0 million warehouse facility, which is currently used to provide standby capability to manage liquidity requirements where appropriate, and expires in July 2023. It also accesses the repo market from time to time, although no such balances remained outstanding at the period end.

3 FUNDING REVIEW (Continued)

Historically the Group has been one of the principal issuers of UK residential mortgage backed securities ('RMBS'), however its reliance on this funding source has been significantly reduced over recent years, with the most recent issuance held internally as contingent funding, rather than placed in the market. No new issues have been made in the period, but securitisation remains a key part of the Group's funding strategy.

While the proportion of the Group's funding represented by wholesale borrowing has remained largely stable in the period, it will therefore reduce further in the second half of the financial year. However, wholesale sources remain an important option within the Group's funding strategy.

3.4 FUNDING OUTLOOK

The continuing development of the Group's retail savings franchise provides a stable and reliable basis for the business going forward. The six-month period has demonstrated the Group's ability to manage its retail funding requirements in a more volatile interest rate environment. The continued close management of funding costs in a period of changing market rates and potential competitive impacts will be key to future margin progression.

The Group is confident that its funding strategy remains diverse, robust and adaptable, and is well placed to support its growth, sustainability and strategic development.

Interim Management Report (Continued)

4 CAPITAL AND LIQUIDITY REVIEW

The Group's capital policy is designed to provide attractive returns to shareholders, preserve the strength of its balance sheet, maintain strong regulatory capital and liquidity positions that safeguard its depositors, and to ensure sufficient capital is available to meet strategic objectives and opportunities going forward.

In the face of economic uncertainty in the UK and of the developing regulatory position on future capital requirements under the 'Basel 3.1' reforms, the Group has maintained a largely stable capital position in the period.

Despite this, the Group has been able to continue its distribution policy, pursuing and extending the share buy-back programmes described in the most recent annual accounts and proposing an enhanced interim dividend for the period.

For regulatory purposes the Group's capital comprises shareholders' equity and its Tier-2 green bond. It has no outstanding AT1 issuance, but has the capacity to issue such securities, if considered appropriate, under an authority renewed by shareholders at the Annual General Meeting held in March 2023.

4.1 REGULATORY CAPITAL

During the half year, the Group has continued to maintain strong regulatory capital ratios, with capital balances being carefully managed. The Group is subject to supervision by the Prudential Regulation Authority ('PRA') and as part of this supervision the regulator sets a Total Capital Requirement ('TCR'), the minimum amount of regulatory capital which the Group must hold. The TCR is defined under the international Basel III rules, which are implemented through the PRA Rulebook.

The TCR includes elements determined based on the Group's Total Risk Exposure ('TRE') together with fixed elements and is held in order to safeguard depositors in the event of severe losses being incurred by the Group.

Transitional relief on the adoption of IFRS 9 was granted to the Group, along with most other UK banks. Additional relief was granted in 2020 for the impact on capital of provisions created in response to the Covid pandemic. This relief is being phased out year-by-year, while any reversal of Covid-related provisions will generate a corresponding reduction in relief. These reliefs now have a minimal impact on the Group's capital measures.

Interim Management Report (Continued)

4 CAPITAL AND LIQUIDITY REVIEW (Continued)

The PRA requires firms to disclose capital measures both on the regulatory basis and as if these reliefs had not been given, referred to as the 'fully loaded' basis. As the reliefs taper over time, the regulatory and fully loaded bases will converge. The Group's principal capital measures, CET1 and Total Regulatory Capital ('TRC') are set out below on both bases.

	Regulatory basis			Fully loaded basis		
	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Capital						
CET1 capital	1,170.4	1,092.4	1,221.8	1,157.1	1,070.5	1,196.0
TRC	1,320.4	1,242.4	1,371.8	1,307.1	1,220.5	1,346.0
Exposure						
TRE	7,479.9	7,095.7	7,515.0	7,466.6	7,073.8	7,489.2
Requirement						
TCR	657.7	625.8	660.6	656.6	623.9	658.4

The Group's CET1 capital comprises its equity shareholders' funds, adjusted as required by the Regulatory Capital Rules of the PRA, and can be used for all capital purposes. TRC, in addition, includes tier 2 capital in the form of the Group's green Tier-2 Bond. This tier 2 capital can be used to meet up to 25% of TCR. While the capital levels on both measures have remained broadly stable, they have been impacted by profit and loss account fluctuations from hedging which increased equity at 30 September 2022, and have since, to some extent, reversed. Aside from that, the continuing positive operational performance has continued to support the capital position, even after allowing for paid and proposed distributions.

The TCR is specific to the Group and is set by the regulator, based on its supervisory reviews. The year-on-year increase in requirements shown above relates principally to the growth in the Group's asset base over the period, mitigated, in the most recent six months, by a reduction in derivative exposures. The TCR at 31 March 2023 represents 8.8% of TRE, in line with the 8.8% calculated at 30 September 2022 and the 8.8% at 31 March 2022, and the regulatory minimum of 8.0%.

The Group's CET1 capital must also cover the CRD IV buffers, the Counter-Cyclical ('CCyB') and Capital Conservation ('CCoB') buffers. These apply to all firms and are based on a percentage of TRE. During the period the CCoB remained at 2.5%, its long-term rate, while the UK CCyB increased to 1.0% in December 2022 (30 September 2022: 0.0%). The Bank of England has announced a further increase to 2.0% from July 2023. This is expected to be the long-term rate of the UK CCyB in normal circumstances.

The capital requirement in respect of these CRD IV buffers increased in the period to £261.8 million at 31 March 2023 (31 March 2022: £177.4 million, 30 September 2022: £187.9 million) on the regulatory basis.

Further buffers may be set by the PRA on a firm-by-firm basis but may not be disclosed.

Interim Management Report (Continued)

4 CAPITAL AND LIQUIDITY REVIEW (Continued)

The Group's capital ratios, after allowing for proposed dividends and any irrevocably committed elements of share buy-back programmes, are set out below.

	Regulatory basis			Fully loaded basis		
	31 March 2023	31 March 2022	30 September 2022	31 March 2023	31 March 2022	30 September 2022
CET1 Ratio	15.6%	15.4%	16.3%	15.5%	15.1%	16.0%
Total Capital Ratio	17.7%	17.5%	18.3%	17.5%	17.3%	18.0%
UK Leverage Ratio	7.6%	7.4%	7.9%	7.6%	7.3%	7.8%

The Group's capital ratios remained relatively stable over the period, with a small downward move in the period mostly a function of the impact of the product mix in the lending books on TRE. As the IFRS 9 reliefs gradually phase out, the measures on the fully loaded basis are converging to those on the regulatory basis, with little difference remaining at 31 March 2023.

On 30 November 2022 the PRA produced a consultation paper containing its proposals to amend its Rulebook to reflect the revisions to the Basel III framework made by the Basel Committee on Banking Supervision ('BCBS') (Basel 3.1). These address changes to both the requirements applying to Internal Ratings Based ('IRB') approaches to credit risk and the Standardised Approach. The new requirements would be introduced from 1 January 2025, with some provisions subject to a five-year phasing-in period.

The Group has considered the proposals carefully and evaluated their potential impact on its business, engaging in dialogue with the regulator on the results. Certain of the proposals might have adverse effects on buy-to-let lending and on credit for small businesses, and the Group, along with other firms active in these fields, has highlighted these issues to the regulator. Notwithstanding this, the impact of the proposals on capital has been considered in the Group's capital planning process. This indicated that the Group would have sufficient available capital through the forecast period, even allowing for the maximum potential impact of the proposals in the consultation paper, which would reduce the Group's CET 1 ratio by 2.3 percentage points.

The PRA has also launched a more extensive consultation on its approach to regulating non-systemically important banks without international activities. Its most recent proposals, referred to as the 'Strong and Simple' regime, would apply to banks with assets of less than £20 billion and no IRB accreditation, although the exact details are still being consulted on. The Group is monitoring these developments and will respond through its capital planning as appropriate.

The Group submitted the second stage of its application for the accreditation of its IRB approach to buy-to-let credit risk for capital adequacy purposes to the PRA in March 2021, and is currently responding to regulatory feedback on elements of this phase. Preparations have also been made for Phase 3 of the process to ensure a swift progression from Phase 2 when approval is received.

4 CAPITAL AND LIQUIDITY REVIEW (Continued)

4.2 LIQUIDITY

The Group's policy is to hold sufficient liquidity in the business to meet its long and short-term cash needs, as well as to provide a buffer under stress, while operating at all times within regulatory requirements. This policy has a consequent effect on the Group's operational capital and funding requirements.

The Board regularly reviews liquidity risk appetite and closely monitors a number of key internal and external measures. The most significant of these, which are calculated for the Paragon Bank regulatory group on a basis which is standardised across the banking industry, are the Liquidity Coverage Ratio ('LCR') and Net Stable Funding Ratio ('NSFR').

The LCR is a measure of short-term resilience which compares available highly liquid assets to forecast short-term outflows, calculated according to a prescribed formula, with a 30-day horizon. The monthly average of the Bank's LCR for the period was 168.0% compared to 148.8% during the first six months of the 2022 financial year, and 146.2% during the 2022 financial year as a whole. These movements reflect a more cautious approach to liquidity in response to the UK economic outlook and issues in the global banking sector, together with a strategic increase in deposit levels over time to facilitate the refinancing of the PM 25 securitisation.

The NSFR is a longer-term measure of liquidity with a one-year horizon, supporting the management of balance sheet maturities. At 31 March 2023, the Bank's NSFR stood at 128.6% (30 September 2022: 122.3%, 31 March 2022: 121.2%), reflecting a marginal strengthening of the position.

4.3 DIVIDENDS AND DISTRIBUTION POLICY

The Group prioritises maintaining a strong capital position, coupled with providing a proportionate level of return to its shareholders. The positive operating result in the period and the capital outlook support the ongoing return of capital to investors, both in the form of dividends and through share buy-backs.

During the period the Company completed a capital reorganisation, as a result of which the capital redemption reserve of £71.8 million, which had arisen on the cancellation of shares acquired in buy-back programmes over recent years, was extinguished, meaning this amount became available for distribution to shareholders.

The Group's stated policy is that the interim dividend should, in normal circumstances, be equal to 50% of the preceding final dividend. Following its half-yearly review of the capital position and forecasts, the Board determined that, in order to address dislocation of the relationship between interim and final dividends for each year which had arisen due to steps taken to manage capital through the Covid pandemic, an enhanced dividend should be paid in the current year, on a one-off basis, while endorsing the policy on an ongoing basis.

4 CAPITAL AND LIQUIDITY REVIEW (Continued)

It declared an interim dividend for the year ending 30 September 2023 of 11.0 pence per share (2022 H1: 9.4 pence). This dividend will absorb £24.5 million of capital and will be paid on 28 July 2023 to shareholders on the register on 7 July 2023.

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

At the time of publication of the Group's 2022 full year results it announced that the Board had authorised a share buy-back of up to £50.0 million of shares in the market, which was completed in the period, along with the remainder of the previous year's programme.

In the six-month period the Group had expended £61.2 million (including costs) on the acquisition of its own equity, acquiring 11.2 million shares.

Given the strength of the capital position at 31 March 2023 and the robust trading performance, the Board has authorised an extension to the programme of up to £50.0 million, which is expected to be completed in the second half of the financial year.

The Group has the authority to make such purchases under a resolution approved by shareholders at the Annual General Meeting in March 2022 and renewed in March 2023. All purchases made under this programme are announced through the Regulatory News Service ('RNS') of the London Stock Exchange on the day of the transaction. All shares purchased are initially to be held in treasury.

4.4 CAPITAL OUTLOOK

The Group's capital base and liquidity position remain strong, supported by its robust processes for forecasting and managing its position. Its requirements are kept under regular review, in light of the level and form of capital required by the current business, its strategic priorities and the regulatory and economic outlook, including the Basel 3.1 proposals. This strength is evidenced by the Group's ability to provide an enhanced interim dividend for the period and to extend its share buy-back programme.

On an ongoing basis, the Group's capital generation allows for a strong level of return to shareholders, both in the form of dividends and share buy-backs, even after potential future regulatory changes are allowed for. This position remains both prudent and sustainable and helps ensure the viability of the business for the benefit of all stakeholders.

Interim Management Report (Continued)

5 FINANCIAL RESULTS

On an underlying basis the six months ended 31 March 2023 have demonstrated continuing growth and improving margins, continuing the momentum reported at the 2022 financial year end. Operating profit before impairment provisions increased by 27.7% compared to the first half of the 2022 financial year, to £136.4 million (2022 H1: £106.8 million). The impact of a more negative outlook for the UK economy than a year earlier, coupled with falling house prices saw increased impairment provisions, resulting in a smaller growth in underlying profit of 22.2% to £128.9 million (2022 H1: £105.5 million) (Appendix A).

The volatility seen in interest rate expectations over the last twelve months continued to impact on the Group's statutory results. Market expectations of future rate movements were scaled back, and a significant amount of the fair value gains recognised in the preceding financial year were unwound. This led to significant fair value losses being booked on derivatives held to hedge the Group's new lending pipeline. While the impact of these gains reduced profit before tax on the statutory basis by 67.7% to £46.4 million (2022 H1: £143.6 million), operationally these represent the reversal of timing differences, rather than core income to the Group and they are therefore excluded from underlying performance in the Group's disclosures. This approach has been consistently adopted by the Group and the likelihood of such a reversal in this period was clearly signalled in previous reporting.

These results, coupled with the Group's share buy-back programme, generated an increase in underlying earnings per share ('EPS') of 28.0% to 42.5 pence per share (2022 H1: 33.2 pence) (Appendix A), while EPS on the statutory basis decreased 63.1% to 16.4 pence per share (2022 H1: 44.4 pence).

5 FINANCIAL RESULTS (Continued)

5.1 CONSOLIDATED RESULTS

CONSOLIDATED RESULTS
For the six months ended 31 March 2022

	2023 H1 £m	2022 H1 £m
Interest receivable	437.6	239.2
Interest payable and similar charges	(225.2)	(64.0)
Net interest income	212.4	175.2
Other operating income	7.8	6.5
Total operating income	220.2	181.7
Operating expenses	(83.8)	(74.9)
Provisions for losses	(7.5)	(1.3)
	128.9	105.5
Fair value net (losses) / gains	(82.5)	38.1
Operating profit being profit on ordinary activities before taxation	46.4	143.6
Tax charge on profit on ordinary activities	(8.5)	(34.5)
Profit on ordinary activities after taxation	37.9	109.1

	2023 H1	2022 H1
Basic earnings per share	16.4p	44.4p
Diluted earnings per share	15.7p	43.0p
Dividend – rate per share for the period	11.0p	9.4p

Income

Total operating income for the six months increased by 21.2% to £220.2 million (2022 H1: £181.7 million), with loan interest continuing to form the largest part of the balance.

The Group increased its net interest margin ('NIM') by 38 basis points (Appendix B) compared to the first half of 2022, with tighter retail funding costs and changes in product mix delivering improved yield. When coupled with a 5.3% increase in the average loan book to £14,382.6 million (2022 H1: £13,658.8 million), this generated an increase of 21.2% in net interest income to £212.4 million compared to the first half of 2022 (2022 H1: £175.2 million).

5 FINANCIAL RESULTS (Continued)

The progression of the Group's annualised NIM, over the first half of each of the past five years is set out below.

	Total Basis points
Six months ended 31 March	
2023	295
2022	257
2021	232
2020	229
2019	224

This demonstrates the improvement in the Group's NIM over the period. This represents the careful long-term management of yields across the Group's businesses and improvements in the average cost of funds as the funding strategy has developed. These were sufficient to compensate for the loss of higher margin acquired loan business as these balances were paid down or sold off.

Other operating income was £7.8 million for the six-month period, increased from the £6.5 million reported for the first half of the 2022 financial year. The increase arises principally from operating lease activities and sundry account fee income, reflecting generally increased activity.

Costs

Operating expenses increased by 11.9% in the period, reaching £83.8 million (2022 H1: £74.9 million). The majority of this increase is driven by payroll costs, with employment-related costs comprising 66.5% of total operating costs, a similar level to that in the comparable period in the previous year (2022 H1: 66.7%).

The Group's average headcount in the six months was 1,522, 2.8% greater than in the comparable period in 2022 (2022 H1: 1,480). However, the combination of a 5% pay increase for most employees at the beginning of the period and a focus on specialist roles amongst new positions, resulted in a 9.9% increase in people costs in the period.

The Group's wider cost base has also been impacted by increasing levels of inflation in the UK economy, particularly in professional services. The Group's extensive digitalisation programme continues to have a significant impact on cost, with major projects taking place across all the Group's principal business lines. Much of this work is carried out in-house, impacting on employment costs, but significant external expenditure is also being incurred. The reliance on internal resource means that the Group capitalises relatively little in respect of software developments, taking costs in current expenditure. Only £1.3 million of such costs were capitalised in the period (2022 H1: £0.6 million).

The Group's IRB programme has continued through the period, as described in section 4 above. While the benefits of the programme will be long-term, costs of developing the approach are expensed as they arise.

5 FINANCIAL RESULTS (Continued)

The progress of the Group's cost:income ratio (Appendix C) over the first half of each of the last five years is set out below.

	%
Six months ended 31 March	
2023	38.1
2022	41.2
2021	42.5
2020	41.8
2019	42.8

Total cost:income has continued the gradual improvement seen over recent periods, despite the levels of expenditure incurred to develop the business for the future.

The efficiency of the Group's operations remains a key focus of its strategy, and control of costs remains a strategic priority. However, the short-term cost base is driven by the overall strategic aspirations of the Group, and the developing expectations of regulators. These factors, particularly in the current inflationary environment in the UK, put significant upward pressure on expenditure, meaning that the achievement of a sustainably lower cost:income ratio remains a longer-term aspiration, rather than a short-term priority.

Impairment provisions

As for all banks, the Group's profit and loss charge for impairment provisions is based on its evaluation of expected credit losses ('ECL') across its lending portfolios. However, where there is uncertainty over the future direction of the UK economy, the likely behavioural response to that direction, or both, evaluating the future potential for loss becomes much more complex.

In the six-month period both interest rates and inflation have increased further and faster than has been seen for many years, with both UK bank base rates and UK inflation measures reaching the highest absolute levels seen for some time. Given the evolution of products, markets and regulation since such levels were last seen, assessment of likely future credit performance demands a high level of judgement.

While many commentators believe that this type of economic environment, coupled with residual weakness from the Covid pandemic is likely to have a seriously adverse effect on credit, actual credit metrics, while showing some negative trends, have responded in a more muted fashion to date.

5 FINANCIAL RESULTS (Continued)

The Group's overall evaluation of all the potentially impacting factors has led to a charge of £7.5 million being reported in the half year (2022 H1: £1.3 million). The progress of the impairment charge and annualised cost of risk (Appendix B) in the first six months of each of the last five years is set out below.

	Write offs £m	Charge £m	Cost of risk %
Six months ended 31 March			
2023	**4.0**	**7.5**	**0.10**
2022	12.6	1.3	0.02
2021	6.1	6.0	0.09
2020	5.9	30.0	0.49
2019	8.3	4.9	0.08

The fluctuating charges set out above show the impacts of successive different sources of uncertainty on credit as they arise and dissipate. The half year ended 31 March 2020 saw the outbreak of the Covid pandemic and the largest part of the provisions made by the Group in response to Covid were booked in that period. Some of this provision was unwound in subsequent periods, depressing the provision charges, particularly in the first half of 2022. In the second half of 2022 provision charges increased again as the UK cost-of-living crisis took hold, and the level of charge for the first half of 2023 remains elevated.

Multiple economic scenarios and impacts

In order to support management's estimation of ECLs the Group has developed models to project losses in its largest books based on customer performance to the reporting date and anticipated future economic conditions. The use of these models therefore requires the use of a range of forward-looking economic scenarios which are each evaluated and then weighted to form an overall projection.

For portfolios where detailed models cannot be used the Group will also consider the potential impact of these economic scenarios where this might be significant.

Economic forecasting at the reporting date remains complex. While the levels of political uncertainty in the UK have reduced somewhat since September 2022, the impacts of the levels of inflation and interest rates seen at 31 March 2023 and the increase in the UK cost of living are yet to become clear, while significant differences remain between expert forecasters over the future trajectory of the UK economy. These factors all increase the risk of error in economic forecasting.

Generally, the consensus of forecasters is for a somewhat worse outlook overall than at the previous financial year end, particularly in the short term, with the rate of activity in the UK economy slow at best, although there is a division of opinion on whether the UK will actually enter a recession. The outlook for property values is also generally gloomy.

5 FINANCIAL RESULTS (Continued)

The Group has constructed the scenarios for its ECL modelling based on a number of forecasts from public and private bodies, synthesised to produce internally coherent sets of data. The central scenario is largely aligned with the current Bank of England forecast at the period end. This scenario is used for the Group's planning process, while upside and downside scenarios have been derived from it.

As in previous years, the severe downside scenario is based on the most recent Bank of England stress testing scenario published in September 2022. This scenario is included to represent the range of highly stressed outcomes for the UK and the Group's customers.

Overall, the forecasts represent an environment where interest rates remain higher than in recent years, the housing market remains is subdued and inflation is at very high levels compared to recent history, with these factors particularly evident in the early part of the scenarios, with some recovery later on.

Given the continuing divergence of opinion on the direction of the economy, the Group has retained the weightings applied to each scenario in its modelling at 30 September 2022, including the 20% weighting for the severe stress scenario, to represent the potential for plausible severe outturns for the UK.

The forecast economic assumptions within each scenario, and the weightings applied, are set out in more detail in note 16.

To illustrate the impact of these scenarios on the Group's IFRS 9 models, the impairment provision at 31 March 2023 before judgemental adjustments has been recalculated, weighting each of the central scenario and the severe scenario at 100%, with the results shown below.

	31 March 2023		30 September 2022		31 March 2022	
	Unadjusted Provision £m	Cover ratio	Unadjusted Provision £m	Cover ratio	Unadjusted Provision £m	Cover ratio
Weighted average	58.2	0.40%	48.5	0.34%	41.1	0.29%
Central scenario	50.8	0.35%	38.3	0.27%	34.3	0.25%
Severe scenario	79.2	0.54%	85.3	0.60%	82.6	0.59%

The calculated provisions remain lower than might be expected, given the uncertain economic outlook. It is clear that this must relate, in part, to the model build process. The data on which the Group's ECL models were based includes relatively few observations under scenarios similar to those predicted, which will make any resulting model less reliable.

It is also clear that while credit metrics have begun to respond to economic pressures, the levels of impact have not yet been as serious as many commentators ultimately expect, indicating that models may not be responding in a timely way to changes over the last six months, especially given the size of those movements.

5 FINANCIAL RESULTS (Continued)

The distribution of gross balances by IFRS 9 stage produced by the Group's impairment methodology at the three most recent six-month period ends is set out below.

	31 March 2023	30 September 2022	31 March 2022
Stage 1	93.1%	85.2%	86.9%
Stage 2	5.7%	13.7%	11.2%
Stage 3	1.0%	0.9%	1.1%
POCI	0.2%	0.2%	0.8%
Total	**100.0%**	**100.0%**	**100.0%**

The levels of cases in Stage 2 and particularly Stage 3 demonstrate the low level of credit impacts from the economic pressures over the six months, particularly on arrears, and the impact of a less volatile set of economic scenarios, particularly in the short term, on Stage 2 triggers in the buy-to-let portfolio. However, the economic outlook remains challenging, and this may result in a short-term increase in these levels, if impacts on customers intensify.

Judgemental adjustments

The fundamental requirement of any provisioning methodology is that the accounts present fairly the assets of the business. Therefore, it is a vital part of the process that all mechanical outputs are challenged based on management's understanding of the business to ensure that the provision is consistent with all available information at the period end, qualitative or quantitative, and whether it can be input into the modelling process or not. While the Group would ideally like its mechanical provisioning procedures to reflect as much of this information as possible, it acknowledges that this can never entirely be the case.

This is particularly true where predicted economic conditions are not represented in the data used to develop the model, where the inherent modelling uncertainty will increase. There is also information which may only be relevant in certain situations, or more qualitative data, such as internal and external feedback, which it would be difficult to incorporate into a statistical modelling framework.

The Group's impairment models rely on the historically observed linkage between actual credit indicators at the reporting date, such as credit bureau data and arrears metrics, and future credit being reliable in current circumstances. Where this is likely not to be the case, the predictive power of the models is diminished.

Management use their understanding of any model limitations, coupled with the wider ongoing and ad hoc management information about the Group's portfolios to determine whether any judgemental adjustments to provisioning are required.

5 FINANCIAL RESULTS (Continued)

Three dominant considerations influenced this thinking at 31 March 2023:

- How far could models be relied on in a situation where both the absolute levels of bank rates and inflation and their rates of change were at levels significantly outside their ranges in recent history?
- How might the generally negative outlook amongst commentators, customers and industry experts be reconcilable to the low levels of impact seen in credit metrics so far?
- What continuing impacts might there be from the Covid pandemic in terms of both corporate weakness and inflated cash balances which might delay or change the normal responses which might be expected in such conditions?

The Group also considered whether some customer groups in the SME business, particularly those related to the construction industry, might be more vulnerable in the specific economic situations being considered.

Having examined the available evidence both internal and external, the Group determined that additional judgemental provisions were required for both the buy-to-let mortgage portfolio and the SME lending operation. These are less severe than those applied at the previous financial year end, reflecting the increased level of provision calculated in the Group's modelling.

The judgemental adjustments generated by this process, analysed by division are set out below.

	31.03.2023 £m	30.09.2022 £m	31.03.2022 £m	30.09.2021 £m
Mortgage Lending	4.0	5.0	7.8	9.2
Commercial Lending	6.0	10.0	6.3	10.2
	10.0	15.0	14.1	19.4

The movement in the Mortgage Lending segment shown above is principally a reflection of the higher levels of modelled provision, impacted by falls in house prices and interest rates. However, it is not considered that the full impacts of these rate rises and other pressures have fully worked through the portfolio, and the potential for more significant credit issues than the model suggests still exists.

The Group remains cautious as to the overall level of strength of businesses in the SME sector. They have been faced by a series of adverse situations over the last three years, which will have reduced the resilience of some customers, and bureau data still shows excess cash balances in the sector, which may be delaying credit impacts, but are unlikely to avert them. There are also parts of the portfolio where customers' businesses relate directly or indirectly to capital projects and where timescales for impacts might be longer. The Group's models in this area were built on a more limited dataset than for its other books, a function of the acquisition date of the business, and care is required to ensure that they are properly responsive. Overall, it is considered that the level of risk in the portfolio remains elevated, with the reduction shown above mostly a response to the increased coverage generated by the models.

5 FINANCIAL RESULTS (Continued)

Management then considered whether there were any customer groups (such as industries or geographies) where the risk was particularly greater than others. No such significant groups have yet been identified, therefore the judgemental uplifts were applied across all performing cases.

The application of these judgemental adjustments is considered to align the accounting provision levels with current loss expectations in the business, taking into account all relevant internal information and allowing for inherent economic uncertainties. The Group will continue to monitor the appropriateness and scale of these overlays going forward and consider the extent to which any of the elements giving rise to them can or should be incorporated into models and standard processes. As part of this process a revised SME lending model is under development which should reduce the need for overlays in this area once it is in place.

Ratios and trends

The results of the Group's ECL modelling, including the impact of the economic scenarios described above, together with judgemental adjustments adopted to address uncertainties over the future performance of accounts, have resulted in the overall provision amounts and coverage ratios set out below.

	31 March 2023 £m	30 September 2022 £m	31 March 2022 £m	30 September 2021 £m
Calculated provision	58.2	48.5	41.1	46.0
Judgemental adjustments	10.0	15.0	14.1	19.4
Total	68.2	63.5	55.2	65.4
Cover ratio				
Mortgage Lending	0.33%	0.31%	0.28%	0.32%
Commercial Lending	1.36%	1.34%	1.18%	1.74%
Total	**0.47%**	**0.44%**	**0.40%**	**0.49%**

The coverage levels at 31 March 2023 remain broadly similar to those seen at the previous financial year end, although a greater amount of the provision has been driven by calculated provisions, reflecting the increased observability of impairment indicators, a more pessimistic economic outlook and lower expectations for asset values. These levels remain higher than the 0.34% coverage ratio seen at 30 September 2019, before the outbreak of the pandemic. That level was recorded when security cover in the buy-to-let book was lower, with an average loan-to-value of 67.4% compared to the 62.5% recorded at 31 March 2023. Future coverage levels will depend on future performance of the UK economy and its impact on the Group's customers and markets.

5 FINANCIAL RESULTS (Continued)

Fair value movements

The fair value line in the Group's profit and loss account primarily reports fair value movements arising from the Group's interest rate hedging arrangements. These are put in place to protect the Group's margins when offering fixed interest rate products in either its savings or lending markets while continuing to honour offers to customers in the event of significant interest rate movements. The Group maintains a cautious approach to interest rate risk and considers its exposures to be appropriately economically hedged. The Group does not engage in any form of speculative derivative trading and all fair value movements relate to banking book exposures.

The accounting entries included in this balance are primarily non-cash items and will reverse over the life of the hedging arrangement, although period-to-period movements are mostly influenced by volatility in market interest rates.

Where derivatives are hedging active loan or savings balances the accounting entries should broadly cancel each other out, although this effect can be distorted in periods of greater interest rate volatility, such as the six months being reported upon, where the heightened expectations of long-term rate levels which existed at 30 September 2023 have generally moderated in the period.

Where derivatives are pre-hedging the lending pipeline such offsets are not available, and the full fair value movement will be shown on this line. Where future interest rate expectations increase significantly between the point at which the pipeline loans were hedged and the point at which the loans complete, then a substantial fair value movement will have been posted to the balance sheet by this time. However, through the life of the loan product the derivative will provide inflows of cash to support the income from the loan, compensating for the difference between the fixed rate already agreed and the fixed rates available in the market at the time of completion.

For this reason, the Group regards these movements as essentially the anticipation of gains belonging economically to later accounting periods and excludes them from underlying results.

During the 2022 financial year, particularly in the second half, there was a significant level of volatility in UK benchmark interest rate expectations which resulted in a gain of £191.9 million for the year being recorded. The impact of market volatility was amplified by the Group's approach to pipeline hedging and the retention strategy applying to maturing five-year fixed loans, which meant that the pipeline was larger and of longer duration (and hence more exposed to movements in rates) than in earlier periods.

In the six months ended 31 March 2023 the reduced volatility in market rates, and the moderation in market expectations for the longer-term level of rates, coupled with the completion of loans in the pipeline hedge at the previous financial year end resulted in much of this gain unwinding and a fair value loss of £82.5m (2022 H1: gain of £38.1 million) being recorded in the period.

Interim Management Report (Continued)

5 FINANCIAL RESULTS (Continued)

The Group has a net derivative position of £863.4 million (at notional value) at 31 March 2023 (30 September 2022: £1,201.0 million, 31 March 2022: £801.3 million), which is unmatched for hedge accounting, although forming part of the economic hedging position. These derivatives must be carried at a fair value based on expected cash flows over their contractual lives. As a substantial proportion of this balance has a lifetime of two to five years, volatility in the interest rate markets can generate substantial month-to-month fluctuations in this valuation which have to be included in the Group's profit.

The table below shows the movements in unmatched exposures over the past 18 months, alongside the maximum and minimum five year swap rates in the year, as a measure of volatility.

		Six months to 31 March 2023	Six months to 31 March 2022	Year to 30 September 2022
		£m	£m	£m
Opening	Loan	1,578.1	681.6	681.6
	Deposit	377.1	683.5	683.5
	Net	1,201.0	(1.9)	(1.9)
Closing	Loan	1,124.0	993.3	1,578.1
	Deposit	260.6	192.0	377.1
	Net	863.4	801.3	1,201.0
Average		1,032.2	399.7	599.6
Swap rate	High	5.28%	1.93%	5.39%
	Low	3.27%	0.74%	0.74%
	Range	2.01%	1.19%	4.65%

This shows the reduction in rate volatility in the period and a reduced pipeline position as loans complete, leading to the reversal of a large part of last year's gain in the profit and loss for the period. Other elements of the gain will reverse over the life of the hedged assets, supporting NIM over that period.

As a result of these accounting transactions the Group is carrying a net fair value hedging asset on its balance sheet of £178.8 million (30 September 2022: £216.7 million, 31 March 2022: £48.6 million) which will revert to zero over the lives of the related instruments (note 18).

5 FINANCIAL RESULTS (Continued)

Taxation

The effective tax rate of the Group in the period on the statutory basis was 18.3%, with the reduction from the rate in the comparable period in the previous year (2022 H1: 24.0%) principally a result of the reversal of deferred tax liabilities created in respect of fair value gains in the previous year. The Group operates in the UK only and materially all its profit falls within the scope of UK taxation. The standard rate of UK corporation tax applicable in the period was 22.0%, with the surcharge applicable to Paragon Bank profits at 5.5%, with the increase in the standard rate from 19.0% offset, to some extent, by the reduction in the surcharge from 8.0% to 3.0% as well as the increase in the level from which the surcharge applies (note 9).

As the bulk of the fair value movements arose in Paragon Bank, the surcharge meant that these were subject to a higher rate of tax than the overall effective rate for the Group. This meant that the effective tax rate on underlying profit was 23.7% %, broadly similar to previous periods (2022 FY: 23.4%, 2022 H1: 22.7%) (Appendix A).

Result

The Group's overall consolidated profit before tax for the six-month period was £46.4 million (2022 H1: £143.6 million) a decrease of 67.7%, principally resulting from the impact of derivative fair values. Profit after tax decreased by 65.3% to £37.9 million (2022 H1: £109.1 million). In addition, other comprehensive income of £1.3 million was recorded (2022 H1: £10.6 million) related to valuation gains on the Group's defined benefit pension plan (the 'Plan').

As a result of these, total consolidated equity increased to £1,360.4 million (31 March 2022: £1,279.7 million) and consolidated tangible equity to £1,189.9 million (31 March 2022: £1,109.6 million), representing a tangible net asset value ('NAV') of £5.35 per share (31 March 2022: £4.59 per share) and a NAV on the statutory basis of £6.11 (31 March 2022: £5.30) (Appendix D).

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

5 FINANCIAL RESULTS (Continued)

5.2 ASSETS AND LIABILITIES

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

SUMMARY BALANCE SHEET
31 March 2023

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Loans to customers			
Mortgage Lending	12,593.3	12,193.4	12,328.7
Commercial Lending	1,961.6	1,721.5	1,881.6
	14,554.9	13,914.9	14,210.3
Hedging adjustment	(318.9)	(151.5)	(559.9)
Derivative financial assets	511.2	201.7	779.0
Cash	2,275.4	1,500.4	1,930.9
Pension surplus	10.4	4.4	7.1
Intangible assets	170.5	170.1	170.2
Other assets	116.9	111.0	116.0
Total assets	17,320.4	15,751.0	16,653.6
Equity	1,360.4	1,279.7	1,417.3
Retail deposits	11,875.9	9,853.7	10,669.2
Hedging adjustment	(37.8)	(30.9)	(99.7)
Other borrowings	3,643.4	4,460.1	4,007.2
Derivative financial liabilities	51.3	32.5	102.1
Other liabilities	427.2	155.9	557.5
Total equity and liabilities	17,320.4	15,751.0	16,653.6

The principal driver of movements in the Group's balance sheet is the size and composition of its loan book. This, together with policies on capital and liquidity determines the Group's funding requirements and the level of its liabilities.

The Group's loan portfolio increased by 4.6%, year-on-year, with increases in both the Mortgage Lending and Commercial Lending divisions, even after the disposal of the unsecured loan book in the second half of the 2022 financial year. These movements are discussed in more detail in the business review (Section 2 above).

5 FINANCIAL RESULTS (Continued)

Funding structure and cash resources

Overall, the Group's retail and wholesale debt funding increased by 8.4% year-on-year, a higher rate than loan book growth as liquidity was built towards the end of the period. This saw cash balances increasing 51.7% over the last twelve months. The funding mix continued to move towards retail funding with 76.5% of debt funding represented by savings balances at 31 March 2023 compared to 68.8% at 31 March 2022. These movements are discussed in more detail in Section 3 above.

Derivatives

The derivative assets and liabilities in the Group's balance sheet relate almost entirely to arrangements for hedging interest rate risk on fixed rate mortgage and savings products. These assets and liabilities are held at fair value, with the valuation based on future expectations of interest rates. The size of the balances is driven by the difference between current expectations for variable rates and the fixed rates applicable to the hedged items, meaning that where market rates move sharply, large balances will be held.

During the six-month period interest rate expectations stabilised, to some extent, with swap valuations therefore falling back. This resulted in an asset position of £511.2 million at 31 March 2023, reduced by £267.8 million in the six months (31 March 2022: £201.7 million, 30 September 2022: £779.0 million). Interest rate expectations also impacted derivative liabilities, which reduced to £51.3 million (31 March 2022: £32.5 million, 30 September 2022: £102.1 million).

While the element of these movements relating to pipeline hedging contributed towards the fair value movements in the profit and loss account described above, they were largely offset by movements in the balance of hedge accounting adjustments, with the credit adjustment to loans to customers reduced by £241.0 million in the six months and the debit adjustment to retail deposits reduced by £61.9 million (note 18).

Pension obligations

The surplus on the Group's defined benefit pension scheme, valued in accordance with IAS 19, increased a little in the period to £10.4 million at 31 March 2023 (31 March 2022: £4.4 million, 30 September 2022: £7.1 million). The underlying assumptions in this valuation are required to be based on market interest and bond rates at the period end, and can be subject to fluctuations where different market measures do not move at the same rate.

The principal inputs to the valuation were largely similar to those used at 30 September 2022. The discount rate used in evaluating scheme liabilities, which is based on long-term corporate bond yields, reduced by 20 basis points, from 5.00% to 4.80%, while the assumed rate of RPI inflation, which is based on gilt yields and counteracts, to some extent, the impact of discount rate movements fell by 35 basis points, from 3.55% to 3.20%.

Interim Management Report (Continued)

5 FINANCIAL RESULTS (Continued)

While the IAS 19 valuation is required to be used in the Group's accounts, pension trustees generally use the technical provisions basis set out in the Pensions Act 2004. On this basis, the Plan had a surplus of £3.8 million at 31 March 2023 (31 March 2022: £1.5 million, 30 September 2022: deficit of £1.4 million), meaning that the scheme was fully funded on this basis.

Other assets and liabilities

Sundry assets were £116.9 million (31 March 2022: £111.0 million, 30 September 2022: £116.0 million), broadly similar to previous period ends.

Sundry liabilities reduced to £427.2 million (31 March 2022: £155.9 million, 30 September 2022: £557.5 million), with the principal movement being a reduction in collateral received from counterparties to derivative asset positions, and in deferred tax provided on those positions, resulting from the changes described in the derivatives section above.

5.3 SEGMENTAL RESULTS

The underlying operating profits of the two segments described in the Business Review in Section 2 are detailed fully in note 2 and are summarised below.

	Six months to 31 March 2023 £m	Six months to 31 March 2022 £m	Year to 30 September 2022 £m
Segmental profit			
Mortgage Lending	118.9	112.9	229.6
Commercial Lending	56.7	40.4	86.7
	175.6	153.3	316.3
Unallocated central costs and other one-off items	(46.7)	(47.8)	(90.3)
	128.9	105.5	226.0

The Group's central administration and funding costs, principally the costs of service areas, establishment costs and interest on excess liquidity and bonds have not been allocated. For the current financial year, the Group's internal cost allocation processes have been updated to recharge costs of certain treasury activities to the segments, as described in note 2. Comparative amounts have been adjusted for consistency.

5 FINANCIAL RESULTS (Continued)

Mortgage Lending

NIM in the Group's core Mortgage Lending operation continued to improve in the period, increasing by 14 basis points year-on-year to 214 basis points (Appendix B). This was driven by the gradual replacement of legacy assets by new business and a tightening of funding costs. Coupled with a 3.7% increase in the average mortgage book to £12,461.0 million (31 March 2022: £12,011.5 million) this generated an 11.2% increase in net interest for the segment to £133.5 million (2022 H1: £120.1 million).

Overall credit performance of the book has worsened a little in the period, but significant adverse credit impacts have yet to be seen. Only 1.2% of the gross loan book at the period end was considered to be credit impaired (31 March 2022: 2.0%, 30 September 2022: 1.1%). The impairment charge for the period was £5.4 million for the six months, similar to the £6.5 million charge in the second half of 2022 (2022 H1: release of £1.9 million). This gives a cost of risk for the period of 9 basis points.

Together these created an increase of 5.3% in contribution made by the segment to group profit to £118.9 million for the six months compared to the corresponding period in 2022 (2022 H1: £112.9 million).

Commercial Lending

Segmental profit in the Commercial Lending division increased to £56.7 million, an increase of 40.3% compared to the first half of 2022 (2022 H1: £40.4 million).

Net interest for the portfolio increased by 27.9% compared to the first half of 2022. This was largely driven by an 16.7% increase in the average loan book to £1,921.6 million (31 March 2022: £1,647.3 million), but also reflects a 61 basis point improvement in NIM between the two periods (Appendix B), generated through product mix changes, yield management and tighter funding costs.

Impairment charges for the period, at £2.1 million were reduced by 34.4% compared to the first half of 2022 which had been impacted by a significant one-off case, and much lower than the £6.2 million recorded in the second half of 2022 (2022 H1: £3.2 million). Loss levels in this segment in the half year have remained at very low levels, with 1.5% of cases considered credit impaired at 31 March 2023 (31 March 2022: 1.0%, 30 September 2022: 0.7%). However, the Group still maintains a cautious outlook for credit in the sector. The interaction of these two factors leads to the low level of charge.

6 OPERATIONAL REVIEW

The Group's strategy is based on specialism, technology and service and the careful management of risk, and the execution of this strategy can only be achieved through a strong focus on its people, systems and controls.

During the period the Group has continued to invest in its people, progress the development of its processes and systems, both internal systems and those facing its customers and business partners, and enhance its risk management framework to support the digitalised vision of its future operating model.

This continuing prioritisation ensures that the Group maintains a firm foundation on which to build its business and deliver its strategy in the future.

6.1 OPERATIONS

The Group has a workforce of over 1,500 people, most of whom work on a hybrid basis, splitting their time between home-based working and one of the Group's office locations. During the six months the hybrid working approach has continued to be refined to ensure both the most effective use of the Group's people and the optimal working experience for them, as well as the best possible interactions with customers and business partners.

The Group recognises that for a specialised business there is unlikely to be a single preferred approach and business areas continue to develop working methods to suit the needs of their operations and customers, investing in appropriate system enhancements as required.

During the six months major projects to improve systems and procedures in the Group's main lending areas continued, with the most recent deliverable a new customer portal in buy-to-let mortgages rolled out shortly after the period end. Significant enhancements made to systems in development finance and SME lending towards the end of the previous year also continued to be rolled out, enabling more customers and business partners to benefit.

Other initiatives in the period included enhancement to the resilience of the hardware supporting the Group's loan administration systems, improvements to telephony for motor finance and improved system-based support for decisioning in SME lending, enhancing efficiency.

The Group's offices remain valuable as hubs to foster collaboration, communication, development and the growth of its culture and identity. During the period initiatives to ensure they remain fit for purpose as working practices evolve continued. These included decarbonisation, initiatives to improve energy efficiency, and the expansion of on-site charging capabilities for electric vehicles.

The operational resilience of the business remains an important area of focus for the Group and its regulators. During the period the second formal self-assessment required by regulators was successfully completed, providing an opportunity to evaluate developments in this area since the exercise was first completed.

Interim Management Report (Continued)

6 OPERATIONS (Continued)

The Group has maintained its focus on high quality customer service throughout the period. Regular surveys are conducted with customers and business introducers to monitor satisfaction, which have remained positive in the period.

The new Financial Conduct Authority ('FCA') Customer Duty begins to come into force from July 2023. Significant work has been undertaken to embed the requirements of the new Duty into the Group's systems and processes, and the Group is confident that it will be able to comply with the required deadlines.

The Group focusses on FOS complaints data as a high-level satisfaction metric, and incident levels remained low throughout the period. Consolidated information for the two group companies required to report to FOS, for the four most recent FOS reporting periods, is set out below.

	Six months ended			
	31 December 2022	30 June 2022	31 December 2021	30 June 2021
Cases reported	44	46	35	50
Uphold rate	15.2%	34.4%	34.2%	34.0%

The overall uphold rate across all companies reported by FOS for the six months ended 31 December 2022 was 34%, compared to 37% in the previous six months. The reduction in the half year is partly attributable to the disposal of the Group's unsecured lending book, which had accounted for a high proportion of FOS cases, in June 2022.

FOS data across the financial services industry is published on the ombudsman's website at www.financial-ombudsman.org.uk. However, the Group's complaint level has regularly been below the threshold for publication.

6.2 GOVERNANCE

The Group is committed to high standards of corporate governance as fundamental to the effective execution of its strategy. There have been no significant changes in the Group's governance framework during the period, and the procedures described in Section B of the Annual Report and Accounts for the year ended 30 September 2022 remain in place. It is subject to the UK Corporate Governance Code (the 'Code') and the Group has continued to comply with the Code's principles and provisions as outlined in the 2022 Annual Report throughout the period.

The Group continues to adopt a 'comply and explain' approach to Provision 21 of the Code, having deferred the external board evaluation, which had been due in 2022, until the new Chair had been in post for a sufficient time to make such an assessment more meaningful, relevant and useful. The Group has now commenced the evaluation process, which will be completed in the second half of the financial year and its results presented in the 2023 Annual Report.

6 OPERATIONS (Continued)

Board of directors and senior management

A review of the skills and experience of the non-executive directors determined that the Board would benefit from additional experience in the fields of sustainability and customer experience, and it was agreed to recruit an additional non-executive director with particular strength in these areas.

Following an extensive search and assessment process, Zoe Howorth was appointed to the Board on 1 June 2023. Zoe's breadth of knowledge, which includes branding, digital and sustainability understanding, and her strong focus on the customer will enhance the diversity of perspective on the Board. Her executive experience includes 16 years with the Coca-Cola Company across a variety of roles, culminating in her role as UK Marketing Director. Zoe is a non-executive director, chair of the ESG committee and a member of the remuneration committee at AG Barr PLC, a FTSE-250 consumer goods business. She also holds a number of non-executive director roles with private companies. In 2021, Zoe joined the board of International Schools Partnership Limited, a global education business, where she has board responsibility for ESG and brand. Zoe is also a non-executive member of the Water Babies International Board.

Hugo Tudor, the Company's senior independent director and chair of its remuneration committee will reach the ninth anniversary of his appointment to the Board in November 2023. The process to identify a successor to Hugo in each of his roles is well progressed and appropriate announcements will be made in due course.

Following the announcement that Pam Rowland intended to retire as the Group's Chief Operating Officer at the end of March 2023, the Group was pleased to announce the appointment of Zish Khan to the position in November 2022. Zish brings a wealth of experience in technology, change and operations having over 20 years' experience across the financial services sector. A smooth transition and handover of responsibilities has been completed.

The Group continues to be conscious of the need to ensure that the Board contains an appropriate balance and diverse set of skills and experience. It has noted statements on diversity and governance from the PRA and the FCA, as well as in the corporate world more generally, setting out enhanced expectations and new regulatory requirements in this area. With effect from 1 June 2023 the Group now complies with the new FCA Listing Rules requirements on diversity, which apply to it for the first time for this financial year.

As at 31 March 2023, the Board had three female directors out of a total of nine board members, forming 33.3% of the Board. Following the appointment of Zoe Howorth on 1 June 2023 this increased to four female directors out of ten board members, or 40% of the Board.

6 OPERATIONS (Continued)

Remuneration policy

The Group's triennial review of Directors' Remuneration policy was approved at the 2023 Annual General Meeting ('AGM') following extensive consultation with shareholders, investor bodies and other stakeholder groups and we thank them for their feedback and support. The Directors' Remuneration Report was passed with 69.19% of votes cast in favour, which represents a "significant vote against" the report as defined by the Code. Accordingly, the Remuneration Committee is considering carefully the points raised by those shareholders who were not supportive of the report and will seek additional input where necessary.

As required by the Code, the Company will publish an update on its position within six months of the 2023 AGM.

6.3 PEOPLE

The Group's people are fundamental to its strategic vision and is proud of its Investors in People Platinum status. At 31 March 2023, the Group employed 1,537 people, an increase of 2% in the half year period. The majority of these new roles are in customer-facing areas of the business and within the Group's Information Technology division, contributing to the Group's business development and digitalisation strategy.

Conditions and culture

The Group continues to promote flexibility around how and where its people work, encouraging hybrid working where possible across all locations, to promote a healthy work life balance. The Group understands the benefits that flexible working brings for many of its employees and the part it can play in developing a more diverse and engaged workforce.

The Group maintains its accreditation from the UK Living Wage Foundation and minimum pay continues to meet the 'Real Living Wage' levels set by the Foundation, last updated in October 2022, and particularly important given cost-of-living pressures. This policy was enhanced by the decision in January 2023 to increase the wage paid to apprentices to be in line with the Living Wage Foundation rate. All other employees below management grade received a minimum 5% pay increase at the beginning of the period, to help them manage cost-of-living issues. Employees were also supported by the Group's profit related pay scheme, which, following the record 2022 profit, provided an additional £3,300 to all full time employees, after allowing for the £500 payment in advance made earlier in the calendar year.

Holiday entitlement for employees remains at a maximum of 31 days and a minimum of 26 days, in addition to two additional company closure days over the Christmas period and all UK public holidays, including the additional bank holiday given for the Coronation. This means that all full-time employees will enjoy at least 37 days of paid holiday this year.

6 OPERATIONS (Continued)

Despite the increase in labour turnover generally in the UK, the Group's annual voluntary attrition rate at 31 March 2023 is running lower than twelve months earlier at 10.0% (31 March 2022: 12.5%). The Group continues to retain long-serving employees, with 30.2% of employees having achieved 10 years' service, of whom 38.8% had been with the Group for over 20 years. Despite these levels of talent retention, vacancy numbers remain consistent given the growth of the Group. Investment has been made in recruitment technology with the on-boarding process streamlined and automated.

The Group's People Forum remains one of the main channels for employee opinions to be fed back to the Board and Executive Committee. The newly appointed Chair of the Board, Robert East, the Chair of the Remuneration Committee, Hugo Tudor, and Tanvi Davda, who was appointed as a non-executive director in September 2022 have met with the People Forum in the past six months. Topics discussed included the Group's strategy, its approach to climate change and other ESG issues, and its approach to workforce remuneration. Meetings between the Forum and various non-executive directors continue on a regular basis.

The wellbeing of the Group's employees is central to its people strategy, and the Wellbeing Team remain the cornerstone of the approach, with ten additional employees being trained as mental health first aiders, keeping the available resource in line with the growth in headcount, and ensuring that all business areas and locations are covered. The Wellbeing Team, which is sponsored by the Chief People Officer, provide a source of support to employees covering the four pillars of wellbeing: emotional, social, financial, and physical, and are able to signpost people to additional resources and support if required.

Interim Management Report (Continued)

6 OPERATIONS (Continued)

Equality and diversity

Equality, diversity, and inclusion ('EDI') continues to be an important part of the Group's people strategy, with oversight from the Board. The EDI Network continues to lead campaigns to raise awareness and understanding of the importance of workforce diversity and an inclusive culture. The Network's continuing programme of activities include Executive Listening Circles, where members of the Executive Committee meet with employees from underrepresented groups to listen to their experiences and gain a different perspective.

Following feedback from the listening circles the Group has launched "Ignite", a new development programme which focuses on supporting the development and career progression of individuals in underrepresented groups. This aims to ensure that everyone can progress in their career regardless of background.

In February 2023 Richard Rowntree, the executive sponsor of the Group's EDI network, was awarded the freedom of the City of London for his work promoting socio-economic diversity in the financial services sector, including his role in the launch of the 'Progress Together', of which the Group was a founding member.

The Group continues to encourage cross-company mentoring with external mentoring programmes, provided in conjunction with the 30% Club, available to staff: 'Mission Gender Equity', a programme focusing on gender diversity aiming to achieve parity of women in leadership roles; and 'Mission Include' which supports individuals from underrepresented groups including those from less advantaged socio-economic backgrounds.

The Group published its Gender Pay Gap report in March 2023 and reported a mean pay gap of 36.3% at 5 April 2022 (2021: 38.4%) and median gap of 32.5% (2021: 36.6%). Whilst the Group's 2022 gender pay gap improved slightly since 2021, the measures remain larger than senior management would like. The marginally positive movement in results is attributable to the number of senior female hires between the reporting dates, increasing female representation in the top pay quartile. These included recruits in several important customer-facing roles.

As noted above, the Group meets the FTSE Women Leaders target of boards having 37.5% female representation. The Group remains committed to HM Treasury's Women in Finance Charter. With this now moving into the second phase, the Group has set a new the target of achieving 40% of women in senior positions by December 2025, using the FTSE Women Leaders definition. At 31 March 2023, the position had improved to 39% (31 March 2022: 37.5%).

6 OPERATIONS (Continued)

Learning and development

The development of the Group's current and future managers and leaders has continued to be an area of focus in the period, with a new cohort entering the well-established Team Leader Academy programme as well as a second cohort beginning the specialist High-Potential Programme ('HPP'). The third cohort to complete the Senior Leadership Programme ('SLDP') also graduated this period. The success of these development programmes, in support of the Group's overall succession plans, has been seen with 67% of graduates from the HPP having secured an internal promotion or change in role, with 46% of those from the SLDP having been promoted to a new role.

The Group continues to make use of the Apprenticeship Levy scheme, with 12 employees graduating from their apprenticeships and securing permanent roles in the business so far this year. There are currently 67 full time apprentices working in the Group. As well as dedicated apprenticeship programmes, the Group utilises the levy through its Team Leader Academy programme. The Group utilised 24% (31 March 2022: 29%) of its available levy pot in the past twelve months. The reduction is due to the increase in overall payroll costs, and the consequential increase in the amount of available levy funds.

The Group is also currently supporting 137 individuals with funding to complete professional qualifications (31 March 2022: 105). Students for the London Institute of Banking and Finance CeMap mortgage qualification continue to account for the majority, followed closely by individuals undertaking Anti-Money Laundering qualifications.

6.4 SUSTAINABILITY

Sustainability, including resilience in the face of climate change risks, is core to the Group's strategy: to focus on specialist customers, delivering long-term sustainable growth and returns through a low risk and robust business model. Sustainability influences every aspect of the Group's business and means:

- Reducing the impact of the Group's operations on the environment
- Ensuring that the Group has a positive effect on our stakeholders and communities
- Delivering sustainable lending and savings offerings through the design of products and the choices of sectors in which to operate

The Sustainability Committee, which reports directly to the Executive Committee, coordinates the Group's overall response to climate change and other sustainability issues. This ensures that information on initiatives within business areas is shared across the Group and facilitates the development of a coordinated and proactive approach to ESG issues. Since its formation in 2021 it has increased the profile of sustainability-related risks and opportunities within the Group and driven improved reporting and understanding of these matters, which in turn has enhanced the approach to identifying and managing climate-related risks and opportunities.

6 OPERATIONS (Continued)

The Group publishes an annual sustainability report, the Responsible Business Report, each December. This provides more detailed information on sustainability initiatives and demonstrates how sustainability is embedded throughout the Group. It is available on the Group's corporate website at www.paragonbankinggroup.co.uk, alongside other information and documentation relevant to ESG issues.

Climate change

The Group has made a commitment to achieve net zero by 2050 in line with, and in support of, UK Government commitments. In doing so the Group recognises that net zero cannot be achieved by any entity in isolation and that this commitment is therefore dependent on appropriate government and industry support and action. As members of Bankers for Net Zero ('B4NZ') the Group aims to provide input into the wider efforts of the financial service industry in creating a clear pathway for the decarbonisation of the UK economy.

Climate change has been designated as a principal risk within the Group's Enterprise Risk Management Framework. As a result, the Group's responses to climate change are considered within the Board's overall strategy. These risks fall into two main groups:

- Physical risks (which arise from weather-related events)
- Transitional risks (which come from the adoption of a low-carbon economy)

Information and measures on climate-related risks and opportunities are considered at board level through monthly sustainability reports presented by the CEO. Developments in sustainable products and climate-related exposures are considered for each business line as part of strategy deep dives which feed into the annual board strategy event and into the Corporate Plan.

The Green Bond Framework reflects the Group's commitment to embed sustainability throughout its strategy, operations, and product offerings including funding and capital raising activities. The Sustainability Committee is responsible for the framework, which can be viewed on the Group's corporate website.

During the six-month period, in-depth risk reviews have been carried out with input from key business areas and credit risk, which identified no new material risks. The findings have been used to inform the Group's climate change scenario analysis exercise and identify the key drivers of its climate change risk profile and opportunities. The exercise was conducted in line with the outputs of the Climate Financial Risk Forum ('CFRF') scenario analysis working group, of which the Group is a member. The results will be escalated up to the Board and integrated within the 2023 ICAAP.

The Group is required by the UK Listing Rules to report on climate change risk and exposures using the Taskforce on Climate-Related Financial Disclosure ('TCFD') framework. The 2022 Annual Report and Accounts contains disclosures for the Group which are consistent with the recommendations of the TCFD and the expectations set out in the Listing Rules. These set out the Group's approach to the identification, monitoring and management of climate risk in greater detail than this Half-Yearly Report and should be referred to if further information is required.

6 OPERATIONS (Continued)

These disclosures will be developed further in the course of the current year in light of emerging market practice and regulatory expectations, with an updated set of TCFD disclosures to be provided in the 2023 Annual Report and Accounts.

Developments within business lines which contribute towards the Group's climate risk strategy are set out in the relevant business reviews, but highlights include:

- Engagement with larger buy-to-let customers on their plans to address the proposed minimum EPC requirements. This will enable the business to develop approaches to support these customers as they move towards compliance. Learnings will be cascaded down to develop solutions applicable to the PRS more widely and will also feed into broader engagement with industry, government and regulatory bodies
- Expansion of the funding available through the Green Homes Initiatives in the development finance operation to increase the number of projects that can be funded through the scheme, following the initial positive uptake
- Extension of motor finance lending criteria to cover light commercial BEVs as well as passenger BEVs

As a financial services provider the direct environmental impact of the Group's operations is considered low. However, the Group recognises the importance of reducing the impact these operations do have on the environment. The Group has committed to reduce its operational footprint to net zero by 2030 and now reports its operational footprint on a quarterly basis at the Sustainability Committee with a summary report escalated to the Board.

In support of the Group's net zero operational footprint target, for the 2022 financial year the Group purchased certified carbon offsets equivalent to its operational footprint for the twelve months, and will repeat that exercise for the current financial year and each year going forward. However, it acknowledges that, ideally, reducing impacts is preferable to offsetting.

Group initiatives to reduce operational environmental impacts during the last six months include:

- Enhanced support for essential car users following the 2022 update to the company car policy which aims to eliminate diesel and petrol vehicles by 2025. Users now receive a subsidy to source an appropriate charging unit at their home address
- Appointment of a new waste contractor for the Group's head office building, with the contract due to commence in May. This will improve waste management and reporting
- Completion of the LED lighting roll out at the Group's head office by April 2023, which will reduce overall energy consumption
- Development of a supplier survey which will be initially rolled out across a sample of suppliers and be aimed at identifying climate and other sustainability risks in those business relationships

6 OPERATIONS (Continued)

Social engagement

During the six months the Group's Charity Committee raised almost £20,000 for Newlife, which supports disabled and terminally ill children and is the employee's chosen charity for the 2023 financial year.

Employees are also using their entitlement to an annual paid volunteering day. So far this year, employees have already contributed 154 days, supporting 18 projects in the community, including 83 individuals volunteering with Newlife. The Group is targeting 400 volunteer days for 2023 with a large number of events already planned for the second half of the financial year.

6.5 RISK MANAGEMENT

The effective management of risk remains 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.

Risk environment

As the Group navigates the post-Covid world, the challenges of the pandemic have been superseded by wider economic and geopolitical issues which demand that the Group remains agile and resilient in its risk management capability. The Group's risk management framework continues to provide a robust mechanism which ensures that new risks are promptly identified, assessed, managed and appropriately overseen from a risk governance perspective. The role of the risk framework has been critical both in the early identification of risk issues and in providing a mechanism to manage such issues as the risk landscape has evolved considerably over the last period.

Whilst economic uncertainties have dominated the risk agenda, new threats have manifested themselves which required the Group to consider their impact on its risk profile. The failure of Silicon Valley Bank ('SVB') in March 2023, followed the collapse of some other US regional banks and the international bank, Credit Suisse, while resolved in an orderly manner, created significant uncertainty in the banking sector and the perceived threat of contagion, with banking stocks in the US, Europe and in the UK suffering share price falls as a result.

Although the direct impact on the Group has been limited, the events during March 2023 are likely to lead regulatory authorities in the UK, Europe and the US to reconsider their approaches to a number of impacted areas. As the situation continues to evolve this may potentially include consideration of:

- The overall functioning of the prudential and resolution regimes
- Liquidity and funding requirements
- Capital requirements to address interest rate risk

6 OPERATIONS (Continued)

- Approach to international branches and subsidiaries
- The PRA's 'Strong and Simple' regime

An initial assessment of the issues leading to the failure of these firms and whether there are any areas of concern for the Group has been undertaken, and no concerns have been identified. Developments continue to be monitored closely to determine potential impacts on the regulatory environment or on the Group directly.

There are a number of other strategic issues that have been prominent in the risk landscape in the six-month period and are expected to continue to pose challenges for the foreseeable future:

- The "cost-of-living" crisis continues to dominate the political and economic agenda with spiralling inflation and consecutive months of interest rate rises seen throughout the first half of the Group's financial year. With the far-reaching implications of increasing inflationary pressures, the Group continues to closely monitor how this may impact its customers and employees
    - In an environment of rising interest rates and cost pressures for both new and existing borrowers, the Group continues to ensure that high standards of prudent lending are maintained. The Group considers its credit policy to be prudent and continues to assess actual and projected arrears trends in setting its lending criteria. Whilst the Group has not seen a significant increase in arrears in its buy-to-let portfolio, early signs of any stress are being monitored across its other lending lines. The Group continues to take a forward-looking, as well as current, view of affordability, and will adjust credit policy to ensure loan repayments are sustainable for customers as appropriate
    - The Group takes its responsibilities in respect of customers with reducing financial resilience and those in vulnerable circumstances extremely seriously and continues to ensure that, where appropriate forbearance solutions are necessary, these are tailored to individual customer circumstances and aligned to regulatory guidance and expectations
    - The Group remains committed to supporting its employees in the face of economic challenges. Various financial and wellbeing initiatives have been instigated to ensure that employees have access to information and resources to assist in navigating cost-of-living challenges. The welfare of its employees is a key priority of the Group, and it will continue to look at innovative ways of ensuring that individuals feel fully supported in the face of the economic challenges they may face

  The Group continues to closely monitor the impacts of government policy and interventions may influence the broader economic landscape

6 OPERATIONS (Continued)

- The ongoing embedding of the Group's operational resilience capability has continued to mature, reflecting regulatory and industry practice and incorporating lessons learned from the pandemic into the overarching framework. Focus over the last six months has been on further refinement and testing of impact tolerances through a comprehensive scenario testing programme, ensuring that enhancements identified through the annual self-assessment process are incorporated into the framework. The Group, therefore, remains well-placed to meet regulatory timeframes and expectations in respect of resilience. Robust operational resilience remains both a critical driver and a priority in the design and execution of the Group's strategic transformation programme
- Prioritising focus on climate change, given the associated risks, remains an ever-present challenge. The UK Government has confirmed its goal of net zero carbon by 2050 and the Group, and the rest of the financial services industry, have a vital role to play in that commitment. The Group considers the impacts of climate change risk through both its operations and its lending activities, and continues to evolve its approach to measuring and mitigating the transition and physical risks potentially caused by climate change
- The uncertainties following the outbreak of conflict between Russia and Ukraine necessitated immediate responses by the Group, with potential exposures to Russian, Belorussian or Ukrainian customers and suppliers identified promptly in the previous financial year. The Group continues to monitor the position carefully through ongoing customer due diligence and risk assessment processes. The Group's threat assessment remains unchanged but investment in cyber controls remains a priority given this particular situation, and the wider threat of cyber terrorism globally

These issues are expected to continue to dominate the risk landscape through the second half of the financial year, particularly with the overall levels of economic uncertainty in the UK and the prospect of continuing inflation and interest rates remaining at levels not seen for many years. The Group will carefully monitor the emerging impacts on both credit risk and the wider risk environment as the situation develops.

The Group continues to review the implications of the post Brexit landscape. Whilst the Group does not have operations outside the UK, it maintains continuous oversight of the implications for its regulatory environment and operations, and on potential stresses which might be caused by the process. In particular, the Board is closely monitoring the ramifications of the various supply chain issues that have manifested themselves, especially in respect of building materials and other equipment that may impact on the Group's operations. Despite these challenges the Group considers it is well placed to address such issues.

6 OPERATIONS (Continued)

Risk management processes

During the six-month period the Group completed its programme to enhance its Enterprise Risk Management Framework ('ERMF') to ensure that its foundations are complete, and it is well-placed to manage all categories of risk and respond to the changing business environment. It is recognised that this is an ongoing journey and will necessitate continuous improvement, but the Group is confident that the robust foundations and practices which have been established will drive effective risk management throughout the organisation. Key deliverables to support the ERMF have included a comprehensive set of policies addressing all principal risks, including further refinements to risk appetites, and ensuring that understanding and management of risk pervades all levels of the Group, embedding a strong and visible risk culture.

The ERMF will continue to evolve as the level of maturity and operations grow, and the Group remains committed to ensuring that risk processes and resources remain appropriate to ensure that all risks are managed within stated appetites as the business develops. The Group continues to review its risk approach to ensure it remains effective and proportionate in terms of both maturity and operation and is fully committed to further enhancement of the ERMF as required over the coming years.

Despite the wider economic and sectoral challenges, the Group is committed to continuing to deliver on key risk management initiatives to build further on the good progress made since the previous financial year end including:

- **FCA Consumer Duty** – Mobilising and progressing a comprehensive programme of work to implement new FCA Consumer Duty requirements across the Group, ensuring that its culture is driving good outcomes for its retail customers
- **Operational resilience -** Ongoing embedding of operational resilience capabilities including addressing actions and vulnerabilities identified in the 2022 self-assessment. These have been further assessed as part of the 2023 assessment. Focus areas have included further refinement of critical business services and tolerances, ensuring these considerations are embedded as part of day-to-day operations, together with enhancement of the Group's technology
- **Climate change -** Addressing the financial risks of climate change through key risk driver assessments, and consideration of the impacts of the wider ESG agenda across the Group's operations
- **Capital requirements (Basel 3.1)** – Following the publication by the PRA of its consultation on the implementation of the Basel 3.1 requirements in November 2022, the Group has provided feedback to the PRA directly and has worked closely with industry peers through UK Finance. The final rules are due to be implemented in January 2025 and the Group has assessed, and continues to assess, the implications of the new regime on its capital structure as requirements are clarified
- **Financial Crime –** Ongoing work to ensure the Group's financial crime risk framework continues to develop and mature, including further investment in technology and resources across the lines of defence during the period

6 OPERATIONS (Continued)

- **IRB** – IRB model methodologies for the buy-to-let and development finance portfolios are fully in place, along with enhancements to the overarching model risk framework and credit risk management practices to support the Group's IRB application process. Following submission of Phase 2 of the buy-to-let application to the PRA in March 2021, initial agreed refinement points were submitted to the regulator in December 2022 and further refinement points are in the process of being finalised. Phase 3 documentation for buy-to-let is nearing completion. Phase 2 documentation for development finance is fully drafted and the final internal governance steps will be completed as soon as the PRA issues an invitation to submit this.

The Group has further continued to develop and evolve its management and oversight of outsourcing arrangements, relationships with important suppliers, cyber security and data management throughout the period. A comprehensive stress testing framework exists which considers non-financial risks on a regular basis in addition to the robustness of capital and liquidity positions.

Principal risks and uncertainties

A summary of the principal risks and uncertainties faced by the Group, required by DTR 4.2.7(2) of the Disclosure and Transparency Rules, is set out on pages 174 to 175. These risks have not changed significantly since those disclosed at the 2022 financial year end.

6.6 REGULATORY CHANGES

Paragon Bank, which, for regulatory purposes, includes most of the Group's activities, is authorised by the PRA and regulated by the PRA and the FCA. The Group is subject to consolidated supervision by the PRA and a number of its subsidiaries are authorised and regulated by the FCA. As a result, current and projected regulatory changes continue to pose a significant risk for the Group, arising from both their impact and of the pace of change. Therefore, the Group monitors the regulatory landscape on an ongoing basis with a particular focus on new and emerging regulations to ensure it is well-placed to respond to such changes in an agile manner.

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

Given the nature of its operations the Group is affected by a broad range of prudential and conduct regulations. The Group engages in regular dialogue with its regulators and responds to all requests promptly.

6 OPERATIONS (Continued)

The volume of requests for information from the FCA has increased over recent periods, and this trend is expected to continue, focussing on the exercise of forbearance for customers as the cost-of-living crisis develops, as well as monitoring Consumer Duty implementation. The Group responds to such requests in a timely fashion and maintains robust controls to support the delivery of good customer outcomes.

The following recent and current developments have the greatest potential impact on the Group:

- **Consumer Duty** – In July 2022, the FCA issued its final rules and guidance on 'A new Consumer Duty', which seeks to set higher expectations for the standard of support provided to customers, and challenges firms to evidence the customer outcomes that they are delivering. The Group remains on track to implement the requirements in line with the staged dates for compliance, with the requirements to be in place by July 2023 for existing products, and by July 2024 for closed products. This activity continues to be championed and overseen by the Board, with a designated non-executive director having been assigned specific responsibility for oversight

- **Customers in vulnerable circumstances** – The treatment of customers in vulnerable circumstances continues to be a strong focus for the FCA, demonstrated in a number of publications throughout the period, such as Dear CEO and Dear Chair letters, and review findings in areas such as the rising cost of living, fair treatment of SME customers and borrowers in financial difficulties. The Group continues to take its responsibilities in this regard very seriously. Significant work continues to be undertaken to revise existing procedures, controls and training provisions to meet regulatory and industry expectations

- **MREL** – The Bank of England's policy statement 'Changes to the Minimum Requirement for Own Funds and Eligible Liabilities ('MREL')' took effect from 1 January 2022. Although the Group is not subject to MREL requirements currently, given its potential for growth it may be required to issue MREL eligible instruments at some point in the future and therefore continues to closely monitor developments and potential impacts

- **Basel 3.1** – The PRA published a Consultation Paper on Basel 3.1 implementation in November 2022. The consultation was recently completed and new requirements have been proposed for implementation on 1 January 2025. The proposed Basel 3.1 standards will impact capital requirements for all relevant banks and building societies with possible implications for competition, strategy, and risk appetites. They may also require updated processes and system developments. The consultation process has also identified a number of critical areas where further clarity is required from the PRA to ensure appropriate and consistent implementation across firms. The Group actively monitors and manages its capital, and continues to assess the implications of a range of different impacts including the implementation of the revised Basel standards

6 OPERATIONS (Continued)

- **Regulatory framework** – Since 2021 the PRA has been exploring options for developing a 'Strong and Simple' prudential framework for banks and building societies that it considers to be neither systemically important nor internationally active. Consultation Paper ('CP') 5/22 in April 2022 set out how a simple firm would be defined. However, within the Basel 3.1 consultation the PRA increased the total assets threshold for simple firms from £15 billion to £20 billion (in addition to other changes). To date this work has culminated in the publication of CP 4/23, setting out proposals related to liquidity reporting requirements, the ILAAP, Pillar 2 liquidity requirements and Pillar 3 reporting for firms who can be classified as simple. The Group continues to monitor developments and potential implications for its operations

- **Operational resilience** – The Group remains firmly on track to meet all requirements of the final rules and guidance on 'building operational resilience in financial services' published in 2021 by the FCA, PRA and Bank of England. The Group has successfully completed the 2023 iteration of its self-assessment enabling it to validate progress in addressing any gaps identified in the 2022 assessment and to help set clear objectives for further refining its approach to resilience

  The Group is committed to a programme of continuous improvement in its resilience capability. Important business services are mapped and tested using severe but plausible scenarios to push the boundaries on the ability of the infrastructure, key dependencies and third parties to recover from disruption. The scenario library has been enhanced for the 2023 testing programme and the groupwide disaster recovery testing plan helps support the ongoing scenario testing programme with clear focus on recovery of important business services. The scenario approach continues to be updated in response to internal or external drivers. In the last six months a further scenario has been incorporated to consider potential power interruptions, to cope with winter demand and possible supply challenges including a specific focus on the impact of an area-wide power blackout on important business services. Actions to manage and close vulnerabilities identified through such testing continue to be tracked through to completion with close oversight provided through the established governance structures. This approach should ensure the Group can meet the regulatory deadline of 2025 where it will need to demonstrate the ability to stay consistently within impact tolerances

- **Climate change** – The Group continues to work towards its commitments to embed its approach to managing climate-related financial risks. The Sustainability Committee, alongside the executive level risk committees, ensures comprehensive consideration of these risks across all aspects of the business and that the Group is well-positioned to address the emerging challenges. Managing the impacts of climate change is seen as a key strategic priority for the Group with board-agreed commitments and a detailed plan of work which has been developed reflecting regulatory and wider requirements. This will continue to be refined as new thinking emerges

6 OPERATIONS (Continued)

The Financial Services and Markets Bill, which sets out how the UK financial sector will be regulated post-Brexit, was published in July 2022 and is currently making its way through the UK parliament. The Bill will implement the outcomes of the Future Regulatory Framework ('FRF') Review, revoking retained EU law relating to financial services and enabling HM Treasury and the financial services regulators to replace it with legislation designed specifically for UK markets, in a way that builds on the existing UK approach to financial services regulation. The Bill covers a wide range of areas, which include giving the FCA and PRA new secondary objectives to advance international competitiveness and the medium to long-term growth of the UK economy, and to have regard to the Government's commitment to reach net zero emissions by 2050. It will also increase the level of accountability of the regulators, with greater levels of involvement by the Treasury and the parliamentary Treasury Select Committee in FCA and PRA consultations.

In addition to the Financial Services and Markets Bill, the Government set out a separate collection of announcements – the so called 'Edinburgh Reforms' - as part of its Autumn Statement in December 2022. This wide-ranging package covers all parts of the financial sector and has been designed to take forward the government's ambition for the UK to be the world's most innovative and competitive global financial centre. The Group continues its close monitoring of developments in this area and the emerging implications of Brexit more widely, and evaluates how these may ultimately impact the specific regulatory frameworks under which the Group operates.

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

Statement of Directors' Responsibilities

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

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

Approved by the Board of Directors and signed on behalf of the Board as the persons responsible within the Company.

CIARA MURPHY

Company Secretary

6 June 2023

Board of Directors

R D East	H R Tudor
(Chair of the Board and Chair of the Nomination Committee)	*(Non-executive director, Chair of the Remuneration Committee and Senior Independent Director)*
B A Ridpath	G H Yorston
(Non-executive director)	*(Non-executive director)*
A C M Morris	P A Hill
(Non-executive director and Chair of the Audit Committee)	*(Non-executive director and Chair of the Risk and Compliance Committee)*
T P Davda (*Non-executive director*)	Z L Howorth *(Non-executive director)*
N S Terrington	R J Woodman
(Chief Executive Officer)	*(Chief Financial Officer)*

INDEPENDENT REVIEW REPORT TO PARAGON BANKING GROUP PLC

Conclusion

We have been engaged by the Company to review the condensed set of financial statements in the half-yearly financial report for the six months ended 31 March 2023 which comprises the consolidated statement of profit or loss, consolidated statement of comprehensive income, consolidated balance sheet, consolidated cash flow statement, consolidated statement of movements in equity and the related explanatory notes.

Based on our review, nothing has come to our attention that causes us to believe that the condensed set of financial statements in the half-yearly financial report for the six months ended 31 March 2023 is not prepared, in all material respects, in accordance with IAS 34 *Interim Financial Reporting* as adopted for use in the UK and the Disclosure Guidance and Transparency Rules ('the DTR') of the UK's Financial Conduct Authority ('the UK FCA').

Basis for conclusion

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

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

Directors' responsibilities

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

As disclosed in note 34, the annual financial statements of the Group are prepared in accordance with UK-adopted international accounting standards. The directors are responsible for preparing the condensed set of financial statements included in the half-yearly financial report in accordance with IAS 34 as adopted for use in the UK.

Our responsibility

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

INDEPENDENT REVIEW REPORT TO PARAGON BANKING GROUP PLC

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

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

Michael McGarry for and on behalf of KPMG LLP

Chartered Accountants

15 Canada Square
London
E14 5GL

6 June 2023

CONDENSED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENT OF PROFIT OR LOSS
For the six months ended 31 March 2023 (Unaudited)

	Note	Six months to 31 March 2023 £m	Six months to 31 March 2022 £m	Year to 30 September 2022 £m
Interest receivable	3	437.6	239.2	545.7
Interest payable and similar charges	4	(225.2)	(64.0)	(174.5)
Net interest income		212.4	175.2	371.2
Other leasing income		13.6	11.8	24.6
Related costs		(10.9)	(9.7)	(20.0)
Net leasing income		2.7	2.1	4.6
Gain on disposal of financial assets	5	-	-	4.6
Other income	6	5.1	4.4	12.6
Other operating income		7.8	6.5	21.8
Total operating income		220.2	181.7	393.0
Operating expenses		(83.8)	(74.9)	(153.0)
Provisions for losses	7	(7.5)	(1.3)	(14.0)
Operating profit before fair value items		128.9	105.5	226.0
Fair value net (losses) / gains	8	(82.5)	38.1	191.9
Operating profit being profit on ordinary activities before taxation		46.4	143.6	417.9
Tax charge on profit on ordinary activities	9	(8.5)	(34.5)	(104.3)
Profit on ordinary activities after taxation		37.9	109.1	313.6

	Note	Six months to 31 March 2023	Six months to 31 March 2022	Year to 30 September 2022
Basic earnings per share	10	16.4p	44.4p	129.2p
Diluted earnings per share	10	15.7p	43.0p	125.9p
Dividend – rate per share for the period	27	11.0p	9.4p	28.6p

The results for the periods shown above relate entirely to continuing operations.

CONDENSED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
For the six months ended 31 March 2023 (Unaudited)

	Note	Six months to 31 March 2023 £m	Six months to 31 March 2022 £m	Year to 30 September 2022 £m
Profit for the period		37.9	109.1	313.6
Other comprehensive income				
Items that will not be reclassified subsequently to profit or loss				
Actuarial gain on pension scheme	23	1.9	13.7	15.3
Tax thereon		(0.6)	(3.1)	(3.7)
Other comprehensive income for the period net of tax		1.3	10.6	11.6
Total comprehensive income for the period		39.2	119.7	325.2

CONDENSED FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEET
31 March 2023 (Unaudited)

	Note	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Assets					
Cash – central banks	11	2,087.1	1,265.7	1,612.5	1,142.0
Cash – retail banks	11	188.3	234.7	318.4	218.1
Loans to customers	12	14,236.0	13,763.4	13,650.4	13,408.2
Derivative financial assets	18	511.2	201.7	779.0	44.2
Sundry assets		44.9	36.4	39.2	69.2
Current tax assets		-	0.7	5.4	-
Deferred tax assets		-	-	-	14.4
Retirement benefit obligations	23	10.4	4.4	7.1	-
Property, plant and equipment		72.0	73.9	71.4	70.4
Intangible assets	19	170.5	170.1	170.2	170.5
Total assets		17,320.4	15,751.0	16,653.6	15,137.0
Liabilities					
Short-term bank borrowings		0.2	0.4	0.4	0.3
Retail deposits	20	11,838.1	9,822.8	10,569.5	9,297.4
Derivative financial liabilities	18	51.3	32.5	102.1	43.9
Asset backed loan notes	21	289.8	477.1	409.3	516.0
Secured bank borrowings	21	341.8	871.3	586.0	730.0
Retail bond issuance	21	112.3	112.2	112.3	237.1
Corporate bond issuance	21	149.3	149.1	149.2	149.0
Central bank facilities	21	2,750.0	2,850.0	2,750.0	2,819.0
Repurchase agreements	21	-	-	-	-
Sundry liabilities	22	410.6	155.8	513.1	90.7
Current tax liabilities		0.2	-	-	1.4
Deferred tax liabilities		16.4	0.1	44.4	-
Retirement benefit obligations	23	-	-	-	10.3
Total liabilities		15,960.0	14,471.3	15,236.3	13,895.1
Called-up share capital	24	241.5	250.5	241.4	262.5
Reserves	25	1,220.5	1,075.8	1,223.9	1,056.1
Own shares	26	(101.6)	(46.6)	(48.0)	(76.7)
Total equity		1,360.4	1,279.7	1,417.3	1,241.9
Total liabilities and equity		17,320.4	15,751.0	16,653.6	15,137.0

The condensed financial statements for the half year were approved by the Board of Directors on 6 June 2023.

CONDENSED FINANCIAL STATEMENTS

CONSOLIDATED CASH FLOW STATEMENT
For the six months ended 31 March 2023 (Unaudited)

	Note	Six months to 31 March 2023 £m	Six months to 31 March 2022 £m	Year to 30 September 2022 £m
Net cash flow generated by operating activities	28	825.9	221.1	1,168.7
Net cash (utilised) by investing activities	29	(1.8)	(1.2)	(2.4)
Net cash (utilised) by financing activities	30	(479.4)	(79.7)	(595.6)
Net increase in cash and cash equivalents		344.7	140.2	570.7
Opening cash and cash equivalents		1,930.5	1,359.8	1,359.8
Closing cash and cash equivalents		2,275.2	1,500.0	1,930.5
Represented by balances within				
Cash	11	2,275.4	1,500.4	1,930.9
Short-term bank borrowings		(0.2)	(0.4)	(0.4)
		2,275.2	1,500.0	1,930.5

CONDENSED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY
For the six months ended 31 March 2023 (Unaudited)

Six months ended 31 March 2023

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m
Transactions arising from							
Profit for the period	-	-	-	-	37.9	-	37.9
Other comprehensive income	-	-	-	-	1.3	-	1.3
Total comprehensive income	-	-	-	-	39.2	-	39.2
Transactions with owners							
Dividends paid (note 27)	-	-	-	-	(43.7)	-	(43.7)
Shares cancelled	-	-	-	-	-	-	-
Capital reorganisation	-	-	(71.8)	-	71.8	-	-
Own shares purchased	-	-	-	-	-	(70.1)	(70.1)
Irrevocable instruction accrual	-	-	-	-	-	10.8	10.8
Exercise of share awards	0.1	0.3	-	-	(6.2)	5.7	(0.1)
Charge for share based remuneration	-	-	-	-	4.6	-	4.6
Tax on share based remuneration	-	-	-	-	2.4	-	2.4
Net movement in equity in the period	0.1	0.3	(71.8)	-	68.1	(53.6)	(56.9)
Opening equity	241.4	71.1	71.8	(70.2)	1,151.2	(48.0)	1,417.3
Closing equity	241.5	71.4	-	(70.2)	1,219.3	(101.6)	1,360.4

CONDENSED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY
For the six months ended 31 March 2023 (Unaudited) (Continued)

Six months ended 31 March 2022

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m
Transactions arising from							
Profit for the period	-	-	-	-	109.1	-	109.1
Other comprehensive income	-	-	-	-	10.6	-	10.6
Total comprehensive income	-	-	-	-	119.7	-	119.7
Transactions with owners							
Dividends paid (note 27)	-	-	-	-	(46.6)	-	(46.6)
Shares cancelled	(12.1)	-	12.1	-	(60.7)	60.7	-
Capital reorganisation	-	-	-	-	-	-	-
Own shares purchased	-	-	-	-	-	(39.7)	(39.7)
Irrevocable instruction accrual	-	-	-	-	-	-	-
Exercise of share awards	0.1	0.3	-	-	(9.8)	9.1	(0.3)
Charge for share based remuneration	-	-	-	-	4.4	-	4.4
Tax on share based remuneration	-	-	-	-	0.3	-	0.3
Net movement in equity in the period	(12.0)	0.3	12.1	-	7.3	30.1	37.8
Opening equity	262.5	70.1	50.3	(70.2)	1,005.9	(76.7)	1,241.9
Closing equity	250.5	70.4	62.4	(70.2)	1,013.2	(46.6)	1,279.7

CONDENSED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENT OF MOVEMENTS IN EQUITY
For the six months ended 31 March 2023 (Unaudited) (Continued)

Year ended 30 September 2022

	Share capital	Share premium	Capital redemption reserve	Merger reserve	Profit and loss account	Own shares	Total equity
	£m	£m	£m	£m	£m	£m	£m
Transactions arising from							
Profit for the year	-	-	-	-	313.6	-	313.6
Other comprehensive income	-	-	-	-	11.6	-	11.6
Total comprehensive income	-	-	-	-	325.2	-	325.2
Transactions with owners							
Dividends paid (note 27)	-	-	-	-	(68.9)	-	(68.9)
Shares cancelled	(21.5)	-	21.5	-	(109.4)	109.4	-
Capital reorganisation	-	-	-	-	-	-	-
Own shares purchased	-	-	-	-	-	(79.5)	(79.5)
Irrevocable instruction accrual	-	-	-	-	-	(10.8)	(10.8)
Exercise of share awards	0.4	1.0	-	-	(10.3)	9.6	0.7
Charge for share based remuneration	-	-	-	-	9.2	-	9.2
Tax on share based remuneration	-	-	-	-	(0.5)	-	(0.5)
Net movement in equity in the year	(21.1)	1.0	21.5	-	145.3	28.7	175.4
Opening equity	262.5	70.1	50.3	(70.2)	1,005.9	(76.7)	1,241.9
Closing equity	241.4	71.1	71.8	(70.2)	1,151.2	(48.0)	1,417.3

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS
For the six months ended 31 March 2023 (Unaudited)

1. GENERAL INFORMATION

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

The condensed financial statements for the six months ended 31 March 2023 and for the six months ended 31 March 2022 have not been audited, as defined in section 434 of the Companies Act 2006.

The figures shown above for the year ended 30 September 2022 and the year ended 30 September 2021 are not statutory accounts. A copy of the statutory accounts for the year has been delivered to the Registrar of Companies. The auditors reported on those statutory accounts and their report was unqualified, did not draw attention to any matters by way of emphasis and did not contain an adverse statement under sections 498 (2) or 498 (3) of the Companies Act 2006.

This half-yearly financial report is also available on the Group's corporate website at www.paragonbankinggroup.co.uk. As previously advised, the half-yearly financial report is available online only, to help to reduce the environmental impact of shareholder communication.

The remaining notes to the accounts are organised in to three sections:

- Analysis – providing further analysis and information on the amounts shown in the primary financial statements
- Capital and Financial Risk – providing information on the Group's management of operational and regulatory capital and its principal financial risks
- Basis of preparation – providing details of the Group's accounting policies and of how they have been applied in the preparation of the condensed financial statements

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

The notes set out below give more detailed analysis of the balances shown in the primary financial statements and further information on how they relate to the operations, results and financial position of the Group.

2. SEGMENTAL INFORMATION

The Group analyses its operations, both for internal management information and external financial reporting, on the basis of the markets from which its assets are generated.

The segments used internally were revised during the second half of the 2022 financial year, following the disposal of the unsecured consumer loan assets of the former Idem Capital segment (note 5) and the new segments were adopted for segmental reporting purposes in the 2022 year end accounts. Information reported on the previous basis in the 2022 Half Year Report has been restated for comparative purposes.

The segments used are described below:

- Mortgage Lending, including the Group's buy-to-let, and owner-occupied first and second charge lending and related activities
- Commercial Lending, including the Group's equipment leasing activities, development finance, structured lending and other offerings targeted towards SME customers, together with its motor finance business

Dedicated financing and administration costs of each of these businesses are allocated to the segment. With effect from the 2023 financial year, interest impacts of fair value hedging activities have been allocated to segments for management accounting purposes. Comparative figures have been adjusted for consistency. Shared central costs are not allocated between segments, nor is income from central cash balances or the carrying costs of unallocated savings balances.

Gains on derecognition of financial assets have not been allocated to segment results.

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

Other assets are not allocated between segments.

All 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.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

2. SEGMENTAL INFORMATION (Continued)

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

Six months ended 31 March 2023

	Mortgage Lending £m	Commercial Lending £m	Unallocated items £m	Total £m
Interest receivable	310.6	96.5	30.5	437.6
Interest payable	(177.1)	(29.1)	(19.0)	(225.2)
Net interest income	133.5	67.4	11.5	212.4
Other operating income	3.1	4.7	-	7.8
Total operating income	136.6	72.1	11.5	220.2
Operating expenses	(12.3)	(13.3)	(58.2)	(83.8)
Provisions for losses	(5.4)	(2.1)	-	(7.5)
	118.9	56.7	(46.7)	128.9

Six months ended 31 March 2022 (Restated)

	Mortgage Lending £m	Commercial Lending £m	Unallocated items £m	Total £m
Interest receivable	176.0	61.4	1.8	239.2
Interest payable	(55.9)	(8.7)	0.6	(64.0)
Net interest income	120.1	52.7	2.4	175.2
Other operating income	2.8	3.7	-	6.5
Total operating income	122.9	56.4	2.4	181.7
Operating expenses	(11.9)	(12.8)	(50.2)	(74.9)
Provisions for losses	1.9	(3.2)	-	(1.3)
	112.9	40.4	(47.8)	105.5

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

2. SEGMENTAL RESULTS (Continued)

Year ended 30 September 2022

	Mortgage Lending £m	Commercial Lending £m	Unallocated Items £m	Total Segments £m
Interest receivable	399.7	134.8	11.2	545.7
Interest payable	(148.5)	(23.6)	(2.4)	(174.5)
Net interest income	251.2	111.2	8.8	371.2
Other operating income	7.4	9.8	4.6	21.8
Total operating income	258.6	121.0	13.4	393.0
Direct costs	(24.4)	(24.9)	(103.7)	(153.0)
Provisions for losses	(4.6)	(9.4)	-	(14.0)
	229.6	86.7	(90.3)	226.0

The segmental profits disclosed above reconcile to the consolidated results as set out below.

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Results shown above	128.9	105.5	226.0
Fair value items	(82.5)	38.1	191.9
Operating profit	46.4	143.6	417.9

The assets of the segments were:

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Mortgage Lending	12,702.5	12,350.1	12,569.2	11,952.9
Commercial Lending	2,016.7	1,764.3	1,923.2	1,612.4
Total segment assets	14,719.2	14,114.4	14,492.4	13,565.3
Unallocated assets	2,601.2	1,636.6	2,161.2	1,571.7
Total assets	17,320.4	15,751.0	16,653.6	15,137.0

An analysis of the Group's loan assets by type and segment is shown in note 12.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

3. INTEREST RECEIVABLE

In preparing the 2022 financial statements the Group reconsidered the analysis it presents of net interest income in light of the increasing magnitude of hedging impacts on these balances, with derivative income and expense attributed to the hedged transaction and shown separately. This provides better information to users and is consistent with approaches currently used by comparable firms. Information in respect of the six months ended 31 March 2022 has been restated on the same basis. While this change affects the total reported amounts of interest receivable and interest payable (note 4) by the amount reported as 'effect of fair value hedging of loan assets' below, total net interest is unaffected.

Interest receivable is analysed as follows.

	31 March 2023 £m	31 March 2022 (restated) £m	30 September 2022 £m
Interest receivable in respect of			
Loans and receivables	294.0	229.9	486.7
Finance leases	27.5	21.5	45.0
Factoring income	1.7	1.5	3.4
Interest on loans to customers	323.2	252.9	535.1
Effect of fair value hedging of loan assets	81.4	(15.5)	(1.5)
Interest on loans to customers after hedging	404.6	237.4	533.6
On pension scheme surplus	0.2	-	-
Other interest receivable	32.8	1.8	12.1
Total interest on financial assets	437.6	239.2	545.7

The above interest arises from:

	31 March 2023 £m	31 March 2022 (restated) £m	30 September 2022 £m
Financial assets held at amortised cost	328.7	233.2	502.2
Finance leases	27.5	21.5	45.0
Derivative instruments held at fair value	81.4	(15.5)	(1.5)
	437.6	239.2	545.7

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

4. INTEREST PAYABLE AND SIMILAR CHARGES

The Group's interest payable disclosure was reanalysed for the purposes of the 2022 financial statements and comparative amounts for the six months ended 31 March 2022 have been restated as described in note 3.

In the disclosures for the six months ended 31 March 2022, as originally presented, transactions relating to fair value hedging were included in 'interest payable on retail deposits' (£12.1m) and 'interest payable on asset backed loan notes' (£1.9m). These amounts have been reanalysed between 'effect of fair value hedging of deposits' below and 'effect of fair value hedging of loan assets' in note 3.

	31 March 2023 £m	31 March 2022 (Restated) £m	30 September 2022 £m
On financial liabilities			
Retail deposits	127.5	43.3	108.8
Effect of fair value hedging of deposits	20.5	(1.5)	4.2
Interest on retail deposits after hedging	148.0	41.8	113.0
Asset backed loan notes	7.7	3.6	9.1
Bank loans and overdrafts	16.0	5.0	13.3
Corporate bonds	3.3	3.3	6.6
Retail bonds	3.2	5.8	9.1
Central bank facilities	45.7	4.0	22.2
Repurchase agreements	0.7	-	-
Total interest on financial liabilities	224.6	63.5	173.3
Pension scheme deficit (note 23)	-	0.1	0.2
Discounting on contingent consideration	-	-	0.1
Discounting on lease liabilities	0.1	0.1	0.2
Other finance costs	0.5	0.3	0.7
	225.2	64.0	174.5

The above amounts relate to

	31 March 2023 £m	31 March 2022 (Restated) £m	30 September 2022 £m
Financial liabilities held at amortised cost	204.1	65.0	169.1
Derivative financial instruments held at fair value	20.5	(1.5)	4.2
Other items	0.6	0.5	1.2
	225.2	64.0	174.5

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

5. GAIN ON DISPOSAL OF FINANCIAL ASSETS

On 8 June 2022 the Group disposed of almost all of its unsecured consumer loan balances, which had been held within the Idem Capital Segment. The Group has no continuing interest in these assets. The carrying value of the loans disposed of was £74.1m and cash consideration of £78.9m was received, resulting in a gain on disposal of £4.6m after allowing for costs arising from the transaction.

This disposal significantly reduced the size of the Idem Capital segment, and subsequently the Group reorganised its segmental reporting as described in note 2.

6. OTHER INCOME

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Loan account fee income	2.8	2.2	6.1
Broker commissions	1.1	1.1	2.3
Third party servicing	1.2	0.9	3.5
Other income	-	0.2	0.7
	5.1	4.4	12.6

All loan account fee income arises from financial assets held at amortised cost.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

7. LOAN IMPAIRMENT PROVISIONS CHARGED / (CREDITED) TO INCOME

The amounts charged / (credited) to the profit and loss account in the period are analysed as follows:

	Mortgage Lending £m	Commercial Lending £m	Total £m
Six months ended 31 March 2023			
Provided in period (note 15)	5.4	3.3	8.7
Recovery of written off amounts	-	(1.2)	(1.2)
	5.4	2.1	7.5
Six months ended 31 March 2022			
Provided in period (note 15)	(1.6)	4.0	2.4
Recovery of written off amounts	(0.3)	(0.8)	(1.1)
	(1.9)	3.2	1.3
Year ended 30 September 2022			
Provided in period (note 15)	5.1	10.7	15.8
Recovery of written off amounts	(0.5)	(1.3)	(1.8)
	4.6	9.4	14.0

8. FAIR VALUE NET (LOSSES) / GAINS

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Ineffectiveness of fair value hedges			
Portfolio hedges of interest rate risk			
Deposit hedge	1.5	1.6	11.6
Loan hedge	(1.9)	10.4	15.1
	(0.4)	12.0	26.7
Other hedging movements	(38.5)	1.2	4.7
Net (losses)/gains on other derivatives	(43.6)	24.9	160.5
	(82.5)	38.1	191.9

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

8. FAIR VALUE NET (LOSSES) / GAINS (CONTINUED)

The fair value net (loss) / gain 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.

The impact of hedging arrangements on the Group's balance sheet is summarised in note 18 and a full description of the Group's use of derivative financial instruments for hedging purposes is set out in note 25 to the financial statements for the year ended 30 September 2022.

9. TAX CHARGE ON PROFIT ON ORDINARY ACTIVITIES

The Group's income tax charge for the six months ended 31 March 2023 represents an effective rate of 18.3% (six months ended 31 March 2022: 24.0%, year ended 30 September 2022: 25.0%). This is based on the Group's best estimate of the annual effective rate of income tax expected for the full year ending 30 September 2023, derived from UK statutory rates, applied to the pre-tax income of the period.

The standard rate of corporation tax in the UK applicable to the Group in the period was 22.0% (2022 H1: 19.0%), based on currently enacted legislation. During the year ended 30 September 2021, the UK Government enacted legislation increasing the standard rate of corporation tax in the UK from 19.0% to 25.0% from April 2023. This has increased the standard rate of corporation tax applicable to the Group to 22.0% for the current year, and will increase that applying in subsequent years to 25.0%. The effect of these changes on deferred tax balances was accounted for in the year ended 30 September 2021.

The Bank Corporation Tax surcharge subjects any taxable profits arising in the Group's banking subsidiary, Paragon Bank PLC (and no other group entity) to an additional rate of tax applied to any amounts of taxable profit in excess of a threshold.

In the financial year ended 30 September 2022 the UK Government enacted legislation reducing the rate of the Banking Surcharge from 8.0% to 3.0%, also from April 2023, while increasing the profit threshold at which the surcharge applies to £100.0m from £25.0m. This has resulted in the surcharge applying to Paragon Bank in the current year reducing to 5.5% with a threshold of £62.5m, while in future years a surcharge of 3.0% on earnings over £100.0m will apply. The impact of this change on deferred tax balances was accounted for in the year ended 30 September 2022. The combination of the standard rate of tax and the surcharge results in taxable profits in excess of the annual threshold arising in Paragon Bank being taxed at 27.5% in the current period (2022: 27.0%). This will rise to 28.0% in subsequent periods.

The deviation of the Group's effective rate from the standard rate is principally the result of movements in deferred tax balances relating to derivatives and hedging. Significant amounts which had been provided at rates including the bank surcharge reversed in the period, reducing the effective rate.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

10. EARNINGS PER SHARE

Earnings per ordinary share is calculated as follows:

	31 March 2023	31 March 2022	30 September 2022
Profit for the period (£m)	37.9	109.1	313.6
Basic weighted average number of ordinary shares ranking for dividend during the period (m)	231.7	245.7	242.7
Dilutive effect of the weighted average number of share options and incentive plans in issue during the period (m)	9.2	8.2	6.4
Diluted weighted average number of ordinary shares ranking for dividend during the period (m)	240.9	253.9	249.1
Earnings per ordinary share - basic	16.4p	44.4p	129.2p
- diluted	15.7p	43.0p	125.9p

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

11. CASH AND CASH EQUIVALENTS

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Balances with central banks	2,087.1	1,265.7	1,612.5	1,142.0
Balances with other banks	188.3	234.7	318.4	218.1
	2,275.4	1,500.4	1,930.9	1,360.1

Not all of the Group's cash is immediately available for its general purposes, including liquidity management. 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.

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

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

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Available cash	2,165.8	1,342.4	1,689.1	1,236.5
Securitisation cash	109.2	156.7	240.5	123.3
ESOP cash	0.4	1.3	1.3	0.3
	2,275.4	1,500.4	1,930.9	1,360.1

Cash and cash equivalents are classified as Stage 1 exposures (see note 14) for the purposes of impairment provisioning. The probabilities of default have been assessed to be so low as to require no significant impairment provision.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

12. LOANS TO CUSTOMERS

The Group's loans to customers at 31 March 2023, analysed between the segments described in Note 2 are as follows:

	31 March 2023	31 March 2022 (restated)	30 September 2022	30 September 2021
	£m	£m	£m	£m
First mortgages	12,415.8	11,874.7	12,122.4	11,460.6
Second charge mortgages	177.5	241.9	206.3	281.7
Unsecured consumer loans	-	76.8	-	87.3
Total Mortgage Lending	12,593.3	12,193.4	12,328.7	11,829.6
Motor finance	286.3	238.0	261.3	229.2
Asset finance	575.6	497.7	563.9	491.1
Finance lease receivables	861.9	735.7	825.2	720.3
Development finance	765.8	672.9	719.9	608.2
Other secured commercial lending	231.1	222.5	238.1	168.0
Other commercial loans	102.8	90.4	98.4	76.6
Total Commercial Lending	1,961.6	1,721.5	1,881.6	1,573.1
Loans to customers	14,554.9	13,914.9	14,210.3	13,402.7
Fair value adjustments from hedge accounting (note 18)	(318.9)	(151.5)	(559.9)	5.5
	14,236.0	13,763.4	13,650.4	13,408.2

The segmental analysis shown above for 31 March 2022 has been restated in line with the revision of the Group's segments described in Note 2. Total balances of each class of lending are unaffected by these changes.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

13. LOAN IMPAIRMENT - BASIS OF PROVISION

Provisioning approach

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

The Group's approach to impairment provision on loans to customers, in accordance with IFRS 9, is set out in detail in note 20 to the annual accounts. This includes an outline of the calculations used and a definition of terms, and the information in this half year report should be read in conjunction with it.

There have been no significant changes in overall approach since the 2022 year end. At that time, as discussed in the 2022 annual accounts, it was necessary for the Group to make significant judgemental adjustments to model-generated provisions to allow for factors related to the uncertain economic outlook for the UK at that time, which had not been reflected by the Group's models. While the position at 31 March 2023 is more stable, the continuing uncertainties surrounding the impacts of increases in interest rates, inflation and the cost of living more widely, and the economic risks to the UK inherent in the current conflict in Ukraine, mean that the Group has taken a broadly similar approach in determining provision at 31 March 2023 to that used at the year end.

Significant Increase in Credit Risk ('SICR')

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

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

For non-modelled portfolios, the SICR assessment is based on the credit monitoring position of the account in question and for all portfolios a number of qualitive indicators which provide evidence of SICR have been considered

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

13. LOAN IMPAIRMENT - BASIS OF PROVISION (CONTINUED)

As part of its determination of whether model outputs for a reliable basis for impairment provisioning, the Group considered wither it had any evidence of groups of accounts demonstrating factors indicating a higher level of credit risk than other accounts in the same portfolios. No such evidence was noted at either 31 March 2023 or 30 September 2022, and hence no additional accounts were identified as having an SICR.

At 31 March 2022 the Group had identified accounts where the customer had been granted a Covid-related payment holiday as being at increased credit risk and an additional £548.9m of balances were designated as having an SICR. The performance of such accounts was monitored through the financial year ended 30 September 2022 and by the end of that year management were able to conclude that accounts would either have stabilised or be identified as defaulted or as at SICR through the Group's normal process. No similar adjustment was therefore required at 30 September 2022 or 31 March 2023.

While no requirement to identify additional SICR cases has arisen in the period, the approach is consistent with that adopted at 30 September 2022, and will be kept under review in future periods.

Judgemental Adjustments

In order to ensure that its loan portfolios are adequately provisioned, the Group considers whether there are factors not fully captured by the modelling process, which indicate a need for judgemental adjustments. These will include considering economic conditions more generally, together with the level to which the Group's models are able to respond to current and anticipated conditions in an appropriate manner.

In the six months ended 31 March 2023 the most significant factors in these considerations were the extent to which uncertainties in the UK economy arising from rapidly rising interest rates, increases in the cost of living and doing business in the UK and the impacts of the continuing conflict in Ukraine were reflected in current customer performance at the period end and were being fully addressed by the Group's provision modelling, particularly in view of the lack of recent observations relating to similar conditions.

Where management has identified a requirement to amend the calculated provision as a result of either model deficiencies or idiosyncratic behaviour in part of the portfolio, judgemental adjustments are applied to the modelled outputs so that the ECL recognised corresponds to expert judgement, taking into account the widest possible range of current information, which might not be factored into the modelling process.

The Group's approach to impairment modelling is based on the analysis of historical credit data. In normal circumstances the Group's objective is to develop its models to the point where the level of judgemental adjustments required is minimal, but in economic conditions where previous relevant experience is limited or non-existent, some form of judgemental adjustment is always likely to be necessary. While high interest rate and inflation scenarios have occurred in the UK in the past, market conditions, products and regulatory expectations have moved on considerably in the meantime, and most such observations would pre-date the existence of buy-to-let mortgages as a distinct asset class. This means that the value of past history as a guide to future credit performance is reduced.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

13. LOAN IMPAIRMENT - BASIS OF PROVISION (Continued)

The current model behaviour and the potential for unobserved credit issues have meant that the requirement for such adjustments over recent periods has been significant. Evidence considered by management included internal performance data, customer and broker feedback, insight surveys, industry intelligence, evidence on the wider economy and quantitative and qualitative data and statements from industry, government and regulatory bodies. These were combined with the expert knowledge within the business to form a broad estimate of the level of provision required across the Group.

As part of this exercise, the potential for climate related issues to impact on customer business models or security values over the timescales for ECL calculation required by IFRS 9 was considered. No specific requirement for additional impairment provisions over the amounts already determined was identified.

The total amounts of judgemental adjustments provided across the Group are set out below by segment.

	31 March 2023 £m	31 March 2022 (restated) £m	30 September 2022 £m
Mortgage Lending	4.0	7.8	5.0
Commercial Lending	6.0	6.3	10.0
	10.0	14.1	15.0

The movements in the period represent principally the extent to which the anticipated economic and customer behaviours which gave rise to judgemental adjustments at 30 September 2022 are now observable and thus are reflected by the Group's models. There has also been a reduction in the levels of economic and political uncertainty in the UK which also impacts on the level of adjustments required. The movements in the 2022 financial year represented a transition from Covid related overlays to ones which relate more to the responsiveness of the Group's provision models to economic conditions at the end of that year.

The adjustment at 30 September 2022 in the Mortgage Lending book was principally a result of a disconnect between the credit metrics which drive the models and the economic expectations of management, brokers and customers at the year end date. While some of the anticipated impacts have begun to manifest themselves in arrears performance, neither the Group nor the mortgage industry more generally has seen a significant reaction to higher levels of interest rates and inflation in credit performance as yet. Combined with potential model limitations in responding to significant rapid changes in interest and inflation rates, management determined it was appropriate to reduce, but not remove the judgmental adjustment.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

13. LOAN IMPAIRMENT - BASIS OF PROVISION (Continued)

In the Commercial Lending segment the adjustment at 30 September 2022 related to general economic exposures for SMEs, with the outlook for the sector considered to be less positive than credit metrics indicated at that time. While business confidence is somewhat improved over the period the outlook is still generally pessimistic and indicative of a much more negative position than indicated by the credit metrics. In order to address some of the weaknesses in its modelling for SME lending impairment, the Group has an ongoing project to reengineer its approach, which is expected to be fully operational by 30 September 2023. However, in the short term a judgemental adjustment remains necessary to ensure appropriate provisioning levels.

The Group's analysis found no evidence of particular concentrations of credit risk below portfolio level. Given this, and the high level nature of the exercise undertaken, the judgemental adjustments have been apportioned across the Group's buy-to-let mortgage and SME lending portfolios to individual cases. As such they are included in the credit risk disclosures required by IFRS 7.

The Group will continue to monitor the requirement for these adjustments as the economic situation develops and its impacts are further reflected in model outputs. It will also consider the extent to which future model enhancements will reduce the need for overlays. It is anticipated that a more normal economic situation would require a lower value of adjustments, but the timescale in which such a scenario might be reached appears uncertain.

14. LOAN IMPAIRMENTS BY STAGE AND DIVISION

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

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

- On initial recognition, and for assets where there has not been an SICR, provisions will be made in respect of losses resulting from the level of credit default events expected in the twelve months following the balance sheet date
- Where a loan has experienced an SICR, whether or not the loan is considered to be credit impaired, provisions are made based on the ECLs over the full life of the loan
- For credit impaired assets, provisions are made on the basis of lifetime ECLs

For assets which are 'Purchased or Originated as Credit Impaired' ('POCI') accounts (those considered as credit impaired at the point of first recognition), such as certain of the Group's acquired assets in the Mortgage Lending segment, the carrying valuation is based on expected cash flows discounted by the EIR determined at the point of acquisition.

The recommendations of the taskforce on Disclosures about Expected Credit Loss ('DECL') suggest standard categories for analysis of firm's loan books. In the context of the DECL categorisation the Group's Mortgage Lending balances are classified as 'UK retail mortgage' business while its Commercial Lending balances, being advanced primarily to SME entities correspond with the 'UK other retail' business classification.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

14. LOAN IMPAIRMENTS BY STAGE AND DIVISION (Continued)

An analysis of the Group's loan portfolios between the stages defined above is set out below. The segmental analysis included in this note for the six months ended 31 March 2022 has been restated for the changes in the segments reported (Note 2).

	Stage 1 £m	Stage 2 * £m	Stage 3 * £m	POCI £m	Total £m
31 March 2023					
Gross loan book					
Mortgage Lending	11,779.6	701.8	134.5	18.6	12,634.5
Commercial Lending	1,828.7	130.1	23.0	6.8	1,988.6
Total	13,608.3	831.9	157.5	25.4	14,623.1
Impairment provision					
Mortgage Lending	(5.9)	(4.4)	(30.9)	-	(41.2)
Commercial Lending	(15.7)	(2.6)	(3.9)	(4.8)	(27.0)
Total	(21.6)	(7.0)	(34.8)	(4.8)	(68.2)
Net loan book					
Mortgage Lending	11,773.7	697.4	103.6	18.6	12,593.3
Commercial Lending	1,813.0	127.5	19.1	2.0	1,961.6
Total	13,586.7	824.9	122.7	20.6	14,554.9
Coverage ratio					
Mortgage Lending	0.05%	0.63%	22.97%	-	0.33%
Commercial Lending	0.86%	2.00%	16.96%	70.59%	1.36%
Total	0.16%	0.84%	22.10%	18.90%	0.47%

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

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

14. LOAN IMPAIRMENTS BY STAGE AND DIVISION (Continued)

	Stage 1 £m	Stage 2 * £m	Stage 3 * £m	POCI £m	Total £m
31 March 2022 (Restated)					
Gross loan book					
Mortgage Lending	10,457.9	1,526.6	143.2	100.4	12,228.1
Commercial Lending	1,689.9	34.3	9.3	8.5	1,742.0
Total	12,147.8	1,560.9	152.5	108.9	13,970.1
Impairment provision					
Mortgage Lending	(5.4)	(5.6)	(23.7)	-	(34.7)
Commercial Lending	(14.9)	(0.8)	(4.4)	(0.4)	(20.5)
Total	(20.3)	(6.4)	(28.1)	(0.4)	(55.2)
Net loan book					
Mortgage Lending	10,452.5	1,521.0	119.5	100.4	12,193.4
Commercial Lending	1,675.0	33.5	4.9	8.1	1,721.5
Total	12,127.5	1,554.5	124.4	108.5	13,914.9
Coverage ratio					
Mortgage Lending	0.05%	0.37%	16.55%	-	0.28%
Commercial Lending	0.88%	2.33%	47.31%	4.71%	1.18%
Total	0.17%	0.41%	18.43%	0.37%	0.40%

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

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

14. LOAN IMPAIRMENTS BY STAGE AND DIVISION (Continued)

	Stage 1 £m	Stage 2 * £m	Stage 3 * £m	POCI £m	Total £m
30 September 2022					
Gross loan book					
Mortgage Lending	10,339.6	1,886.4	119.3	21.4	12,366.7
Commercial Lending	1,817.4	77.2	5.1	7.4	1,907.1
Total	12,157.0	1,963.6	124.4	28.8	14,273.8
Impairment provision					
Mortgage Lending	(5.8)	(6.1)	(26.1)	-	(38.0)
Commercial Lending	(19.7)	(1.9)	(2.4)	(1.5)	(25.5)
Total	(25.5)	(8.0)	(28.5)	(1.5)	(63.5)
Net loan book					
Mortgage Lending	10,333.8	1,880.3	93.2	21.4	12,328.7
Commercial Lending	1,797.7	75.3	2.7	5.9	1,881.6
Total	12,131.5	1,955.6	95.9	27.3	14,210.3
Coverage ratio					
Mortgage Lending	0.06%	0.32%	21.88%	-	0.31%
Commercial Lending	1.08%	2.46%	47.06%	20.27%	1.34%
Total	0.21%	0.41%	22.91%	5.21%	0.44%

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

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

POCI balances included in the Commercial Lending segment arise from acquired businesses, where those assets were identified as credit impaired at the point of acquisition when the acquired portfolios as a whole were evaluated. Additional provision arising on these assets post-acquisition is shown as 'Impairment provision' above.

The Group's acquired consumer loans are included in the Mortgage Lending segment. Acquired loans which were performing on acquisition are included in the staging analysis above.

Acquired portfolios which were largely non-performing at acquisition, and which were purchased at a deep discount to face value, are shown as POCI assets above. Although no provision is shown above for such assets, the effect of the discount on purchase is included in the gross value ensuring that the carrying value is substantially less than the current balances due from customers and the level of cover is considerable.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

14. LOAN IMPAIRMENTS BY STAGE AND DIVISION (Continued)

Analysis of Stage 2 loans

The table below analyses the accounts in Stage 2 between those not more than one month in arrears where an SICR has nonetheless been identified from other information and accounts more than one month in arrears.

Cases which have been greater than one month in arrears in the last three months, but which are not at the balance sheet date are shown as 'recent arrears' in the tables below.

In all cases accounts which are more than one month in arrears, where this is a meaningful measure, are considered to have an SICR. However, in certain loan portfolios, regular monthly payments of pre-set amounts are not required and hence this criterion cannot be used.

The value of accounts in Stage 2 has reduced significantly in the Mortgage Lending segment over the six-month period. This is driven principally by a lower number of accounts identified through model based criteria which are driven by the economic scenarios input into the models. The economic forecasts at 30 September 2023 included significant short term shifts in interest rates and house prices. These have been reflected in actual economic performance, to some extent, and the initial part of the March scenarios have lower anticipated movements.

The number of arrears cases being recorded has actually increased, as a result of increasing economic pressure on customers. However the scale of this increase is less than indicated by the Group's modelling at 30 September 2022, with accounts not, so far, as severely impacted by rate rises and cost-of-living issues as predicted. Together these factors have led to a reduction in the overall Stage 2 pool.

In the Commercial Lending segment the number of Stage 2 accounts has generally increased across all categories as the impact of economic pressures begins to be demonstrated, but arrears levels remain low.

Overall Stage 2 provisions have decreased with the Stage 2 balance, but coverage levels, on average, have increased. Provision coverage levels in the Mortgage Lending segment have generally increased, partly as a result of downward pressure on property prices impacting on security values. Coverage levels in the Commercial Lending segment fell, although this was more related to the mix of Stage 2 assets, with more SICR cases being identified in books with greater average security values.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

14. LOAN IMPAIRMENTS BY STAGE AND DIVISION (CONTINUED)

	< 1 month arrears	Recent arrears	> 1 <= 3 months arrears	Total
	£m	£m	£m	£m
31 March 2023				
Gross loan book				
Mortgage Lending	631.5	13.5	56.8	701.8
Commercial Lending	126.3	1.4	2.4	130.1
Total	757.8	14.9	59.2	831.9
Impairment provision				
Mortgage Lending	(3.2)	-	(1.2)	(4.4)
Commercial Lending	(2.2)	(0.1)	(0.3)	(2.6)
Total	(5.4)	(0.1)	(1.5)	(7.0)
Net loan book				
Mortgage Lending	628.3	13.5	55.6	697.4
Commercial Lending	124.1	1.3	2.1	127.5
Total	752.4	14.8	57.7	824.9
Coverage ratio				
Mortgage Lending	0.51%	-	2.11%	0.63%
Commercial Lending	1.74%	7.14%	12.50%	2.00%
Total	0.71%	0.67%	2.53%	0.84%

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

14. LOAN IMPAIRMENTS BY STAGE AND DIVISION (Continued)

	< 1 month arrears	Recent arrears	> 1 <= 3 months arrears	Total
	£m	£m	£m	£m
31 March 2022 (Restated)				
Gross loan book				
Mortgage Lending	1,501.5	7.5	17.6	1,526.6
Commercial Lending	29.3	1.3	3.7	34.3
Total	1,530.8	8.8	21.3	1,560.9
Impairment provision				
Mortgage Lending	(5.3)	-	(0.3)	(5.6)
Commercial Lending	(0.6)	-	(0.2)	(0.8)
Total	(5.9)	-	(0.5)	(6.4)
Net loan book				
Mortgage Lending	1,496.2	7.5	17.3	1,521.0
Commercial Lending	28.7	1.3	3.5	33.5
Total	1,524.9	8.8	20.8	1,554.5
Coverage ratio				
Mortgage Lending	0.35%	-	1.70%	0.37%
Commercial Lending	2.05%	-	5.41%	2.33%
Total	0.39%	-	2.35%	0.41%

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

14. LOAN IMPAIRMENTS BY STAGE AND DIVISION (Continued)

	< 1 month arrears £m	Recent arrears £m	> 1 <= 3 months arrears £m	Total £m
30 September 2022				
Gross loan book				
Mortgage Lending	1,850.0	10.8	25.6	1,886.4
Commercial Lending	74.2	0.2	2.8	77.2
Total	1,924.2	11.0	28.4	1,963.6
Impairment provision				
Mortgage Lending	(5.4)	(0.1)	(0.6)	(6.1)
Commercial Lending	(1.6)	-	(0.3)	(1.9)
Total	(7.0)	(0.1)	(0.9)	(8.0)
Net loan book				
Mortgage Lending	1,844.6	10.7	25.0	1,880.3
Commercial Lending	72.6	0.2	2.5	75.3
Total	1,917.2	10.9	27.5	1,955.6
Coverage ratio				
Mortgage Lending	0.29%	0.93%	2.34%	0.32%
Commercial Lending	2.16%	-	10.71%	2.46%
Total	0.36%	0.91%	3.17%	0.41%

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

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

14. LOAN IMPAIRMENTS BY STAGE AND DIVISION (Continued)

Analysis of Stage 3 loans

The table below analyses the accounts in Stage 3 between those:

- In the process of sale or other enforcement procedures ('Realisations')
- Where a receiver of rent ('RoR') has been appointed by the Group to manage the property on the customers' behalf
- Which are being managed on a long-term basis and where full recovery is possible, but which are considered to meet regulatory default criteria at the balance sheet date ('>3 month arrears')
- which no longer meet regulatory default criteria, but which are being retained in Stage 3 for a probationary period ('Probation')

Where an account meets two of the criteria, it will be assigned to the category shown first in the list above.

RoR accounts in Stage 3 may be fully up-to-date with full recovery possible. These accounts are included in Stage 3 as they are classified as defaulted for regulatory purposes.

The number and value of Stage 3 accounts has increased in the six-month period across all books. This has mostly been driven by increases in the number of accounts either in serious arrears, or which had been in serious arrears at some time in the period. This sort of increase is not unexpected in a climate of economic tightening. Realisation and RoR cases, however, have remained broadly stable so far.

Coverage levels in the Mortgage Lending segment on Stage 3 cases have moved up, mostly reflecting falls in house prices, and consequently security values, while the relatively low amount of Commercial Lending cases and the variety of credit profiles covered by the division's lending means that the coverage ratio at any particular time tends to be more a function of the particular accounts in the Stage 3 population at that point, rather than indicative of a general trend.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

14. LOANS IMPAIRMENTS BY STAGE AND DIVISION (Continued)

	Probation	> 3 month arrears	RoR managed	Realisations	Total
	£m	£m	£m	£m	£m
31 March 2023					
Gross loan book					
Mortgage Lending	9.8	45.7	49.1	29.9	134.5
Commercial Lending	0.3	17.8	-	4.9	23.0
Total	10.1	63.5	49.1	34.8	157.5
Impairment provision					
Mortgage Lending	(0.5)	(1.8)	(19.6)	(9.0)	(30.9)
Commercial Lending	-	(1.6)	-	(2.3)	(3.9)
Total	(0.5)	(3.4)	(19.6)	(11.3)	(34.8)
Net loan book					
Mortgage Lending	9.3	43.9	29.5	20.9	103.6
Commercial Lending	0.3	16.2	-	2.6	19.1
Total	9.6	60.1	29.5	23.5	122.7
Coverage ratio					
Mortgage Lending	5.10%	3.94%	39.92%	30.10%	22.97%
Commercial Lending	-	8.99%	-	46.94%	16.96%
Total	4.95%	5.35%	39.92%	32.47%	22.10%

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

14. LOANS IMPAIRMENTS BY STAGE AND DIVISION (Continued)

	Probation £m	> 3 month arrears £m	RoR managed £m	Realisations £m	Total £m
31 March 2022 (Restated)					
Gross loan book					
Mortgage Lending	9.5	39.8	74.3	19.6	143.2
Commercial Lending	1.1	2.3	-	5.9	9.3
Total	10.6	42.1	74.3	25.5	152.5
Impairment provision					
Mortgage Lending	-	(1.0)	(16.2)	(6.5)	(23.7)
Commercial Lending	(0.3)	(1.4)	-	(2.7)	(4.4)
Total	(0.3)	(2.4)	(16.2)	(9.2)	(28.1)
Net loan book					
Mortgage Lending	9.5	38.8	58.1	13.1	119.5
Commercial Lending	0.8	0.9	-	3.2	4.9
Total	10.3	39.7	58.1	16.3	124.4
Coverage ratio					
Mortgage Lending	-	2.51%	21.80%	33.16%	16.55%
Commercial Lending	27.27%	60.87%	-	45.76%	47.31%
Total	2.83%	5.70%	21.80%	36.08%	18.43%

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

14. LOANS IMPAIRMENTS BY STAGE AND DIVISION (Continued)

	Probation £m	> 3 month arrears £m	RoR managed £m	Realisations £m	Total £m
30 September 2022					
Gross loan book					
Mortgage Lending	6.0	37.5	49.6	26.2	119.3
Commercial Lending	0.2	0.7	-	4.2	5.1
Total	6.2	38.2	49.6	30.4	124.4
Impairment provision					
Mortgage Lending	(0.4)	(1.0)	(17.2)	(7.5)	(26.1)
Commercial Lending	-	(0.2)	-	(2.2)	(2.4)
Total	(0.4)	(1.2)	(17.2)	(9.7)	(28.5)
Net loan book					
Mortgage Lending	5.6	36.5	32.4	18.7	93.2
Commercial Lending	0.2	0.5	-	2.0	2.7
Total	5.8	37.0	32.4	20.7	95.9
Coverage ratio					
Mortgage Lending	6.67%	2.67%	34.68%	28.63%	21.88%
Commercial Lending	-	28.57%	-	52.38%	47.06%
Total	6.45%	3.14%	34.68%	31.91%	22.91%

The security values available to reduce exposure at default in the calculation shown above for Stage 3 accounts are set out below. The estimated value of the security represents, for each account, the lesser of the valuation estimate and the exposure at default in the central scenario. Security values are based on the most recent valuation of the relevant asset held by the Group, indexed or depreciated as appropriate.

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
First mortgages	80.5	78.0	66.2
Second mortgages	11.1	14.7	14.6
Asset finance	2.1	2.3	1.6
Motor finance	1.0	1.8	0.7
	94.7	96.8	83.1

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

14. LOANS IMPAIRMENTS BY STAGE AND DIVISION (Continued)

The RoR managed accounts are being managed to ensure the optimal resolution for landlords, tenants and lenders and have largely reached a long-term, stable position, but the existence of the RoR arrangement causes the accounts to be treated as defaulted for regulatory purposes. The Group's RoR arrangements are described in more detail below.

Mortgage Lending balances with over three months arrears include second charge mortgage accounts originated over ten years ago which have been over three months in arrears for some time. These accounts are generally making regular payments and have significant levels of equity in the underlying property which reduces the required provision to the value shown above. It is expected that a high proportion of these accounts will eventually redeem naturally, either on the sale of the property or by the satisfaction of the amount due through instalment payments.

Buy-to-let receiver of rent cases (Stage 3)

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 following table analyses the number and gross carrying value of RoR managed accounts shown above by the date of the receivers' appointment, illustrating this position.

	31 March 2023		31 March 2022		30 September 2022	
	Number	£m	Number	£m	Number	£m
Managed accounts						
Appointment date						
2010 and earlier	177	27.5	313	52.7	199	31.2
2011 to 2013	35	5.0	52	8.5	42	6.3
2014 to 2016	13	1.8	19	2.6	14	1.9
2016 and later	104	14.8	74	10.5	79	10.2
Total managed accounts	329	49.1	458	74.3	334	49.6
Accounts in the process of realisation	162	28.6	100	14.9	141	23.5
	491	77.7	558	89.2	475	73.1

Receiver of rent accounts in the process of realisation at the period end are included under that heading in the Stage 3 tables above.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

15. LOAN IMPAIRMENTS - PROVISION MOVEMENTS IN THE PERIOD

The movements in the impairment provision calculated under IFRS 9, analysed by business segments, are set out below.

	Mortgage Lending £m	Commercial Lending £m	Total £m
At 30 September 2022	38.0	25.5	63.5
Provided in period (Note 2)	5.4	3.3	8.7
Amounts written off	(2.2)	(1.8)	(4.0)
Assets derecognised	-	-	-
At 31 March 2023 (Note 14)	41.2	27.0	68.2
At 30 September 2021	37.7	27.7	65.4
Provided in period (Note 2)	(1.6)	4.0	2.4
Amounts written off	(1.4)	(11.2)	(12.6)
Assets derecognised	-	-	-
At 31 March 2022 (Restated) (Note 14)	34.7	20.5	55.2
At 30 September 2021	37.7	27.7	65.4
Provided in period (Note 2)	5.1	10.7	15.8
Amounts written off	(3.6)	(12.9)	(16.5)
Assets derecognised	(1.2)	-	(1.2)
At 30 September 2022 (Note 14)	38.0	25.5	63.5

Accounts are considered to be written off for accounting purposes if a balance remains once standard enforcement processes have been completed, subject to any amount retained in respect of expected salvage receipts. This has no effect on the net carrying value, only on the amounts reported as gross loan balances and accumulated impairment provisions.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

15. LOAN IMPAIRMENTS - PROVISION MOVEMENTS IN THE PERIOD (Continued)

A more detailed analysis of these movements by IFRS 9 stage on a consolidated basis for the six months ended 31 March 2023, the six months ended 31 March 2022, and the year ended 30 September 2022 are set out below.

These tables, and the matching tables analysing movements in gross balances, have been compiled by comparing opening and closing balances on each account and analysing the movements between them.

Changes due to credit risk includes all changes in model parameters whether related to account performance, external credit data or model assumptions, including economic scenarios and weightings.

There have been no changes in models creating significant movements in balances in the period.

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Loss allowance at 30 September 2022	25.5	8.0	28.5	1.5	63.5
New assets originated or purchased	4.1	-	-	-	4.1
Changes in loss allowance					
Transfer to Stage 1	2.7	(2.6)	(0.1)	-	-
Transfer to Stage 2	(1.1)	1.7	(0.6)	-	-
Transfer to Stage 3	(0.1)	(1.2)	1.3	-	-
Changes on stage transfer	(2.3)	1.3	7.3	-	6.3
Changes due to credit risk	(7.2)	(0.2)	2.4	3.3	(1.7)
Loans sold	-	-	-	-	-
Write offs	-	-	(4.0)	-	(4.0)
Loss allowance at 31 March 2023	21.6	7.0	34.8	4.8	68.2

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

15. LOAN IMPAIRMENTS - PROVISION MOVEMENTS IN THE PERIOD (Continued)

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Loss allowance at 30 September 2021	15.0	11.3	38.9	0.2	65.4
New assets originated or purchased	6.6	-	-	-	6.6
Changes in loss allowance					
Transfer to Stage 1	1.0	(0.8)	(0.2)	-	-
Transfer to Stage 2	(0.7)	1.1	(0.4)	-	-
Transfer to Stage 3	(0.1)	(0.5)	0.6	-	-
Changes on stage transfer	(0.9)	0.6	1.8	-	1.5
Changes due to credit risk	(0.6)	(5.3)	-	0.2	(5.7)
Loans sold	-	-	-	-	-
Write offs	-	-	(12.6)	-	(12.6)
Loss allowance at 31 March 2022	20.3	6.4	28.1	0.4	55.2

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Loss allowance at 30 September 2021	15.0	11.3	38.9	0.2	65.4
New assets originated or purchased	7.2	-	-	-	7.2
Changes in loss allowance					
Transfer to Stage 1	2.6	(2.3)	(0.3)	-	-
Transfer to Stage 2	(1.6)	2.3	(0.7)	-	-
Transfer to Stage 3	(0.2)	(0.4)	0.6	-	-
Changes on stage transfer	(2.4)	1.8	4.3	-	3.7
Changes due to credit risk	4.9	(4.7)	3.4	1.3	4.9
Loans sold	-	-	(1.2)	-	(1.2)
Write offs	-	-	(16.5)	-	(16.5)
Loss allowance at 30 September 2022	25.5	8.0	28.5	1.5	63.5

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

15. LOAN IMPAIRMENTS-PROVISION MOVEMENTS IN THE PERIOD (Continued)

During the six months ended 31 March 2023 the impairment allowance remained relatively stable with the increase concentrated in Stage 3 cases, driven by the level of actual defaults in the period and reduced levels of available security through declining house prices in the mortgage segment.

Stage 1 movements include changes in judgemental adjustments in the period, with items formerly addressed by these provisions beginning to move through Stage 2 and Stage 3. These movements were driven both by account performance, and by the impact of more severe actual and forecast economic conditions.

During the year ended 30 September 2022 the impairment allowance remained relatively stable, due to the opposing effects of the easing of Covid-related pressures on the UK economy and mounting concerns about the nation's economic health more generally, with inflation and interest rates increasing and the potential for impacts from the conflict in Ukraine.

The increase in Stage 1 provision in that year came mostly from new lending, coupled with the need to make judgemental increases in the provision balance. Stage 2 provisions fell slightly as the impacts of additional Covid-related SICRs in 2021 fell away. Stage 3 provision reduced as bought forward cases were resolved, in both the Commercial Lending and Mortgage Lending divisions.

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

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Balance at 30 September 2022	12,157.0	1,963.6	124.4	28.8	14,273.8
New assets originated or purchased	1,593.2	-	-	-	1,593.2
Changes in staging					
Transfer to Stage 1	1,213.4	(1,211.6)	(1.8)	-	-
Transfer to Stage 2	(265.8)	271.9	(6.1)	-	-
Transfer to Stage 3	(12.8)	(50.5)	63.3	-	-
Redemptions and repayments	(1,424.9)	(150.2)	(22.2)	(6.2)	(1,603.5)
Loans sold	-	-	-	-	-
Write offs	-	-	(4.0)	-	(4.0)
Other changes	348.2	8.7	3.9	2.8	363.6
Balance at 31 March 2023	13,608.3	831.9	157.5	25.4	14,623.1
Loss allowance	(21.6)	(7.0)	(34.8)	(4.8)	(68.2)
Carrying value	13,586.7	824.9	122.7	20.6	14,554.9

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

15. LOAN IMPAIRMENTS - PROVISION MOVEMENTS IN THE PERIOD (Continued)

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Balance at 30 September 2021	11,900.4	1,279.1	164.3	124.3	13,468.1
New assets originated or purchased	1,432.3	-	-	-	1,432.3
Changes in staging					
Transfer to Stage 1	124.6	(122.5)	(2.1)	-	-
Transfer to Stage 2	(495.0)	501.2	(6.2)	-	-
Transfer to Stage 3	(13.8)	(12.1)	25.9	-	-
Redemptions and repayments	(1,006.2)	(111.8)	(18.2)	(30.8)	(1,167.0)
Loans sold	-	-	-	-	-
Write offs	-	-	(12.6)	-	(12.6)
Other changes	205.5	27.0	1.4	15.4	249.3
Balance at 31 March 2022	12,147.8	1,560.9	152.5	108.9	13,970.1
Loss allowance	(20.3)	(16.4)	(28.1)	(0.4)	(55.2)
Carrying value	12,127.5	1,554.5	124.4	108.5	13,914.9

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
Balance at 30 September 2021	11,900.4	1,279.1	164.3	124.3	13,468.1
New assets originated or purchased	3,020.8	-	-	-	3,020.8
Changes in staging					
Transfer to Stage 1	519.4	(516.8)	(2.6)	-	-
Transfer to Stage 2	(1,365.2)	1,378.2	(13.0)	-	-
Transfer to Stage 3	(29.5)	(16.6)	46.1	-	-
Redemptions and repayments	(2,311.2)	(230.4)	(55.6)	(33.1)	(2,630.3)
Loans sold	-	-	(1.5)	(73.8)	(75.3)
Write offs	-	-	(16.5)	-	(16.5)
Other changes	422.3	70.1	3.2	11.4	507.0
Balance at 30 September 2022	12,157.0	1,963.6	124.4	28.8	14,273.8
Loss allowance	(25.5)	(8.0)	(28.5)	(1.5)	(63.5)
Carrying value	12,131.5	1,955.6	95.9	27.3	14,210.3

Other changes includes interest and similar charges.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

16. LOAN IMPAIRMENTS - ECONOMIC INPUTS TO CALCULATIONS

Impairment provision under IFRS 9 is calculated on a forward-looking ECL basis, based on expected economic conditions in multiple internally coherent scenarios. While the provision calculation is intended to address all possible future economic outcomes, the Group, in common with most other lenders, uses a small number of differing scenarios as representatives of this universe of potential outturns.

The Group uses four distinct economic scenarios chosen to represent the range of possible outcomes and allow for the impact of economic asymmetry in the calculations. Each scenario comprises a number of economic parameters and while models for different portfolios may not use all of the variables, the set, as a whole, is defined for the Group and must be consistent.

As the Group does not have an internal economics function, in developing its economic scenarios it considers analysis from reputable external sources to form a general market consensus which informs its central scenario. These sources include data and forecasts produced by the Office of Budget Responsibility ('OBR') and the PRA as well as private sector economic research bodies. The Group also takes account of public statements from bodies such as the Bank of England and the UK Government to inform its final position.

The central scenario used for IFRS 9 impairment purposes is the same scenario which forms the basis of the Group's business planning and forecasting and will therefore generally carry the highest probability weighting. In its March 2023 forecasting cycle (the 'April reforecast') the Group has adopted a central economic scenario derived using a broadly equivalent approach to that used in September 2022, with the starting point of the scenario updated to reflect the actual movements of economic variables in the six months. The general trend of the Group's central forecasts follows that published by the Bank of England in February 2023, with inflation beginning to fall and resilience in the labour market. Monetary policy remains restrictive, and a short shallow recession occurs in the early part of the forecast.

Compared to the central scenario adopted at 30 September 2022, the new central forecast is generally more pessimistic across most variables, with a much more severe decline in house prices than in the earlier scenario. The scenario also begins from the actual March 2023 economic position, so the interest rate rises, inflation and house price falls observed in the period are included in the starting position.

The upside and downside scenarios continue to be derived from the central scenario, as they have been in previous periods. The shapes of these three scenarios are broadly similar across the period, with the upside scenario having a more rapid reduction in inflation and a stronger recovery, while the downside includes additional pressure on house prices, rising unemployment with interest rates being reduced more rapidly in response.

The severe scenario has been derived from stress testing scenarios published by the Bank of England, as in previous periods, with the 2022 Annual Cyclical Scenario ('ACS') published in September 2022 being used at 31 March 2023. This scenario is based on weaker growth in household real incomes, lower confidence and tighter financial conditions producing domestic and global recessions.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

16. LOAN IMPAIRMENTS - ECONOMIC INPUTS TO CALCULATIONS (Continued)

Following a review of the weightings of the different scenarios, set against the overall potential for variability in the future economic outlook, the Group decided to maintain the scenario weightings used at 30 September 2022. While the economic outlook is more settled than it was six months earlier there remains a significant divergence in opinions on the likely outlook for the UK economy, with a potential for serious downside outcomes. This supports the maintenance of the September 2022 weightings.

Sensitivities comparing the effect of these weightings with those which might be seen in a more normal economic environment are set out in Note 17.

The weightings attached to each scenario are set out below

	31 March 2023	30 September 2022	31 March 2022
Central Scenario	40%	40%	40%
Upside Scenario	10%	10%	10%
Downside Scenario	30%	30%	35%
Severe Scenario	20%	20%	15%
	100%	100%	100%

The Group's economic scenarios comprise seven variables based on standard publicly available metrics for the UK. These variables are:

- Year-on-year change in Gross Domestic Product ('GDP') as measured by the Office of National Statistics ('ONS')
- Year-on-year change in the House Price Index ('HPI') as measured by the Nationwide Building Society
- Bank Base Rate ('BBR'), as set by the Bank of England
- Consumer Price Inflation ('CPI') as measured by the ONS
- Unemployment rate, as measured by the ONS
- Annual change in secured lending, as measured by the Bank of England 'mortgage advances' data series
- Annual change in consumer credit, as measured by the Bank of England 'unsecured advances' data series

The projected average values of each of these variables in each of the first five years of the forecast period are set out below. Values are shown for the twelve months ending on 31 March or 30 September in each year as appropriate.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

16. LOAN IMPAIRMENTS - ECONOMIC INPUTS TO CALCULATIONS (Continued)

31 March 2023

GDP (year-on-year change)

	2024	2025	2026	2027	2028
	%	%	%	%	%
Central scenario	(0.7)	(0.1)	0.7	1.2	1.2
Upside scenario	1.3	0.7	0.7	1.2	1.2
Downside scenario	(2.3)	0.1	1.4	1.2	1.2
Severe scenario	(3.7)	(0.2)	1.2	1.2	0.8

HPI (year-on-year change)

	2024	2025	2026	2027	2028
	%	%	%	%	%
Central scenario	(8.8)	(0.7)	3.3	4.4	3.7
Upside scenario	(3.9)	5.7	7.1	5.6	4.9
Downside scenario	(14.0)	(6.2)	3.2	4.0	3.7
Severe scenario	(13.1)	(15.1)	-	7.0	5.6

BBR (rate)

	2024	2025	2026	2027	2028
	%	%	%	%	%
Central scenario	4.1	3.9	3.6	3.4	3.1
Upside scenario	4.5	4.5	4.3	3.8	3.2
Downside scenario	3.1	2.1	2.0	2.0	2.0
Severe scenario	5.8	5.8	5.1	4.3	3.5

CPI (rate)

	2024	2025	2026	2027	2028
	%	%	%	%	%
Central scenario	5.6	2.5	1.7	1.9	1.9
Upside scenario	5.5	3.2	2.8	2.1	1.9
Downside scenario	4.1	1.1	0.5	1.2	2.1
Severe scenario	16.7	10.0	3.0	2.3	2.0

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

16. LOAN IMPAIRMENTS - ECONOMIC INPUTS TO CALCULATIONS (Continued)

Unemployment (rate)

	2024 %	2025 %	2026 %	2027 %	2028 %
Central scenario	4.2	4.8	5.2	5.2	4.2
Upside scenario	4.0	4.5	4.7	4.6	4.1
Downside scenario	4.7	5.4	6.1	5.7	4.7
Severe scenario	6.8	8.4	7.8	7.2	6.2

Secured lending (annual change)

	2024 %	2025 %	2026 %	2027 %	2028 %
Central scenario	2.8	2.4	3.0	3.5	3.5
Upside scenario	3.5	3.2	3.8	4.1	3.5
Downside scenario	2.0	1.7	2.3	2.9	3.5
Severe scenario	(0.9)	0.2	2.3	3.4	3.5

Consumer credit (annual change)

	2024 %	2025 %	2026 %	2027 %	2028 %
Central scenario	2.8	3.6	3.5	3.5	3.5
Upside scenario	3.5	4.4	4.3	4.1	3.5
Downside scenario	2.0	2.9	2.8	2.9	3.5
Severe scenario	(4.6)	(2.3)	1.6	3.7	3.5

31 March 2022

GDP (year-on-year change)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	2.8	2.0	1.1	1.9	1.5
Upside scenario	4.2	2.5	1.4	2.0	1.5
Downside scenario	1.6	1.8	1.1	1.9	1.5
Severe scenario	(1.4)	(2.0)	1.2	1.1	1.0

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

16. LOAN IMPAIRMENTS - ECONOMIC INPUTS TO CALCULATIONS (Continued)

HPI (year-on-year change)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	3.2	0.6	3.0	3.5	3.2
Upside scenario	6.8	4.6	4.0	4.9	5.0
Downside scenario	2.5	(3.2)	(2.4)	1.6	3.2
Severe scenario	(4.8)	(15.4)	(14.4)	2.3	3.2

BBR (rate)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	1.3	1.9	2.0	2.0	2.0
Upside scenario	1.1	1.3	1.3	1.3	1.3
Downside scenario	0.8	0.8	0.8	0.8	0.8
Severe scenario	2.3	4.0	4.0	3.9	3.4

CPI (rate)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	7.2	3.0	1.7	1.9	2.0
Upside scenario	6.4	2.4	2.0	1.9	2.0
Downside scenario	6.1	3.1	2.0	2.0	2.0
Severe scenario	7.9	4.9	2.9	2.4	2.0

Unemployment (rate)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	4.0	4.3	4.6	4.5	4.3
Upside scenario	3.8	3.8	4.0	3.9	3.8
Downside scenario	4.4	4.7	5.0	4.9	4.7
Severe scenario	6.4	9.2	8.8	8.2	7.5

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

16. LOAN IMPAIRMENTS - ECONOMIC INPUTS TO CALCULATIONS (Continued)

Secured lending (annual change)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	2.7	3.9	4.1	4.0	3.5
Upside scenario	3.4	4.6	4.9	4.8	4.3
Downside scenario	1.9	3.1	3.4	3.3	2.8
Severe scenario	1.9	(0.9)	0.2	2.3	3.4

Consumer credit (annual change)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	4.3	5.0	4.6	4.9	4.5
Upside scenario	5.0	5.8	5.4	5.6	5.3
Downside scenario	3.5	4.3	3.9	4.1	3.8
Severe scenario	(2.8)	(4.6)	(2.3)	1.6	4.0

30 September 2022

GDP (year-on-year change)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	0.4	1.3	1.3	1.9	1.2
Upside scenario	1.9	3.0	2.2	2.7	1.7
Downside scenario	(2.2)	0.6	1.4	1.9	1.2
Severe scenario	(3.6)	(0.2)	1.2	1.2	1.2

HPI (year-on-year change)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	(0.6)	0.8	3.9	4.2	4.4
Upside scenario	4.7	4.7	6.8	6.8	5.0
Downside scenario	(6.5)	(3.3)	4.4	4.0	4.0
Severe scenario	(7.2)	(15.4)	(14.4)	2.7	5.5

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

16. LOAN IMPAIRMENTS - ECONOMIC INPUTS TO CALCULATIONS (Continued)

BBR (rate)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	4.6	4.3	3.8	3.3	3.0
Upside scenario	4.1	4.3	3.8	3.4	3.1
Downside scenario	5.0	4.4	3.8	3.3	3.0
Severe scenario	5.8	5.8	5.1	4.3	3.5

CPI (rate)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	10.4%	3.9%	2.2%	1.6%	1.9%
Upside scenario	9.7%	2.9%	1.9%	2.0%	1.9%
Downside scenario	13.0%	8.8%	2.9%	2.0%	1.9%
Severe scenario	16.7%	10.0%	3.0%	2.3%	2.0%

Unemployment (rate)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	4.2%	4.9%	4.8%	4.6%	4.3%
Upside scenario	3.5%	4.3%	4.3%	4.1%	3.8%
Downside scenario	4.6%	5.8%	6.3%	6.2%	5.7%
Severe scenario	6.4%	9.2%	8.8%	8.2%	7.5%

Secured lending (annual change)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	3.3%	2.6%	2.5%	3.5%	3.5%
Upside scenario	4.1%	3.3%	3.2%	4.2%	4.3%
Downside scenario	2.6%	1.8%	1.7%	2.7%	2.8%
Severe scenario	0.2%	(0.7)%	1.3%	3.0%	3.7%

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

16. LOAN IMPAIRMENTS - ECONOMIC INPUTS TO CALCULATIONS (Continued)

Consumer credit (annual change)

	2023 %	2024 %	2025 %	2026 %	2027 %
Central scenario	3.6%	3.1%	3.6%	3.5%	3.5%
Upside scenario	4.4%	3.9%	4.4%	4.3%	4.3%
Downside scenario	2.9%	2.4%	2.9%	2.8%	2.8%
Severe scenario	(3.7)%	(4.4)%	0.1%	2.8%	4.7%

After the end of the initial five year period, the final rate or rate of change (as appropriate) is assumed to continue into the future in each scenario.

To illustrate the levels of non-linearity in the various scenarios, the maximum and minimum quarterly levels for each variable over the five year period commencing on the balance sheet date are set out below.

31 March 2023

	Central scenario		Upside scenario		Downside scenario		Severe scenario	
	Max %	Min %	Max %	Min %	Max %	Min %	Max %	Min %
Economic driver								
GDP	1.2	(0.8)	2.0	0.2	1.6	(2.5)	1.2	(5.0)
HPI	4.4	(11.3)	7.4	(7.4)	4.1	(15.1)	7.2	(16.4)
BBR	4.3	3.0	4.5	3.0	3.8	2.0	6.0	3.3
CPI	8.5	1.4	7.5	1.7	8.0	0.4	17.0	2.0
Unemployment	5.3	4.0	4.7	3.8	6.3	4.3	8.5	4.8
Secured lending	3.5	2.3	4.3	3.1	3.5	1.6	3.5	(1.2)
Consumer credit	3.8	2.5	4.5	3.3	3.5	1.8	4.2	(5.2)

31 March 2022

	Central scenario		Upside scenario		Downside scenario		Severe scenario	
	Max %	Min %	Max %	Min %	Max %	Min %	Max %	Min %
Economic driver								
GDP	3.4	1.1	4.4	1.2	2.4	0.8	2.3	(4.4)
HPI	6.5	0.0	8.2	3.8	6.1	(4.8)	5.1	(17.8)
BBR	2.0	1.0	1.3	1.0	0.8	0.8	4.0	0.8
CPI	8.0	1.6	7.5	1.8	7.0	1.9	8.5	1.9
Unemployment	4.7	3.9	4.1	3.7	5.1	4.3	9.2	4.5
Secured lending	4.5	2.5	5.3	3.3	3.8	1.8	3.7	(1.2)
Consumer credit	5.0	3.0	5.8	3.8	4.3	2.3	4.8	(5.2)

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

16. LOAN IMPAIRMENTS - ECONOMIC INPUTS TO CALCULATIONS (Continued)

30 September 2022

	Central scenario		Upside scenario		Downside scenario		Severe scenario	
	Max %	Min %	Max %	Min %	Max %	Min %	Max %	Min %
Economic driver								
GDP	2.2	(0.3)	3.5	1.2	2.2	(2.7)	1.2	(5.0)
HPI	4.8	(4.5)	7.5	3.3	4.9	(13.1)	5.7	(17.8)
BBR	5.0	3.0	4.5	3.0	5.5	3.0	6.0	3.3
CPI	10.8	1.4	10.3	1.7	14.0	1.8	17.0	1.8
Unemployment	5.0	3.9	4.5	3.4	6.3	4.1	9.2	4.5
Secured lending	4.0	2.3	4.8	3.1	3.3	1.6	3.7	(1.2)
Consumer credit	5.0	2.5	5.8	3.3	4.3	1.8	4.8	(5.2)

The asymmetry in the models is demonstrated by comparing the calculated impairment provision with that which would have been produced using the central scenario alone, 100% weighted.

	31 March 2023 £m	31 March 2022 (Restated) £m	30 September 2022 £m
Provision using central scenario 100% weighted			
Mortgage Lending	35.3	29.1	29.1
Commercial Lending	25.5	19.3	24.2
	60.8	48.4	53.3
Calculated impairment provision	68.2	55.2	63.5
Effect of multiple economic scenarios	7.4	6.8	10.2

17. IMPAIRMENT PROVISION – SENSITIVITY ANALYSIS

The calculation of impairment provisions under IFRS 9 is subject to a variety of uncertainties arising from assumptions, forecasts and expectations about future events and conditions. To illustrate the impact of these uncertainties, sensitivity calculations have been performed for some of the most significant.

These sensitivities are intended as mathematical illustrations of the impacts of the various assumptions of the Group's modelling. They do not necessarily represent alternative potential impairment values as other factors might also need to be considered in arriving at a final provision figure if circumstances differed from those at the balance sheet date.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

17. IMPAIRMENT PROVISION – SENSITIVITY ANALYSIS (Continued)

Economic conditions

To illustrate the potential impact of differing future economic scenarios on the total impairment, the provisions which would be calculated if each of the economic scenarios were 100% weighted are shown below.

	31 March 2023		30 September 2022	
Scenarios	**Provision £m**	**Difference £m**	**Provision £m**	**Difference £m**
Central	60.8	(7.4)	53.3	(10.2)
Upside	55.1	(13.1)	46.8	(16.7)
Downside	68.5	0.3	62.5	(1.0)
Severe downside	89.2	21.0	100.3	36.8

The weighted average of these 100% weighted provisions need not equal the weighted average ECL due to the impact of the differing PDs on staging.

Scenario weightings

In order to illustrate the impact of scenario weightings on the outcomes, the impairment provision requirements were sensitised using alternative weightings. The sensitivity is based on the weightings used at IFRS 9 transition on 1 October 2018. The use of the 2018 weighting is intended to represent a more settled outlook than has been evident at either of the three most recent year ends. Judgemental adjustments are assumed to remain constant.

The weightings used, and the results of applying this sensitivity to the 31 March 2023 scenarios are set out below.

	Weighting				Impairment	Difference
	Central	**Upside**	**Downside**	**Severe**	**£m**	**£m**
As reported	40%	10%	30%	20%	68.2	-
Sensitivity	40%	30%	25%	5%	62.3	(5.9)

Significant increase in credit risk

The most significant driver of SICR is relative PD. If all PDs across the Group's principal buy-to-let mortgage book were increased by 10%, loans with a gross value of £83.5m would transfer from Stage 1 to Stage 2 (30 September 2022: £136.8m), and the total provision would increase by £0.5m from the combined effects of higher PDs on expected losses and the impact of providing for expected lifetime losses, rather than 12-month losses on the additional Stage 2 cases (30 September 2022: £0.9m).

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

17. IMPAIRMENT PROVISION – SENSITIVITY ANALYSIS (Continued)

Value of security

The principal assumptions impacting the LGD are the estimated security values. If the rate of growth in house prices assumed by the model after the forecast minimum were halved, ignoring any PD effects, then the provision for the Group's first and second mortgage assets under the central scenario would increase by £0.7m (30 September 2022: £2.7m).

Receiver of rent

The majority of receiver of rent cases, which are included in Stage 3, are managed long-term and therefore their assumed realisation date has an important impact on the provision calculation. If the assumed rate of realisation was increased by 20%, the impairment provision in the central scenario would increase by £0.2m (30 September 2022: £0.4m).

18. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING

The Group uses derivative financial instruments such as interest rate risk swaps for risk management purposes only. Each such derivative contract is entered into for economic hedging purposes to manage a particular identified risk and any gains or losses arising are incidental to this objective. No trading in derivative financial instruments is undertaken.

A detailed description of the Group's use of derivatives and its accounting for derivatives and hedging is set out in Note 25 to the 2022 Group Accounts.

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Derivative financial assets	511.2	201.7	779.0	44.2
Derivative financial liabilities	(51.3)	(32.5)	(102.1)	(43.9)
	459.9	169.2	676.9	0.3
Of which:				
Interest rate swaps in hedging relationships	433.9	151.7	554.5	(3.0)
Other interest rate swaps	26.0	17.6	121.9	3.5
Currency futures	-	(0.1)	0.5	(0.2)
	459.9	169.2	676.9	0.3

All hedging relationships and strategies at 30 September 2022 described in note 25 to the 2022 Group Accounts have continued in the period.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

18. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (Continued)

The balances held on the Group's balance sheet relating to the hedging of interest rate risk on its fixed rate customer loan and deposit balances are summarised below.

	Note	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Derivative financial instruments					
Assets		511.2	201.7	779.0	44.2
Liabilities		(51.3)	(32.5)	(102.1)	(43.9)
		459.9	169.2	676.9	0.3
Fair value hedging adjustments					
On loans to customers	12	(318.9)	(151.5)	(559.9)	5.5
On retail deposits	20	37.8	30.9	99.7	3.0
		(281.1)	(120.6)	(460.2)	8.5
Net balance sheet position		178.8	48.6	216.7	8.8
Collateral balances					
Posted (in sundry assets)		-	-	-	36.6
Received (in sundry liabilities)	22	(244.2)	(64.2)	(388.6)	(0.2)
		(244.2)	(64.2)	(388.6)	36.4

19. INTANGIBLE ASSETS

Intangible assets at net book value comprise:

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Goodwill	164.4	164.4	164.4	164.4
Computer software	4.6	3.4	3.9	3.4
Other intangibles	1.5	2.3	1.9	2.7
Total assets	170.5	170.1	170.2	170.5

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

19. INTANGIBLE ASSETS (Continued)

The balance for goodwill at 31 March 2023 shown above includes £113.0m in respect of the SME Lending Cash Generating Unit ('CGU') and £49.8m in respect of the Development Finance CGU. Given the changes in the economic outlook for the UK since 30 September 2022, and their potential impact on the outlook for these businesses, these balances have been retested for impairment in accordance with IAS 36 for good order.

These tests were conducted in the same way as those described in note 30 to the 2022 Group Accounts, using five year forecasts updated as part of the Group's half yearly planning cycle. The levels of business activity in these forecasts are considered by management to form a reasonable basis for the assessment of goodwill based on past experience and the current economic environment. The revised key assumptions are set out below.

- The level of business activity in the SME Lending CGU assumes a compound annual growth rate ('CAGR') for new business over the five-year period of 10.99%, a small increase from the 10.56% assumed at 30 September 2022 The new lending forecasts are the key driver for cash flow and profitability in the Group's forecasting models.
- The level of business activity in the Development Finance CGU assumes a CAGR for drawdowns over the five-year period of 6.45%, compared with 8.77% used at 30 September 2022
- In both CGUs cash flows beyond the five-year budget are extrapolated using a constant growth rate of 1.21% (30 September 2022: 1.54%) which does not exceed the long-term average growth rates for the markets in which the businesses are active
- The discount rate in both tests is based on third party estimates of the implied industry cost of capital. The pre-tax discount rate applied to the SME Lending cash flow projection is 15.1% (30 September 2022: 14.8%) while that applied to the Development Finance CGU was 14.9% (30 September 2022: 14.4%)

As an illustration of the sensitivity of these impairment tests to movements in the key assumptions:

- The Group has calculated that a 0.0% growth rate combined with a 9.5% reduction in profit levels in the SME Lending CGU and a stable pre-tax discount rate would eliminate the projected headroom of £43.5m. While such movements are not expected by management, they are considered as 'reasonably possible' for the purposes of IAS 36. A 0.0% growth rate combined with a 13.1% reduction in profit levels would generate a write down of £10.0m

  In the testing carried out at 30 September 2022, a 0.0% growth rate combined with a 7.5% reduction in profit levels would have eliminated the projected headroom of £43.5m. A 0.0% growth rate combined with an 11.2% reduction in profit levels would have generated a write down of £10.0m.
- Management believes any reasonably possible change in the key assumptions in the Development Finance CGU would not cause the recoverable amount of the CGU to fall below the balance sheet carrying value. This was also the case in the testing carried out at 30 September 2022

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

20. 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 notice and easy access accounts. The method of interest calculation on these deposits is analysed below.

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Fixed rate	7,574.4	5,711.5	6,201.3	5,466.0
Variable rates	4,301.5	4,142.2	4,467.9	3,834.4
	11,875.9	9,853.7	10,669.2	9,300.4

The weighted average interest rate on retail deposits at 31 March 2023, analysed by charging method, is set out below.

	31 March 2023 %	31 March 2022 %	30 September 2022 %	30 September 2021 %
Fixed rate	2.93	1.26	1.74	1.25
Variable rates	2.70	0.63	1.55	0.42
All deposits	2.84	0.99	1.66	0.91

The contractual maturity of these deposits is analysed below.

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Amounts repayable				
In less than three months	883.5	1,000.7	929.0	789.0
In more than three months but not more than one year	4,832.1	3,382.0	3,732.1	3,105.4
In more than one year, but not more than two years	1,763.0	1,457.2	1,627.3	1,580.1
In more than two years, but not more than five years	504.0	413.4	421.4	507.4
Total term deposits	7,982.6	6,253.3	6,709.8	5,981.9
Repayable on demand	3,893.3	3,600.4	3,959.4	3,318.5
	11,875.9	9,853.7	10,669.2	9,300.4
Fair value adjustments for portfolio hedging (note 18)	(37.8)	(30.9)	(99.7)	(3.0)
	11,838.1	9,822.8	10,569.5	9,297.4

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

21. BORROWINGS

On 27 February 2023 Fitch Ratings confirmed the Group's Long-Term Issuer Default Rating at BBB+, with a stable outlook. It also confirmed the senior unsecured debt rating at BBB and the rating of the Group's Tier-2 bond at BBB-, with this security therefore enjoying an investment-grade rating.

All borrowings described in the Group Accounts for the year ended 30 September 2022 remained in place throughout the period.

During the period the Group accessed repo facilities with UK banks, but no balances remained outstanding at the period end.

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

On 15 May 2023, after the balance sheet date, the Group repaid its borrowing under the Paragon Mortgages (No. 25) PLC securitisation, in accordance with the call option, with the mortgage loan assets of the securitisation refinanced from existing funding sources. These notes were carried at £250.2m at 31 March 2023.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

22. SUNDRY LIABILITIES

Sundry liabilities include:

	Note	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Amounts falling due within one year				
Contingent consideration		-	1.9	2.2
Lease liabilities		2.4	2.2	2.2
Accrued interest		97.3	29.2	42.2
CSA liabilities	18	244.2	64.2	388.6
Other sundry liabilities		33.9	37.7	54.8
		377.8	135.2	490.0
Amounts falling due after more than one year				
Lease liabilities		6.7	7.6	6.8
Accrued interest		22.4	9.2	13.0
Other sundry liabilities		3.7	3.8	3.3
		32.8	20.6	23.1
Total				
Contingent consideration		-	1.9	2.2
Lease liabilities		9.1	9.8	9.0
Other sundry liabilities		401.5	144.1	501.9
		410.6	155.8	513.1

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

23. RETIREMENT BENEFIT OBLIGATIONS

The defined benefit obligation at 31 March 2023 has been calculated on a year-to-date basis. Since the last IAS 19 actuarial valuation at 30 September 2022, there have been movements in financial conditions, requiring an adjustment to the actuarial assumptions underlying the calculation of the defined benefit obligation at 31 March 2023. In particular, over the period since the 30 September 2022 actuarial valuation, the discount rate has decreased by 20 basis points per annum, whereas expectations of long-term inflation have decreased by a higher amount, around 35 basis points.

The net effect of these changes, together with the Group's contributions and the performance of the plan assets, has resulted in the value of the net defined benefit surplus at 31 March 2023 increasing from the position at 30 September 2022. The impact of allowing for the changes in actuarial assumptions has been recognised as an actuarial gain in other comprehensive income.

The Group has recognised the surplus as an asset at the balance sheet date as it anticipates being able to access economic benefits at least as great as the carrying value. However such assets are eliminated from capital for regulatory purposes (note 32).

The movements in the amount recognised in respect of the defined benefit plan during the six-month period ended 31 March 2023 are summarised below.

	Six months to 31 March 2023 £m	Six months to 31 March 2022 £m	Year to 30 September 2022 £m
Opening pension surplus / (deficit)	7.1	(10.3)	(10.3)
Employer contributions	1.9	1.9	4.0
Amounts posted to profit and loss			
Current service cost	(0.2)	(0.4)	(0.9)
Net funding cost (note 3/note 4)	0.2	(0.1)	(0.2)
Administrative expenses	(0.5)	(0.4)	(0.8)
Amounts posted to other comprehensive income			
Return on plan assets not included in interest	1.8	(7.5)	(43.1)
Experience (loss) on liabilities	(1.1)	-	(1.3)
Actuarial gain / (loss) from changes in financial assumptions	1.2	21.2	61.9
Actuarial gain / (loss) from changes in demographic assumptions	-	-	(2.2)
Closing pension surplus / (deficit)	10.4	4.4	7.1

Pursuant to the recovery plan agreed with the Trustee of the pension plan, the Group has effectively granted a first charge over its freehold head office building as security for its agreed contributions. No account of this charge is taken in the calculation of the above surplus / (deficit).

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

24. CALLED-UP SHARE CAPITAL

Movements in the issued share capital in the period were:

	Six months to 31 March 2023 Number	Six months to 31 March 2022 Number	Year to 30 September 2022 Number
Ordinary shares of £1 each			
Opening share capital	241,409,624	262,495,185	262,495,185
Shares issued	135,998	113,554	386,039
Shares cancelled	-	(12,100,834)	(21,471,600)
Closing share capital	241,545,622	250,507,905	241,409,624

During the period, the Company issued 135,998 shares (six months ended 31 March 2022: 113,554; year ended 30 September 2022: 386,039) to satisfy options granted under Sharesave schemes for a consideration of £463,863 (six months ended 31 March 2022: £341,517; year ended 30 September 2022: £1,309,525).

On 24 November 2021, 12,100,834 shares held in treasury at 30 September 2021 were cancelled. On 8 September 2022 a further 9,370,766 shares, purchased into treasury during the year ended 30 September 2022 were also cancelled.

On 1 June 2023, after the period end, 12,870,044 of the shares held in treasury at the balance sheet date (note 26) were cancelled.

25. RESERVES

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Share premium account	71.4	70.4	71.1	70.1
Capital redemption reserve	-	62.4	71.8	50.3
Merger reserve	(70.2)	(70.2)	(70.2)	(70.2)
Profit and loss account	1,219.3	1,013.2	1,151.2	1,005.9
	1,220.5	1,075.8	1,223.9	1,056.1

On 28 March 2023 the High Court confirmed the cancellation of the Company's capital redemption reserve, following shareholder approval at the AGM on 1 March 2023. This reserve had arisen on the cancellation of ordinary shares which had been purchased in the market and held in treasury. The balance outstanding on the capital redemption reserve was transferred to the profit and loss account.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

26. OWN SHARES

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Treasury shares			
Opening balance	18.2	60.7	60.7
Shares purchased	61.2	27.2	66.9
Shares cancelled	-	(60.7)	(109.4)
Closing balance	79.4	27.2	18.2
ESOP shares			
Opening balance	19.0	16.0	16.0
Shares purchased	8.9	12.5	12.6
Options exercised	(5.7)	(9.1)	(9.6)
Closing balance	22.2	19.4	19.0
Irrevocable authority to purchase			
Opening balance	10.8	-	-
Given in period	-	-	10.8
Expiring / utilised in the period	(10.8)	-	-
Closing balance	-	-	10.8
Total closing balance	101.6	46.6	48.0
Total opening balance	48.0	76.7	76.7
Number of shares held			
Treasury	14,870,044	5,025,743	3,640,519
ESOP	4,126,511	4,015,675	3,879,160
Total at own shares	18,996,555	9,041,418	7,519,679

At 31 March 2022 an irrevocable instruction for the purchase of a further £12.7m of shares was in place.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

27. EQUITY DIVIDEND

Amounts recognised as distributions to equity shareholders in the period:

	Six months to 31 March 2023 £m	Six months to 31 March 2022 £m	Year to 30 September 2022 £m
Final dividend for the year ended 30 September 2022 of 19.2p per share	43.7	-	-
Final dividend for the year ended 30 September 2021 of 18.9p per share	-	46.6	46.6
Interim dividend for the year ended 30 September 2022 of 9.4p per share	-	-	22.3
	43.7	46.6	68.9

An interim dividend of 11.0p per share is proposed for the period (2022: 9.4p per share), for the reasons set out in note 32(c). This will be paid on 28 July 2023 with a record date of 7 July 2023. The amount expected to be absorbed by this dividend, based on the number of shares in issue at the balance sheet date is £24.5m (31 March 2022: £22.7m). The interim dividend will be recognised in the accounts when it is paid.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

28. NET CASH FLOW FROM OPERATING ACTIVITIES

	Six months to 31 March 2023 £m	Six months to 31 March 2022 £m	Year to 30 September 2022 £m
Profit before tax	46.4	143.6	417.9
Non-cash items included in profit, and other adjustments			
Depreciation of property, plant and equipment	1.8	1.7	3.5
(Profit) / loss on disposal of property, plant and equipment	-	(0.1)	(0.1)
Amortisation of intangible assets	1.0	1.0	2.0
Non-cash movements on borrowings	0.8	1.0	1.9
Impairment losses on loans to customers	7.5	1.3	14.0
Charge for share based remuneration	4.6	4.4	9.2
Net (increase) / decrease in operating assets			
Assets held for leasing	(0.7)	(3.4)	(2.3)
Loans to customers	(352.1)	(513.5)	(821.6)
Derivative financial instruments	267.8	(157.5)	(734.8)
Fair value of portfolio hedges	(241.0)	157.0	565.4
Other receivables	(7.1)	28.4	22.9
Net increase / (decrease) in operating liabilities			
Retail deposits	1,206.7	553.3	1,368.8
Derivative financial instruments	(50.8)	(11.4)	58.2
Fair value of portfolio hedges	61.9	(27.9)	(96.7)
Other liabilities	(91.8)	68.1	416.9
Cash generated by operations	855.0	246.0	1,225.2
Income taxes (paid)	(29.1)	(24.9)	(56.5)
Net cash flow generated by operating activities	825.9	221.1	1,168.7

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

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

29. NET CASH FLOW USED IN INVESTING ACTIVITIES

	Six months to 31 March 2023 £m	Six months to 31 March 2022 £m	Year to 30 September 2022 £m
Proceeds from sales of operating property, plant and equipment	-	0.1	0.6
Purchases of operating property, plant and equipment	(0.5)	(0.7)	(1.3)
Purchases of intangible assets	(1.3)	(0.6)	(1.7)
Net cash (utilised) by investing activities	(1.8)	(1.2)	(2.4)

30. NET CASH FLOW FROM FINANCING ACTIVITIES

	Six months to 31 March 2023 £m	Six months to 31 March 2022 £m	Year to 30 September 2022 £m
Shares issued	0.4	0.4	1.4
Dividends paid (note 27)	(43.7)	(46.6)	(68.9)
Repayment of asset backed floating rate notes	(120.0)	(39.3)	(107.6)
Redemption of Retail Bonds	-	(125.0)	(125.0)
Movement on central bank facilities	-	31.0	(69.0)
Movement on other bank facilities	(244.4)	140.9	(144.6)
Capital element of lease payments	(1.1)	(0.7)	(1.7)
Purchase of own shares (note 26)	(70.1)	(39.7)	(79.5)
Exercise of share awards	(0.5)	(0.7)	(0.7)
Net cash (utilised) by financing activities	(479.4)	(79.7)	(595.6)

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – ANALYSIS
For the six months ended 31 March 2023 (Unaudited)

31. RELATED PARTY TRANSACTIONS

In the six months ended 31 March 2023, the Group has continued the related party relationships described in note 53 on page 265 of the Group's 2022 Annual Report and Accounts. Related party transactions in the period comprise the compensation of the Group's key management personnel, the acceptance of retail deposits from certain non-executive directors, and transactions with the Group Pension Plan.

There have been no changes in these relationships which could have a material effect on the financial position or performance of the Group in the period.

Retail deposits of £698,000 by directors were outstanding at the period end (31 March 2022: £18,000, 30 September 2022: £779,000) and the maximum outstanding in the period was £797,000 (31 March 2022: £19,000, 30 September 2022: £793,000).

Except for the transactions referred to above, there have been no related party transactions in the six months ended 31 March 2023.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

The notes below describe the processes and measurements which the Group uses to manage its capital position and its exposure to credit risk. It should be noted that certain capital measures, which are presented to illustrate the Group's position, are not covered by the Independent Review Report. Where this is the case, the relevant disclosures are marked as such.

32. 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 protection of the Group's capital base and its long-term viability are key strategic priorities.

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

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

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

32. CAPITAL MANAGEMENT (Continued)

(a) Regulatory Capital

The Group is subject to supervision by the PRA on a consolidated basis, as a group containing an authorised bank. For regulatory purposes the Company is designated as a CRR consolidation entity as defined by the PRA Rulebook. As part of this supervision the regulator will issue a Total Capital Requirement ('TCR') setting an amount of regulatory capital, relative to its risk weighted assets, which the Group is required to hold at all times, in order to safeguard depositors from loss in the event of severe losses being incurred by the Group. This is set in accordance with international Basel rules, issued by the Basel Committee on Banking Supervision ('BCBS') which, following the implementation of the Financial Services Act 2021 on 1 January 2022, are implemented through the PRA Rulebook.

The Group's regulatory capital is monitored by the Board of Directors, its Risk and Compliance Committee and the Asset and Liability Committee, which 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 Group has taken advantage of the transitional reliefs allowing the capital impacts of IFRS 9 transition and Covid-related provisions to be phased in over the financial years up to 30 September 2024. Where such reliefs are taken, firms are also required to disclose their capital positions calculated as if the reliefs were not available (the 'fully loaded' basis).

The tables below demonstrate that at 31 March 2023 the Group's total regulatory capital of £1,320.4m (31 March 2022: £1,242.4m, 30 September 2022: £1,371.8m) was comfortably in excess of the amounts required by the regulator, including £657.7m in respect of its Total Capital Requirement ('TCR') (31 March 2022: £625.8m, 30 September 2022: £660.6m), which is comprised of fixed and variable elements (none of these amounts are covered by the independent review report).

At 31 March 2023 the Group's TCR represented 8.8% of Total Risk Exposure ('TRE') (31 March 2022: 8.8%, 30 September 2022: 8.8%).

The CRR also requires firms to hold additional capital buffers, including a Capital Conservation Buffer ('CCoB') of 2.5% of TRE (at 31 March 2023) and a Counter Cyclical Capital Buffer ('CCyB'), currently 1.0% of TRE (30 September 2022: 0.0%). The UK CCyB will increase to 2.0% of TRE from July 2023, which is expected to be long-term rate in a standard risk environment. Firm specific buffers may also be required.

The Group's regulatory capital differs from its equity as certain adjustments are required by the PRA Rulebook or the regulator. A reconciliation of the Group's equity to its regulatory capital determined in accordance with the PRA Rulebook at 31 March 2023 is set out below.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

32. CAPITAL MANAGEMENT (Continued)

	Note	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Total equity	§	1,360.4	1,279.7	1,417.3	1,241.9
Deductions					
Proposed dividend	27	(24.5)	(22.7)	(44.9)	(46.6)
Irrevocable share buy-back instructions	26	-	(12.7)	-	-
IFRS 9 transitional relief	*	13.3	21.9	25.8	29.7
Intangible assets	19	(170.5)	(170.1)	(170.2)	(170.5)
Pension surplus net of deferred tax	23	(7.8)	(3.5)	(5.3)	-
Software relief	†	-	-	-	1.4
Prudent valuation adjustments	β	(0.5)	(0.2)	(0.9)	(0.1)
Insufficient coverage	ψ	(0.0)	(0.0)	(0.0)	-
Common Equity Tier 1 ('CET1') capital		1,170.4	1,092.4	1,221.8	1,055.8
Other tier 1 capital		-	-	-	-
Total Tier 1 capital		1,170.4	1,092.4	1,221.8	1,055.8
Corporate bond		150.0	150.0	150.0	150.0
Eligibility cap	ϕ	-	-	-	-
Total Tier 2 capital		150.0	150.0	150.0	150.0
Total regulatory capital ('TRC')		1,320.4	1,242.4	1,371.8	1,205.8

§ Including results for the six months ended 31 March 2023 which have been verified by the Group's external auditor for regulatory purposes.

* Firms are permitted to phase in the impact of IFRS 9 transition and of the impact of Covid-related IFRS 9 impairment provisions over a five year period. This is explained more fully in note 59 (a) to the 2022 Group Accounts.

† Under a relief enacted by the EU in December 2020 an amount in respect of software assets in intangibles was added back to capital. This was calculated in accordance with Article 36 (1) (b) of the CRR. This relief was rescinded for UK firms from 1 January 2022.

β For capital purposes, assets and liabilities held at fair value, such as the Group's derivatives, are required to be valued on a more conservative basis than the market value basis set out in IFRS 13. This difference is represented by the prudent valuation adjustment above, calculated using the 'Simplified Approach' set out in the PRA Rulebook.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

32. CAPITAL MANAGEMENT (Continued)

ψ Regulatory deduction where there is insufficient coverage for non-performing exposures required under Article 47(c) of the CRR which remains in force in the UK for the time being under the Brexit arrangements. The amount required at 31 March 2023 was less than £0.1m (30 September 2022: less than £0.1m).

ϕ The PRA Rulebook restricts the amount of tier 2 capital which is eligible for regulatory purposes to 25% of TCR.

The TRE amount calculated under the PRA Rulebook framework against which this capital is held, and the proportion of these assets it represents, are calculated as shown below.

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Credit risk				
Balance sheet assets	6,690.6	6,362.5	6,652.1	6,073.5
Off balance sheet	72.9	92.0	85.4	143.9
IFRS 9 transitional relief	13.3	21.9	25.8	29.7
Total credit risk	6,776.8	6,476.4	6,763.3	6,247.1
Operational risk	633.1	576.0	633.1	576.0
Market risk	-	-	-	-
Other	70.0	43.3	118.6	13.7
Total risk exposure ('TRE')	7,479.9	7,095.7	7,515.0	6,836.8
Solvency ratios	**%**	**%**	**%**	**%**
CET1	15.6%	15.4	16.3	15.4
TRC	17.7%	17.5	18.3	17.6

This table is not covered by the Independent Review Report

The risk weightings for credit risk exposures are currently calculated using the Standardised Approach. The Basic Indicator Approach is used for operational risk.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

32. CAPITAL MANAGEMENT (Continued)

On a fully loaded basis (excluding the effect of IFRS 9 transitional relief) the Group's capital ratios would be:

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
CET1 Capital	1,170.4	1,092.4	1,221.8	1,055.8
Add back: IFRS 9 relief	(13.3)	(21.9)	(25.8)	(29.7)
Fully loaded CET1 Capital	1,157.1	1,070.5	1,196.0	1,026.1
TRC	1,320.4	1,242.4	1,371.8	1,205.8
Add back: IFRS 9 relief	(13.3)	(21.9)	(25.8)	(29.7)
Fully loaded TRC	1,307.1	1,220.5	1,346.0	1,176.1
Total risk exposure	7,479.9	7,095.7	7,515.0	6,836.8
Add back: IFRS 9 relief	(13.3)	(21.9)	(25.8)	(29.7)
Fully loaded TRE	7,466.6	7,073.8	7,489.2	6,807.1
Fully loaded solvency ratios	%	%	%	%
CET1	15.5	15.1	16.0	15.1
TRC	17.5	17.3	18.0	17.3

This table is not covered by the Independent Review Report

The TRC at 31 March 2023 on the fully loaded basis of £1,307.1m (31 March 2022: £1,220.5m, 30 September 2022: £1,346.0m) was in excess of the TCR of £656.6m (31 March 2022: £623.9m, 30 September 2022: £658.4m) on the same basis (amounts not covered by the Independent Review Report).

The table below shows the calculation of the UK leverage ratio, based on the consolidated balance sheet assets adjusted as required. The PRA has proposed a minimum UK leverage ratio of 3.25% for UK firms with retail deposits of over £50.0 billion. In addition, in October 2021 the PRA stated its expectation that all other UK firms should manage their leverage risk so that this ratio does not ordinarily fall below 3.25%.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

32. CAPITAL MANAGEMENT (Continued)

	Note	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Total balance sheet assets		17,320.4	15,751.0	16,653.6	15,137.0
Add Credit fair value adjustments on loans to customers	12	318.9	151.5	559.9	-
Debit fair value adjustments on retail deposits	20	37.8	30.9	99.7	3.0
Adjusted balance sheet assets		17,677.1	15,933.4	17,313.2	15,140.0
Less: Derivative assets	18	(511.2)	(201.7)	(779.0)	(44.2)
Central bank deposits	11	(2,087.1)	(1,265.7)	(1,612.5)	(1,142.0)
Cash Ratio Deposits		(32.9)	(27.6)	(30.2)	(23.7)
Accrued interest on sovereign exposures		(2.1)	(0.4)	(1.0)	-
On-balance sheet items		15,043.8	14,438.0	14,890.5	13,930.1
Less: Intangible assets	19	(170.5)	(170.1)	(170.2)	(170.5)
Pension surplus	23	(10.4)	(4.4)	(7.1)	-
Software relief		-	-	-	1.4
Total on balance sheet exposures		14,862.9	14,263.5	14,713.2	13,761.0
Regulatory exposure for derivatives		279.1	-	434.7	-
Derivative assets	18	-	201.7	-	44.2
Potential future exposure on derivatives		-	29.4	-	36.3
Total derivative exposures		279.1	231.1	434.7	80.5
Post offer pipeline at gross notional amount		986.7	1,322.2	1,307.9	1,380.3
Adjustment to convert to credit equivalent amounts		(819.9)	(1,110.4)	(1,094.1)	(1,128.3)
Off balance sheet items		166.8	211.8	213.8	252.0
Tier 1 capital		1,170.4	1,092.4	1,221.8	1,055.8
Total leverage exposure before IFRS 9 relief		15,308.8	14,706.4	15,361.7	14,093.5
IFRS 9 relief		13.3	21.9	25.8	29.7
Total leverage exposure		15,322.1	14,728.3	15,387.5	14,123.2
UK leverage ratio		7.6%	7.4%	7.9%	7.5%

This table is not covered by the Independent Review Report

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

32. CAPITAL MANAGEMENT (Continued)

The fully loaded leverage ratio is calculated as follows:

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Fully loaded tier 1 capital	1,157.1	1,070.5	1,196.0	1,026.1
Total leverage exposure before IFRS 9 relief	15,308.8	14,706.4	15,361.7	14,093.5
Fully loaded UK leverage exposure	7.6%	7.3%	7.8%	7.3%

This table is not covered by the Independent Review Report

Following regulatory changes introduced from 1 January 2022, the Group calculates regulatory exposure on derivatives using the Standardised Approach for Counterparty Credit Risk ('SA-CCR'), which includes elements based on the market value of derivative assets adjusted for collateral, amongst other things, and based on potential future exposure in respect of all derivatives held. In previous years the Mark-to-Market approach was used, however this is no longer available.

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

Capital requirements in subsidiary entities

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

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

RoTE is defined by the Group by comparing the profit after tax for the period, adjusted for amortisation charged on intangible assets, to the average of the opening and closing equity positions, excluding intangible assets and goodwill.

It effectively reflects a return on equity as if all intangible assets are eliminated immediately against reserves. As this is similar to the approach used for the capital of financial institutions it is widely used in the sector.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

32. CAPITAL MANAGEMENT (Continued)

The Group's consolidated annualised RoTE for the six months ended 31 March 2023 is derived as follows:

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
Profit for the period	37.9	109.1	313.6	164.5
Amortisation of intangible assets	1.0	1.0	2.0	2.0
Adjusted profit	38.9	110.1	315.6	166.5
Divided by				
Opening equity	1,417.3	1,241.9	1,241.9	1,156.0
Opening intangible assets	(170.2)	(170.5)	(170.5)	(170.1)
Opening tangible equity	1,247.1	1,071.4	1,071.4	985.9
Closing equity	1,360.4	1,279.7	1,417.3	1,241.9
Closing intangible assets	(170.5)	(170.1)	(170.2)	(170.5)
Closing tangible equity	1,189.9	1,109.6	1,247.1	1,071.4
Average tangible equity	1,218.5	1,090.5	1,159.3	1,028.7
Return on tangible equity	6.4%	20.2%	27.2%	16.2%

This table is not covered by the Independent Review Report

(c) 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. In addition to the payment of dividends, the Board may also consider whether it is appropriate to apply excess capital in the market purchase of the Group's shares.

The distributable reserves of the Company comprise its profit and loss account balance and, other than the requirement for Paragon Bank PLC to retain an appropriate level of regulatory capital, there are no restrictions preventing profits elsewhere in the Group from being distributed to the parent.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

32. CAPITAL MANAGEMENT (Continued)

Since the year ended 30 September 2018, the Company has adopted a policy of paying out approximately 40% of its basic earnings per share as dividend (a dividend cover ratio of around 2.5 times), in the absence of any idiosyncratic factors which might make such a dividend inappropriate. This policy is reviewed by the Board at least annually. The Company considers it has access to sufficient cash resources to pay dividends at this level and that its distributable reserves are abundant for this purpose.

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

To determine whether the application of this policy in the current year was appropriate the Board considered the Group's capital position and forecast capital requirements based on its strategic outlook, supported by the half-yearly reforecasting exercise.

This included considering the capital impacts of stress testing carried out as part of both the forecasting and ICAAP processes, and the potential impact of ongoing developments in the regulatory regime for capital, including the introduction in the UK of Basel 3.1. This analysis also took account of Covid-related impacts on the relative size of interim and final dividends in recent years and the desire to normalise the ongoing relationship between the half year and final payments. Based on these considerations the Board concluded that a one-off enhancement to the interim dividend could be made in the current year and declared an interim dividend for the period of 11.0p per share (2022 H1: 9.4p per share). It also confirmed that the Group's normal approach of paying an interim dividend of 50% of the preceding year's final dividend would continue to apply in future years.

During the period the share buy-back programme announced during the 2022 financial year was completed under an irrevocable authority put in place in September 2022. A buy-back programme for the current financial year, for up to £50.0m of ordinary shares, was announced at the time of the Group's 2022 results announcement. The amount expended in these programmes, which were completed before the period end, was £61.2m (note26).

As part of its half year consideration of capital, the Board of Directors authorised an extension of the current year's buy-back programme of up to £50.0m. All shares acquired in buy-back programmes are initially held in treasury.

The directors have considered the distributable reserves of the Company and concluded that these distributions are appropriate.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

33. CREDIT RISK

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

The Group's loan assets at 31 March 2023, 31 March 2022 and 30 September 2022 are analysed below.

	31 March 2023		31 March 2022		30 September 2022	
	£m	%	£m	%	£m	%
Buy-to-let mortgages	12,383.3	85.1%	11,833.1	85.0%	12,086.0	85.1%
Owner occupied mortgages	32.5	0.2%	41.6	0.3%	36.4	0.2%
Total first charge residential mortgages	12,415.8	85.3%	11,874.7	85.3%	12,122.4	85.3%
Second charge mortgage loans	177.5	1.2%	241.9	1.8%	206.3	1.4%
Loans secured on residential property	12,593.3	86.5%	12,116.6	87.1%	12,328.7	86.7%
Development finance	765.8	5.3%	672.9	4.8%	719.9	5.1%
Loans secured on property	13,359.1	91.8%	12,789.5	91.9%	13,048.6	91.8%
Asset finance loans	519.1	3.6%	430.3	3.1%	498.8	3.5%
Motor finance loans	286.3	1.9%	238.0	1.7%	261.3	1.8%
Aircraft mortgages	32.5	0.2%	26.7	0.2%	33.7	0.3%
Secured RLS and CBILS	56.5	0.4%	67.4	0.5%	65.1	0.4%
Structured lending	174.2	1.2%	171.7	1.2%	178.7	1.3%
Invoice finance	24.4	0.2%	24.1	0.2%	25.7	0.2%
Total secured loans	14,452.1	99.3%	13,747.7	98.8%	14,111.9	99.3%
Professions finance	65.4	0.5%	49.5	0.4%	60.9	0.4%
Unsecured RLS, CBILS and BBLS	19.8	0.1%	26.9	0.2%	22.9	0.2%
Other unsecured commercial loans	17.6	0.1%	14.0	0.1%	14.6	0.1%
Unsecured consumer loans	-	-	76.8	0.5%	-	-
Total loans to customers	14,554.9	100.0%	13,914.9	100.0%	14,210.3	100.0%

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

33. CREDIT RISK (Continued)

First and second charge mortgages are secured by charges over residential properties in England and Wales, or similar Scottish or Northern Irish securities.

Development finance loans are secured by a first charge (or similar Scottish security) over the development property and various charges over the build.

Asset finance loans and motor finance loans are effectively secured by the financed asset, while aircraft mortgages are secured by a charge on the aircraft funded.

Structured lending and invoice finance balances are effectively secured over the assets of the customer, with security enhanced by maintaining balances at a level less than the total amount of the security (the advance percentage).

Professions finance are generally short-term unsecured loans made to firms of lawyers and accountants for working capital purposes.

Loans made under the Recovery Loan Scheme ('RLS'), the Coronavirus Business Interruption Loan Scheme ('CBILS') and the Bounce Back Loan Scheme ('BBLS') have the benefit of a guarantee underwritten by the UK Government.

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

There are no significant concentrations of credit risk to individual counterparties due to the large number of customers included in the portfolios. All lending is to customers within the UK. The total gross carrying value of the Group's Loans to Customers due from customers with total portfolio exposures over £10.0m is analysed below by product type.

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Buy-to-let mortgages	167.1	152.0	151.9
Development finance	354.8	231.7	306.9
Structured lending	172.8	166.8	179.4
Asset finance	12.5	-	-
	707.2	550.5	638.2

The threshold of £10.0m is used internally for monitoring large exposures.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

33. CREDIT RISK (Continued)

Credit grading

An analysis of the Group's loans to customers by absolute level of credit risk at 31 March 2023 is set out below. The analysed amount represents gross carrying amount.

	Stage 1 £m	Stage 2 £m	Stage 3 £m	POCI £m	Total £m
31 March 2023					
Very low risk	11,251.5	164.1	1.6	7.6	11,424.8
Low risk	2,042.5	392.0	55.0	1.5	2,491.0
Moderate risk	132.1	153.9	8.9	2.3	297.2
High risk	35.3	85.9	11.4	3.5	136.1
Very high risk	44.4	34.3	77.5	8.8	165.0
Not graded	102.5	1.7	3.1	1.7	109.0
Total gross carrying amount	13,608.3	831.9	157.5	25.4	14,623.1
Impairment	(21.6)	(7.0)	(34.8)	(4.8)	(68.2)
Total loans to customers	13,586.7	824.9	122.7	20.6	14,554.9
31 March 2022					
Very low risk	10,127.4	678.5	1.4	38.4	10,845.7
Low risk	1,684.4	733.0	81.7	13.9	2,513.0
Moderate risk	160.2	96.0	5.8	18.6	280.6
High risk	41.5	24.0	8.2	18.2	91.9
Very high risk	48.3	28.2	49.2	15.6	141.3
Not graded	86.0	1.2	6.2	4.2	97.6
Total gross carrying amount	12,147.8	1,560.9	152.5	108.9	13,970.1
Impairment	(20.3)	(6.4)	(28.1)	(0.4)	(55.2)
Total loans to customers	12,127.5	1,554.5	124.4	108.5	13,914.9
30 September 2022					
Very low risk	10,270.3	846.7	1.1	9.2	11,127.3
Low risk	1,563.9	932.0	63.6	1.9	2,561.4
Moderate risk	118.6	114.1	4.3	2.5	239.5
High risk	35.0	34.6	9.7	4.1	83.4
Very high risk	44.4	35.1	42.2	9.3	131.0
Not graded	124.8	1.1	3.5	1.8	131.2
Total gross carrying amount	12,157.0	1,963.6	124.4	28.8	14,273.8
Impairment	(25.5)	(8.0)	(28.5)	(1.5)	(63.5)
Total loans to customers	12,131.5	1,955.6	95.9	27.3	14,210.3

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

33. CREDIT RISK (Continued)

Gradings above are based on credit scorecards or internally assigned risk ratings as appropriate for the individual asset class. These measures are calibrated across product types and used internally to monitor the Group's overall credit risk profile against its risk appetite.

These gradings represent current credit quality on an absolute basis and this may result in assets in higher IFRS 9 stages with low risk grades, especially where a case qualifies through breaching, for example, an arrears threshold but is making regular payments. This will apply especially to Stage 3 cases reported in note 14, other than those shown as 'realisations'.

Examples of these cases include fully up-to-date receiver of rent cases, customers who may be up-to-date on accounts with other lenders creating an overall positive rating, and accounts where the default on the Group's loan has yet to impact on external credit score.

A small proportion of the loan book (0.7%) is classed as 'not graded' above. This rating relates to loans that have been fully underwritten at origination but where the customer falls outside the automated assessment techniques used post-completion. This has been slightly reduced from the 0.9% classified as ungraded at 30 September 2022 principally as a result of mix changes in the portfolio. This disclosure is expected to be developed further in future periods.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

33. CREDIT RISK (Continued)

Credit characteristic by portfolio

Loans secured on residential property

An analysis of the indexed loan-to-value ('LTV') ratio for those loan accounts secured on residential property by value at 31 March 2023 is set out below. LTVs for second charge mortgages are calculated allowing for the interest of the first charge holder, based on the most recent first charge amount held by the Group, while for acquired accounts the effect of any discount on purchase is allowed for.

	31 March 2023		31 March 2022		30 September 2022	
	First Mortgages	Second Charge Mortgages	First Mortgages	Second Charge Mortgages	First Mortgages	Second Charge Mortgages
	%	%	%	%	%	%
LTV ratio						
Less than 70%	75.0	93.4	89.0	94.2	89.2	95.6
70% to 80%	20.5	4.0	9.5	3.4	9.4	2.4
80% to 90%	3.3	1.1	0.3	1.0	0.4	0.8
90% to 100%	0.3	0.4	0.3	0.4	0.3	0.2
Over 100%	0.9	1.1	0.9	1.0	0.7	1.0
	100.0	100.0	100.0	100.0	100.0	100.0
Average LTV ratio	62.4	53.1	59.2	53.2	57.8	50.6
Buy-to-let	62.5		59.2		57.9	
Owner-occupied	40.2		38.9		37.6	

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 a decrease of 5.6% during the six months ended 31 March 2023 and an annual decrease of 3.1% in the year ended 31 March 2023 compared to an increase of 9.5% in the year ended 30 September 2022.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

33. CREDIT RISK (Continued)

The geographical distribution of the Group's residential mortgage assets by gross carrying value is set out below.

	First Charge			Second Charge		
	31 March 2023	31 March 2022	30 September 2022	31 March 2023	31 March 2022	30 September 2022
	%	%	%	%	%	%
East Anglia	3.3	3.3	3.3	3.4	3.3	3.3
East Midlands	5.8	5.5	5.7	6.2	6.2	6.2
Greater London	18.1	18.3	18.2	7.6	7.9	7.8
North	3.5	3.2	3.3	4.2	4.0	4.1
North West	10.3	10.3	10.3	7.6	7.5	7.7
South East	30.7	31.7	31.2	38.1	38.9	38.2
South West	8.8	8.7	8.8	8.3	8.4	8.4
West Midlands	6.2	5.7	5.9	7.3	7.2	7.4
Yorkshire and Humberside	7.7	7.9	7.8	6.1	6.0	6.1
Total England	94.4	94.6	94.5	88.8	89.4	89.2
Northern Ireland	-	0.1	0.1	2.1	1.9	2.0
Scotland	2.5	2.2	2.3	5.5	5.3	5.4
Wales	3.1	3.1	3.1	3.6	3.4	3.4
	100.0	100.0	100.0	100.0	100.0	100.0

Development finance

Development finance loans generally 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. The average loan to gross development value ('LTGDV') ratio for the portfolio at the period end, a measure of security cover, is analysed below.

	31 March 2023		31 March 2022		30 September 2022	
	By value	By number	By value	By number	By value	By number
	%	%	%	%	%	%
LTGDV						
50% or less	10.3	6.6	7.9	5.5	7.9	5.1
50% to 60%	20.5	22.0	21.1	21.1	17.0	21.7
60% to 65%	39.2	35.1	43.4	44.0	45.0	39.1
65% to 70%	21.6	26.3	24.3	25.4	22.2	27.2
70% to 75%	5.5	7.3	1.0	2.2	5.8	6.2
Over 75%	2.9	2.7	2.3	1.8	2.1	0.7
	100.0	100.0	100.0	100.0	100.0	100.0

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

33. CREDIT RISK (Continued)

The average LTGDV cover at the period end was 62.0% (31 March 2022: 62.1%, 30 September 2022: 62.1%).

LTGDV is calculated by comparing the current expected end of term exposure with the latest estimate of the value of the completed development based on surveyors' reports.

At 31 March 2023, the development finance portfolio comprised 259 accounts (31 March 2022: 275, 30 September 2022: 276) with a total carrying value of £765.8m (31 March 2022: £672.9m, 30 September 2022: £719.9m). Of these accounts, 14 were included in Stage 2 at 31 March 2023 (31 March 2022: 4, 30 September 2022: 9), with 7 accounts included as Stage 3 (31 March 2022: 2, 30 September 2022: none). In addition, one acquired account had been classified as POCI (31 March 2022: 1, 30 September 2022: 1). An allowance for these losses was made in the IFRS 3 fair value calculation.

The geographical distribution of the Group's development finance loans by gross carrying value is set out below.

	31 March 2023 %	31 March 2022 %	30 September 2022 %
East Anglia	2.8	2.5	2.8
East Midlands	12.6	9.3	11.7
Greater London	11.5	7.7	10.5
North	1.0	1.2	1.2
North West	0.3	0.9	0.1
South East	42.2	50.5	46.3
South West	16.1	15.2	13.0
West Midlands	5.4	6.6	7.1
Yorkshire and Humberside	6.6	4.9	6.0
Total England	98.5	98.8	98.7
Northern Ireland	-	-	-
Scotland	1.5	1.2	1.3
Wales	-	-	-
	100.0	100.0	100.0

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

33. CREDIT RISK (Continued)

Asset finance and Motor finance

Asset finance customers are generally small or medium sized businesses. The nature of the assets underlying the Group's asset finance lending, including loans financed through CBILS and RLS loans, by gross carrying value is set out below.

	31 March 2023 %	31 March 2022 %	30 September 2022 %
Commercial vehicles	39.7	35.9	37.4
Construction plant	33.2	33.8	33.2
Technology	5.0	4.6	6.1
Manufacturing	5.6	6.7	4.9
Refuse disposal vehicles	3.1	4.2	4.7
Other vehicles	4.8	4.6	3.7
Print and paper	1.2	1.9	2.4
Agriculture	2.2	2.7	1.3
Other	5.2	5.6	6.3
	100.0	100.0	100.0

Motor finance loans are secured over cars, motorhomes and light commercial vehicles and represent exposure to consumers and small businesses.

Structured lending

The Group's structured lending division provides revolving loan facilities to support non-bank lending businesses. Loans are made to a Special Purpose Vehicle ('SPV') company controlled by the customer and effectively secured on the loans made by the SPV. Exposure is limited to a percentage of the underlying assets, providing a buffer against credit loss.

Summary details of the structured lending portfolio are presented below.

	31 March 2023	31 March 2022	30 September 2022	30 September 2021
Number of transactions	8	8	8	8
Total facilities (£m)	220.7	203.0	220.5	185.5
Carrying value (£m)	174.2	171.7	178.7	118.9

The maximum advance under these facilities was generally 80% of the underlying assets, except where loans secured by residential property form the security for the facility, where 90% is permissible.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

33. CREDIT RISK (Continued)

These accounts do not have a requirement to make regular payments, operating on a revolving basis. The performance of each loan is monitored monthly on a case by case basis by the Group's Credit Risk function, assessing compliance with covenants relating to both the customers and the performance and composition of the asset pool. These assessments, which are reported to Credit Committee, are used to inform the assessment of expected credit loss under IFRS 9.

At 31 March 2023 two facilities were identified as Stage 2, with the remainder identified as Stage 1. At March 2022 and 30 September 2022 all facilities were identified as Stage 1.

RLS, CBILS and BBLS

Loans under these schemes have the benefit of guarantees underwritten by the UK Government, which launched them as a response to the impact of Covid on UK SMEs.

CBILS and BBLS were launched in 2020 and remained open for new applications until March 2021. RLS was launched in April 2021 as a successor scheme and has subsequently been extended twice. It is currently expected to be available until June 2024.

The Group offered term loans and asset finance loans under CBIL scheme. Interest and fees are paid by the UK Government for the first twelve months and the government guarantees covers up to 80% of the lender's principal loss after the application of any proceeds from the asset financed (if applicable).

Loans under the BBL scheme are six-year term loans at a standard 2.5% per annum interest rate. The UK Government pays the interest on the loan for the first twelve months and provides lenders with a guarantee covering the whole outstanding balance.

The Group offers term loans and asset finance loans under the RLS. Interest and fees are payable by the customer from inception. The Government guarantee covers up to 80% of the lender's principal loss, after the application of any proceeds from the asset financed (if applicable), on applications received before 1 January 2022 and up to 70% for applications received thereafter.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

33. CREDIT RISK (Continued)

The Group's outstanding RLS, CBILS and BBLS loans at 31 March 2023 were:

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
RLS			
Term loans	0.9	0.3	0.6
Asset finance	37.8	39.1	41.5
Total RLS	38.7	39.4	42.1
CBILS			
Term loans	15.4	22.1	18.3
Asset finance	18.7	28.3	23.6
Total CBILS	34.1	50.4	41.9
BBLS	3.5	4.5	4.0
Total	76.3	94.3	88.0
Total term loans	19.8	26.9	22.9
Total asset finance	56.5	67.4	65.1
	76.3	94.3	88.0

At 31 March 2023, £0.7m of this balance was considered to be non-performing (31 March 2022: £0.1m, 30 September 2022: £0.6m).

Unsecured consumer loans

The Group disposed of almost all its unsecured consumer loan portfolio during the second half of the year ended 30 September 2022. (note 5).

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

33. CREDIT RISK (Continued)

Arrears performance

The number of accounts in arrears by asset class, based on the most commonly quoted definition of arrears for the type of asset, at 31 March 2023, 31 March 2022 and 30 September 2022, compared to the industry averages at those dates published by UK Finance ('UKF') and the Finance and Leasing Association ('FLA'), was:

	31 March 2023 %	31 March 2022 %	30 September 2022 %
First mortgages			
Accounts more than three months in arrears			
Buy-to-let accounts including receiver of rent cases	0.25	0.15	0.15
Buy-to-let accounts excluding receiver of rent cases	0.16	0.11	0.11
Owner-occupied accounts	3.28	4.13	2.79
UKF data for mortgage accounts more than three months in arrears			
Buy-to-let accounts including receiver of rent cases	0.46	0.44	0.41
Buy-to-let accounts excluding receiver of rent cases	0.43	0.42	0.39
Owner-occupied accounts	0.78	0.85	0.80
All mortgages	0.72	0.77	0.72
Second charge mortgage loans			
Accounts more than 2 months in arrears			
All accounts	22.59	20.13	21.33
Post-2010 originations	2.37	1.50	1.88
Legacy cases	25.92	23.89	24.45
Purchased assets	28.98	26.03	27.71
FLA data for second mortgages	6.60	8.10	7.50
Motor finance loans			
Accounts more than 2 months in arrears			
All accounts	1.44	3.37	2.07
Originated cases	1.34	2.20	1.58
Purchased assets	4.28	12.93	8.94
FLA data for consumer point of sale hire purchase	3.70	3.30	3.30
Asset finance loans			
Accounts more than 2 months in arrears	0.17	0.21	0.08
FLA data for business lease/hire purchase loans	0.60	0.90	0.80

No published industry data for asset classes comparable to the Group's other books has been identified. Where revised data at 31 March 2022 or 30 September 2022 has been published by the FLA or UKF, the comparative industry figures above have been amended.

Arrears information is not given for development finance, structured lending or invoice finance activities as the structure of the products means that such a measure is not appropriate.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

33. CREDIT RISK (Continued)

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

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

The figures shown above for second charge mortgages 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.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – CAPITAL AND FINANCIAL RISK
For the six months ended 31 March 2023 (Unaudited)

33. CREDIT RISK (Continued)

Acquired assets

In the debt purchase industry, Estimated Remaining Collections ('ERCs') 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 (which will be treated as POCI under IFRS 9) but is less applicable for some 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 IFRS 9 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 ERCs value for the Group's purchased consumer assets are set out below. These are derived from the same models and assumptions used in the effective interest rate calculations. ERCs are set out both for all purchased consumer portfolios and for those classified as POCI under IFRS 9.

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m	30 September 2021 £m
All purchased consumer assets				
Carrying value	65.4	164.3	75.3	185.2
84 month ERCs	76.4	195.3	88.6	221.2
120 month ERCs	82.5	212.3	94.2	245.2
POCI assets only				
Carrying value	18.6	102.2	21.4	113.2
84 month ERCs	25.3	127.8	29.9	143.9
120 month ERCs	29.7	142.3	33.0	163.4

Amounts shown include loans disclosed as loans to customers (note 12). They include first mortgages, second charge mortgages, and, in amounts shown at 31 March 2022 and 30 September 2021, unsecured consumer loans. The year-on-year reduction primarily reflects the disposal of the Group's unsecured consumer lending assets (note 5).

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the six months ended 31 March 2023 (Unaudited)

The notes set out below describe the accounting basis on which the Group prepares its accounts, the particular accounting policies adopted by the Group and the principal judgements and estimates which were required in the preparation of the condensed financial information.

They also include other information describing how the condensed financial information has been prepared required by legislation and accounting standards.

34. ACCOUNTING POLICIES

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

The condensed financial statements are required to be prepared on the basis of the accounting policies expected to be used in the production of the financial statements for the year.

The Group is required, by the Companies Act 2006 and the Listing Rules of the FCA, to prepare its financial statements for the year ending 30 September 2023 in accordance with UK-adopted international accounting standards. In the financial years reported on this also means, in the Group's circumstances, that the financial statements also accord with IFRS as approved by the International Accounting Standards Board.

The requirements of UK-adopted IFRS have not changed for the current year and therefore the accounting policies adopted in the current year are the same as those set out in the 2022 Annual Report and Accounts of the Group.

The Group has historically chosen to present an additional comparative balance sheet.

New and revised reporting standards

In the preparation of these consolidated financial statements, no accounting standards are being applied for the first time.

There are no new reporting standards and interpretations in issue but not effective which address matters relevant to the Group's accounting and reporting.

No new or revised reporting standards significantly affecting the Group's accounting have been issued since the approval of the Group's financial statements for the year ended 30 September 2022.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the six months ended 31 March 2023 (Unaudited)

34. ACCOUNTING POLICIES (Continued)

Restatement of segments

Following the sale of a substantial part of the assets of the former Idem Capital segment in the second half of the financial year ended 30 September 2022 (note 5) the remaining segment represented a disproportionately small part of the Group compared to the other two segments. The directors determined it was appropriate to adopt a new segmental analysis, described in note 2 to the 2022 year end accounts, and comparative amounts at 31 March 2022 have been restated for this half year report.

This restatement has no impact on the overall profit, assets and liabilities, equity, capital or cash flows of the Group.

The segmental results of the Idem Capital segment reported for the first half of the 2022 financial year (a profit of £6.6m) and the loan assets of the segment at 31 March 2022 (£196.0m) have been subsumed into the two ongoing segments in the comparative disclosures.

35. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

The critical accounting estimates and judgements affecting the condensed financial information are the same as those described in notes 66 and 67 to the accounts of the Group for the year ended 30 September 2022.

Updated commentary on the critical accounting judgements related to significant increase in credit risk, and the critical accounting estimates related to impairment losses on loans to customers, effective interest rates and impairment of goodwill is set out below.

(a) Significant Increase in Credit Risk ('SICR')

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

As part of its consideration of the adequacy of its impairment provisioning, management have considered whether there are any factors not reflected in its normal approach which indicate that a group, or groups of accounts should be considered as having SICR. No such accounts were identified.

If additional accounts were determined to have an SICR, these balances would attract additional impairment provision, as such cases are provided on the basis of lifetime expected loss, rather the 12-month expected loss, and the overall provision charge would be higher. Conversely, if cases are incorrectly identified as SICR, impairment provisions will be overstated. Furthermore, adjustments to current PD estimates in the Group's models may also have the effect of identifying more or less accounts as having an SICR.

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

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the six months ended 31 March 2023 (Unaudited)

35. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (Continued)

(b) Impairment losses on loans to customers

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

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

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

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

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

In evaluating the potential impact of the economic situation at 31 March 2023, this process is made more complex by both the elevated level of uncertainties and the lack of recent experience of similar situations against which to benchmark. At the same time, the level to which economic pressures on customers have yet to manifest themselves in credit metrics is still unclear.

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

In order to provide forward looking economic inputs to the modelling of the ECL, the Group must derive a set of scenarios which are internally coherent. The Group addresses these requirements using four distinct economic scenarios chosen to represent the range of possible outcomes. These scenarios at 31 March 2023 have been derived in light of the current economic situation, modelling a variety of possible outcomes as described in note 16. It should be noted, however, that there remains a significant range of differing opinions amongst economists about the longer-term prospects for the UK, although this has narrowed somewhat over the six-month period.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the six months ended 31 March 2023 (Unaudited)

35. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (Continued)

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

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

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

In addition to uncertainty created by the economic scenarios, the Group recognises that economic situations can arise which lie outside the range of situations considered when it originally derived its IFRS 9 approach to impairment. It is considered that the current forecast scenarios, which include higher rates of interest and inflation than in the historically observed data, represent situations where its models may not be able to fully allow for potential economic impacts on its loan portfolios. It therefore assessed, for each class of asset, whether any adjustment to the normal approach was required to ensure sufficient provision was created and also reviewed other available data, both from account performance and customer feedback to form a view of the underlying reasons for observed customer behaviours and of their future intentions and prospects.

As a result of this exercise additional requirements for provision were identified, to compensate for potential model weakness and to allow for economic pressures in the wider economy which cannot be identified by a modelled approach. By their nature such adjustments are less systematic and therefore subject to a wider range of outturns. The nature and amounts of these judgemental adjustments are set out in note 13.

The position after considering all these matters is set out in notes 13 to 15, together with further information on the Group's approach. The economic scenarios referred to above and their impact on the overall provision are set out in note 16, while sensitivity analyses on impairment provisioning are set out the note 17.

(c) 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, including those relating to early redemption charges. Where an account may have differing interest charging arrangements in different phases of its contractual life, such as accounts which have a fixed mortgage rate for a set period and revert to a variable rate, the behavioural life will have a significant impact on the overall EIR. For each portfolio a model is in place to ensure that income is appropriately spread.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the six months ended 31 March 2023 (Unaudited)

35. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (Continued)

For loan accounts where borrowers typically repay their balances before the contractual repayment date, such as those in the Group's mortgage portfolios the estimated life of the account will be dependent on customer behaviour. The customer may choose to sell their property and redeem the mortgage at any point, but may also choose to refinance their account, if a more attractive alternative is available. The behavioural life of the loan may therefore by influenced by levels of activity in the residential property market, or by the nature and pricing of alternative funding sources, at each point in the loans life and these are likely to vary over time.

The Group models these lives, based on its current expectation of future borrower behaviour, and uses them to determine the correct EIR to be applied to each account. The underlying estimates are based on historical data and reviewed regularly. The accuracy of the EIR applied would therefore be compromised by any differences between actual repayment profiles and those predicted, which in turn would depend directly on customer behaviour.

The Group therefore keeps its models under review and refines its modelling in the light of any emerging deviations from expected behaviour. These are particularly likely where the current or expected economic environment differs from historic scenarios for which relevant data observations are available. This is currently the case, with market mortgage rates at far higher levels than have been seen in many years. In such cases management consider carefully the impacts which any new conditions may have on customer behaviour and reflect them in the model as appropriate, revisiting these assumptions regularly as observable data becomes available, with a detailed exercise to analyse any emerging themes taking place every six months as part of the half year and year end results processes.

For purchased loans the EIR calculation will involve estimating the likely future credit performance of the accounts at the time of acquisition as well as the customers' payment behaviour. In the initial modelling historical data obtained from the vendor will be examined, with assumptions revisited through the asset lives based on actual and expected customer behaviour.

To illustrate the potential impact of variability of the estimate, 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 of the assumed average lives of loans secured on residential property by three months would reduce balance sheet assets by £13.1m (30 September 2022: £13.3m), while an increase of the assumed asset lives of such assets by three months would increase balance sheet assets by £13.1m (30 September 2022: £13.3m).
- An increase of 50% in the number of five year fixed rate buy-to-let loan assets assumed to redeem before the end of the fixed rate period, and therefore generating additional early redemption charges, would increase balance sheet assets by £9.5m (30 September 2022: £8.8m).
- A reduction (or increase) in estimated cash flows from purchased loan assets of 5% would reduce (or increase) balance sheet assets by £1.7m (30 September 2022: £2.0m).

As any of these changes would, in reality, be accompanied by movements in other factors, actual outcomes may differ from these estimates.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the six months ended 31 March 2023 (Unaudited)

35. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (Continued)

(d) Impairment of goodwill

The carrying value of goodwill recognised on acquisitions is validated by use of an impairment test based on the projected cash flows for the CGU, based on management forecasts and other assumptions described in note 19 including a discount factor.

The accuracy of this impairment calculation would be compromised by any differences between the forecasts used and the levels of business activity that the CGU is able to achieve in practice. The potential impacts of Covid scarring and wider economic uncertainties in the UK mean that there is a greater risk of inaccuracy in compiling these forecasts. 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 19.

36. GOING CONCERN BASIS

The condensed financial information for the half year has 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 applicable to half-yearly reporting.

Particular focus is given to the Group's financial forecasts for this period to ensure the adequacy of resources available for the Group to meet its business objectives on both a short-term and strategic basis. The guidance requires that this assessment covers a period of at least twelve months from the date of approval of this half-yearly report.

The business activities of the Group, its current operations and those factors likely to affect its future results and development, together with a description of its financial position and funding position, are described in the Interim Management Report on pages 5 to 68. The principal risks and uncertainties affecting the Group in the forthcoming six months are described on pages 174 to 175.

Note 59 to the 2022 Group Accounts includes an analysis of the Group's regulatory and working capital position and policies, while notes 60 to 63 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, market and liquidity risk. Notes 66 and 67 to those accounts discusses critical accounting judgements and estimates affecting the results and financial position disclosed therein. The position and policies described in these notes remain materially unchanged to the date of this half-yearly report, subject to the changes in funding described in note 21.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the six months ended 31 March 2023 (Unaudited)

36. GOING CONCERN BASIS (Continued)

Financial forecasts

The Group has a formalised process of budgeting, reporting and review. The Group's planning procedures forecast its profitability, capital position, funding requirement and cash flows. Detailed 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 forecast is updated every six months, and the directors have based their going concern assessment of the reforecast for the period beginning on 1 April 2023.

The Group makes extensive use of stress testing in compiling and reviewing its forecasts. This stress testing approach was recently reviewed in detail as part of the annual Internal Capital Adequacy Assessment Process ('ICAAP') cycle, where testing considered the impact of a number of severe but plausible scenarios. During the planning process, sensitivity analysis was carried out on a number of key assumptions that underpin the forecast to evaluate the impact of the Group's principal risks.

The key stresses modelled in detail to evaluate the forecast were:

- An increase in buy-to-let volumes. This examined the impact of higher volumes at a reduced yield on profitability and illustrated the extent to which capital resources and liquidity would be stretched due to the higher cash and capital requirements
- Higher funding costs – higher cost on all new savings deposits, both front book and back book throughout the forecast horizon. This scenario illustrates the impact of a significant, prolonged margin squeeze on profitability, and whether this would cause significant impacts on any capital, liquidity or encumbrance ratios
- Higher buy-to-let redemption rates for buy-to-let mortgages reaching the end of their fixed rate period. This illustrates the potential risk inherent in the five-year fixed rate business
- Increased economic stress on customers. As well as modelling the impact of each of the economic scenarios set out in note 16 across the forecast horizon, the severe economic scenario was also modelled over the five-year horizon. To ensure this represented a worst-case scenario all other assumptions were held steady, although in reality adjustments to new business appetite and other factors would be made
- Combined downside stress - the half-year IFRS 9 downside economic scenario described in note 16 was modelled out for the plan horizon along with a plausible set of other adverse factors to the business model, creating a prolonged tail-risk

These stresses did not take account of management actions which might mitigate the impact of the adverse assumptions used. They were designed to demonstrate how such stresses would affect the Group's financing, capital and liquidity positions and highlight any areas which might impact the Group's going concern status. Under all of these scenarios, the Group was able to meet its obligations over the forecast horizon and maintain a surplus over its regulatory requirements for both capital and liquidity through normal balance sheet management activities.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the six months ended 31 March 2023 (Unaudited)

36. GOING CONCERN BASIS (Continued)

As part of the ICAAP process the Group also assessed the potential operational risks it could face. This was done through the analysis of the impact and cost of a series of severe but plausible scenarios. This analysis did not highlight any factors which cast doubt on the Group's ability to continue as a going concern.

The Group began the forecast period with a strong capital and liquidity position enabling the management of any significant outflows of deposits and / or reduced inflows from customer receipts. Overall, the forecasts, even under reasonable further levels of stress show the Group retaining sufficient equity, capital, cash and liquidity throughout the forecast period to satisfy its regulatory and operational requirements.

Availability of funding and liquidity

The availability of funding and liquidity is a key consideration, including retail deposit, wholesale funding, central bank and other contingent liquidity options.

The Group's retail deposits of £11,875.9m (note 20) are repayable within five years, with 80.9% (£9,608.9m) of this balance payable within twelve months of the balance sheet date. The liquidity exposure represented by these deposits is closely monitored, a process supervised by the Asset and Liability Committee. The Group is required to hold liquid assets in Paragon Bank to mitigate this liquidity risk. At 31 March 2023, Paragon Bank held £1,944.3m of balance sheet assets for liquidity purposes, all of which comprised central bank deposits (note 11). A further £150.0m of liquidity was provided by the long/short repo arrangement described in the Group's 2022 Annual Report and Accounts. This brings the total available to £2,094.3m.

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') updated annually. The Bank maintains a liquidity framework that includes a short to medium-term cash flow requirement analysis, a longer-term funding plan and access to the Bank of England's liquidity insurance facilities, where pre-positioned assets would support further drawings of £944.5m. Holdings of the Group's own externally rated mortgage backed loan notes can also be used to access the Bank of England's liquidity facilities or other funding arrangements. At 31 March 2023 the Group had £1,226.7m (30 September 2022: £455.2m) of such notes available for use, of which £984.6m were rated AAA (30 September 2022: £213.6m). The available AAA notes would give access to £772.9m (30 September 2022: £171.6m) if used to support drawings on Bank of England facilities.

The Group's securitisation funding structures provide match funding for part of the asset base. Repayment of the securitisation borrowings is restricted to funds generated by the underlying assets and there is limited recourse to the Group's general funds. Recent and current loan originations are financed through retail deposits and may be refinanced through securitisation where this is appropriate and cost-effective. While the Group has not accessed the public securitisation market in the period, the market remains active and the Group maintains the infrastructure required to access it.

The earliest maturity of any of the Group's working capital debt is in August 2024, when a retail bond issue of £112.5m matures. All central bank borrowings mature in 2025.

SELECTED NOTES TO THE ACCOUNTS – BASIS OF PREPARATION

For the six months ended 31 March 2023 (Unaudited)

36. GOING CONCERN BASIS (Continued)

The Group's access to debt is also enhanced by its BBB+ corporate rating, confirmed by Fitch Ratings in February 2023, and its status as an issuer is evidenced by the BBB-, investment grade, rating of its £150.0m Tier-2 Bonds. It has regularly accessed the capital markets for warehouse funding and corporate and retail bonds over recent years and continues to be able to access these markets. The Group has access to the short-term repo market which it accesses from time to time.

The Group's cash analysis which includes the impact of all scheduled debt and deposit repayments, continues to show a strong free cash position, even after allowing scope for significant discretionary payments and capital distributions.

As described in note 32, the Group's capital base is subject to consolidated supervision by the PRA. Its capital at 31 March 2023 was in excess of regulatory requirements and the Group's forecasts indicate that this will continue to be the case.

Going Concern assessment

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

After performing this assessment, the directors concluded that there was no material uncertainty as to whether the Group would be able to maintain adequate capital and liquidity for at least twelve months following the date of approval of this half-yearly report and consequently that it was appropriate for them to continue to adopt the going concern basis in preparing the half-yearly financial information for the Group.

37. FINANCIAL ASSETS AND FINANCIAL LIABILITIES

The Group's financial assets and financial liabilities are valued on one of two bases, defined by IFRS 9:

- Financial assets and liabilities carried at fair value through profit and loss ('FVTPL')
- Financial assets and liabilities carried at amortised cost

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

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the six months ended 31 March 2023 (Unaudited)

37. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (Continued)

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

The Group had no financial assets or liabilities in the period ended 31 March 2023 or the year ended 30 September 2022 carried at fair value and valued using level 3 measurements, other than contingent consideration amounts (note 22).

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

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

(a) Assets and liabilities carried at fair value

The following table summarises the Group's financial assets and liabilities which are carried at fair value.

	Note	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Financial assets				
Derivative financial assets	18	511.2	201.7	779.0
		511.2	201.7	779.0
Financial liabilities				
Derivative financial liabilities	18	51.3	32.5	102.1
Contingent consideration	22	-	1.9	2.2
		51.3	34.4	104.3

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 market interest rate, adjusted for risk as appropriate. The principal inputs to these valuation models are SONIA (and formerly LIBOR) sterling benchmark interest rates.

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 18.

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the six months ended 31 March 2023 (Unaudited)

37. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

Contingent consideration

The value of contingent consideration balances shown in note 22 are required to be stated at fair value in the accounts. These amounts are valued based on the expected outcomes of the performance tests set out in respective sale and purchase agreements, discounted as appropriate. The most significant inputs to these valuations are the Group's forecasts on future activity relating to business generated by operational units acquired, business derived as a result of the vendor's contacts or other goodwill, and any other new business flows which are or might be attributable to the acquisition agreement, which are drawn from the overall Group forecasting model. As such, these are classified as unobservable inputs and the valuations classified as level 3 measurements.

(b) Assets and liabilities carried at amortised cost

The fair values for financial assets and liabilities held at amortised cost, determined in accordance with the methodologies set out in this note are summarised below.

	31 March 2023		31 March 2022		30 September 2022	
	Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m
Financial assets						
Cash	2,275.4	2,275.4	1,500.4	1,500.4	1,930.9	1,930.9
Loans to customers	14,554.9	14,276.6	13,914.9	13,966.9	14,210.3	13,898.4
Sundry financial assets	39.9	39.9	32.2	32.2	35.4	35.4
	16,870.2	16,591.9	15,447.5	15,499.5	16,176.6	15,864.7
Financial liabilities						
Short term bank borrowings	0.2	0.2	0.4	0.4	0.4	0.4
Asset backed loan notes	289.8	289.8	477.1	477.1	409.3	409.3
Secured bank borrowings	341.8	341.8	871.3	871.3	586.0	586.0
Retail deposits	11,875.9	11,799.6	9,853.7	9,844.1	10,669.2	10,592.9
Corporate and retail bonds	261.6	244.4	261.3	275.2	261.5	254.4
Other financial liabilities	393.4	393.4	131.7	131.7	491.2	491.2
	13,162.7	13,069.2	11,595.5	11,599.8	12,417.6	12,334.2

CONDENSED FINANCIAL STATEMENTS

SELECTED NOTES TO THE ACCOUNTS – BASIS OF PREPARATION
For the six months ended 31 March 2023 (Unaudited)

37. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (CONTINUED)

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.

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.

Loans to customers

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 3 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 withdrawal rates. Given the mixture of observable and non-observable inputs, these are considered to be level 3 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.

These assets and liabilities are of relatively low value and may be settled at their carrying value at the balance sheet date or shortly thereafter.

ADDITIONAL FINANCIAL INFORMATION (APPENDICIES)

For the six months ended 31 March 2023 (not covered by the Independent Review Report)

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

A. UNDERLYING PROFIT

The Group reports underlying profit excluding fair value accounting adjustments arising from its hedging arrangements and certain one-off items of income and costs relating to asset sales and acquisitions.

The fair value adjustments arise principally as a result of market interest rate movements, outside the Group's control. They are profit neutral over time and are not included in operating profit for management reporting purposes. They are also disregarded by many external analysts.

The transactions relating to the asset disposals and acquisitions do not form part of the day-to-day activities of the Group and, therefore, their removal provides greater clarity on the Group's operational performance.

This definition of 'underlying' has been chosen following consideration of the needs of investors and analysts following the Group's shares, and because management feel it better represents the underlying economic performance of the Group's business.

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Profit on ordinary activities before tax	46.4	143.6	417.9
Add back: Fair value adjustments	82.5	(38.1)	(191.9)
Profit on disposal of loans	-	-	(4.6)
Underlying profit	128.9	105.5	221.4

Underlying basic earnings per share, calculated on the basis of underlying profit adjusted for tax, is derived as follows:

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Underlying profit	128.9	105.5	221.4
Tax on underlying result	(30.5)	(23.9)	(51.8)
Underlying earnings	98.4	81.6	169.6
Basic weighted average number of shares (note 10)	231.7	245.7	242.7
Underlying earnings per share	42.5p	33.2p	69.9p

ADDITIONAL FINANCIAL INFORMATION (APPENDICIES)

For the six months ended 31 March 2023 (not covered by the Independent Review Report)

A. UNDERLYING PROFIT (CONTINUED)

For the six months ended 31 March 2023 and the year ended 30 September 2022 tax on underlying profit has been calculated based on the effective rate which would result from the exclusion of the adjusting items from the corporation tax calculation. This gives an effective tax rate of 23.7% for the six months ended 31 March 2023 (30 September 2022: 23.4%). The underlying result for the six months ended 31 March 2022 has been recalculated on the same basis, using an underlying effective tax rate of 22.7%.

Underlying return on tangible equity is derived using underlying earnings calculated on the same basis shown above. Tangible equity is calculated excluding the impacts of fair value hedging. This approach was adopted in the 2022 year end reporting for the first time, due to the materiality of the balance sheet effect of the hedges. The underlying RoTE for the six months ended 31 March 2022 has been restated accordingly.

	Note	Six months to 31 March 2023 £m	Six months to 31 March 2022 £m	Year to 30 September 2022 £m
Underlying earnings		98.4	81.6	169.6
Amortisation of intangible assets		1.0	1.0	2.0
Adjusted underlying earnings		99.4	82.6	171.6
Opening underlying tangible equity				
Equity		1,417.3	1,241.9	1,241.9
Intangible assets	19	(170.2)	(170.5)	(170.5)
Balance sheet impact of fair values	18	(216.7)	(8.8)	(8.8)
Deferred tax thereon		53.2	(2.2)	(2.2)
		1,083.6	1,060.4	1,060.4
Closing underlying tangible equity				
Equity		1,360.4	1,279.7	1,417.3
Intangible assets	19	(170.5)	(170.1)	(170.2)
Balance sheet impact of fair values	18	(178.8)	(48.6)	(216.7)
Deferred tax thereon		31.2	8.2	53.2
		1,042.3	1,069.2	1,083.6
Average underlying tangible equity		1,062.9	1,064.8	1,072.0
Annualised underlying RoTE		18.7%	15.5%	16.0%

ADDITIONAL FINANCIAL INFORMATION (APPENDICIES)

For the six months ended 31 March 2023 (not covered by the Independent Review Report)

B. INCOME STATEMENT RATIOS

Net interest margin ('NIM') and cost of risk (impairment charge as a percentage of average loan balance) for the Group and its segments are calculated as shown. Not all net interest is allocated to segments and therefore total segment net interest in these tables will not equal net interest for the Group (see note 2).

Six months to 31 March 2023

	Mortgage Lending £m	Commercial Lending £m	Total £m
Opening loans to customers (note 12)	12,328.7	1,881.6	14,210.3
Closing loans to customers (note 12)	12,593.3	1,961.6	14,554.9
Average loans to customers	12,461.0	1,921.6	14,382.6
Net interest (note 2)	133.5	67.4	212.4
NIM (annualised)	2.14%	7.01%	2.95%
Impairment provision charge (note 2)	5.4	2.1	7.5
Cost of risk (annualised)	0.09%	0.22%	0.10%

Six months to 31 March 2022

	Mortgage Lending £m	Commercial Lending £m	Total £m
Opening loans to customers (note 12)	11,829.6	1,573.1	13,402.7
Closing loans to customers (note 12)	12,193.4	1,721.5	13,914.9
Average loans to customers	12,011.5	1,647.3	13,658.8
Net interest (note 2)	120.1	52.7	175.2
NIM (annualised)	2.00%	6.40%	2.57%
Impairment provision charge / (release) (note 2)	(1.9)	3.2	1.3
Cost of risk (annualised)	(0.03)%	0.39%	0.02%

ADDITIONAL FINANCIAL INFORMATION (APPENDICIES)

For the six months ended 31 March 2023 (not covered by the Independent Review Report)

B. INCOME STATEMENT RATIOS (Continued)

Year to 30 September 2022

	Mortgage Lending £m	Commercial Lending £m	Total £m
Opening loans to customers (note 12)	11,829.6	1,573.1	13,402.7
Closing loans to customers (note 12)	12,328.7	1,881.6	14,210.3
Average loans to customers	12,079.2	1,727.3	13,806.5
Net interest (note 2)	251.2	111.2	371.2
NIM	2.08%	6.44%	2.69%
Impairment provision charge (note 2)	4.6	9.4	14.0
Cost of risk	0.04%	0.54%	0.10%

C. COST:INCOME RATIO

Cost:income ratio is derived as follows:

	31 March 2023	31 March 2022	30 September 2022
Operating expenses (£m)	83.8	74.9	153.0
Total operating income (£m)	220.2	181.7	393.0
Cost / Income	38.1%	41.2%	38.9%

Underlying cost: income ratio is derived as follows:

	31 March 2023 £m	31 March 2022 £m	30 September 2022 £m
Cost – as above	83.8	74.9	153.0
Income – as above	220.2	181.7	393.0
Less: profit on disposal of loans	-	-	(4.6)
	220.2	181.7	388.4
Underlying cost: income ratio	38.1%	41.2%	39.4%

ADDITIONAL FINANCIAL INFORMATION (APPENDICIES)

For the six months ended 31 March 2023 (not covered by the Independent Review Report)

D. NET ASSET VALUE

	Note	31 March 2023	31 March 2022	30 September 2022
Total equity (£m)		1,360.4	1,279.7	1,417.3
Outstanding issued shares (m)	24	241.5	250.5	241.4
Treasury shares (m)	26	(14.9)	(5.0)	(3.6)
Shares held by ESOP schemes (m)	26	(4.1)	(4.0)	(3.9)
		222.5	241.5	233.9
Net asset value per £1 ordinary share		£6.11	£5.30	£6.06
Tangible equity (£m)	32	1,189.9	1,109.6	1,247.1
Tangible net asset value per £1 ordinary share		£5.35	£4.59	£5.33

PRINCIPAL RISKS AND UNCERTAINTIES

There are a number of potential risks and uncertainties which could have a material impact on the Group's performance over the remaining six months of the financial year and could cause actual results to differ materially from expected and historical results. The uncertainties around the longer-term impacts of the pandemic continue to be identified and assessed but overall in the opinion of the directors these have not changed materially from those described in Section A2.2 of the Annual Report and Accounts of the Group for the year ended 30 September 2022.

The development of these risks in the six months and the risk areas of greatest concern are described in section 6.5 of this report.

The principal risks are summarised below.

- **Capital risk** -The risk that there is or will be insufficient capital for the Group to operate effectively including meeting minimum regulatory requirements, operating within board approved risk appetite and supporting its strategic goals
- **Liquidity and funding risk** - The risk that the Group has insufficient financial resources to enable it to meet its obligations as they fall due, cannot raise or maintain sufficient funds to finance its future plans, or can only secure such resources at excessive cost, and / or encumbrance.
- **Credit risk** - The risk of financial loss arising from a customer or financial counterparty failing to meet their obligations to the Group when they fall due or a change in the credit quality of the third party or instrument. This includes the risk of losses arising from customers' inability to make payments on their accounts and the risk of realisations from security assets being less than anticipated.
- **Market risk** - The risk of changes in the net value of, or net income arising from, assets and liabilities in the Group's banking book from adverse movements in market prices.
- **Model risk** - The risk that the Group may make incorrect decisions based on the output of internal models, due to errors in the development, implementation or use of such models resulting in a loss or misreporting within financial statements. This may relate to the design and operation of models or the selection of input assumptions.
- **Reputational risk** - The risk of negative consequences arising from a failure to meet the expectations and standards of the Group's customers, investors, regulators or other counterparties whilst undertaking business activities
- **Strategic risk -** The risk that the corporate plan does not fully align to, and support, the Group's strategic priorities or is not executed effectively as a result of external factors, incorrect planning assumptions or insufficient or inadequate resources
- **Climate change risk** - The risk of climate changes impacting the Group either directly or indirectly through its third-party relationships. This includes the transitional risk to its strategy and profile through moving to a low carbon operating environment and any physical risks to the business or its assets arising from changes to the natural environment

PRINCIPAL RISKS AND UNCERTAINTIES

- **Conduct risk** - The risk that the Group designs, prices and sells products that could cause foreseeable harm to its customers, or which fail to deliver fair value and enable customers to pursue their financial objectives. This includes risks relating to communications with customers, dealing with customers who may be vulnerable and arrears handling, and the Group's obligations under the new FCA Consumer Duty
- **Operational risk** - The risk of financial and non- financial detriment resulting from inadequate or failed internal procedures, people and systems or from external events. This includes risks relating to the Group's IT systems, cyber security and data handling; compliance with legal and regulatory requirements; procedures for the prevention and detection of money laundering and other financial crime; and the Group's resilience planning and business continuity arrangements

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

CAUTIONARY STATEMENT

Sections of this Half-yearly Report, including but not limited to the Interim Management Report may contain forward-looking statements with respect to certain of the plans and current goals and expectations relating to the future financial condition, business performance and results of the Group. These statements can be identified by the fact that they do not relate strictly to historical or current facts. They use words such as ‘anticipate’, ‘estimate’, ‘expect’, ‘intend’, ‘will’, ‘project’, ‘plan’, ‘believe’, ‘target’ and other words and terms of similar meaning in connection with any discussion of future operating or financial performance but are not the exclusive means of identifying such statements. These have been made by the directors in good faith using information available up to the date on which they approved this report, and the Group undertakes no obligation to update or revise these forward-looking statements for any reason other than in accordance with its legal or regulatory obligations (including under the UK Market Abuse Regulation, UK Listing Rules and the Disclosure Guidance and Transparency Rules of the Financial Conduct Authority (‘FCA’)).

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 that could cause actual results or events to differ materially from those expressed or implied by the forward-looking statements. There are also 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. As a result, you are cautioned not to place reliance on such forward-looking statements as a prediction of actual results or otherwise.

These factors include, but are not limited to: material impacts related to foreign exchange fluctuations; macro-economic activity; the impact of outbreaks, epidemics or pandemics, and the extent of their impact on overall demand for the Group’s services and products; potential changes in dividend policy; changes in government policy and regulation (including the monetary, interest rate and other policies of central banks and other regulatory authorities in the principal markets in which the Group operates) and the consequences thereof; actions by the Group’s competitors or counterparties; third party, fraud and reputational risks inherent in its operations; the UK’s exit from the EU; unstable UK and global economic conditions and market volatility, including currency and interest rate fluctuations and inflation or deflation; the risk of a global economic downturn; acts of terrorism and other acts of hostility or war and responses to, and consequences of, those acts; technological changes and risks to the security of IT and operational infrastructure, systems, data and information resulting from increased threat of cyber and other attacks; general changes in government policy that may significantly influence investor decisions (including, without limitation, actions taken in support of managing and mitigating climate change and in supporting the global transition to net zero carbon emissions); societal shifts in customer financing and investment needs; and other risks inherent to the industries in which the Group operates.

Nothing in this Half-yearly Report should be construed as a profit forecast.