

**PARAGON MORTGAGES (NO. 9) PLC**

**Report and Financial Statements**

**Year ended 30 September 2007**

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## **DIRECTORS' REPORT**

The directors present their annual report and the audited financial statements for the year ended 30 September 2007

### **BUSINESS REVIEW AND PRINCIPAL ACTIVITIES**

The Company is a wholly owned subsidiary of The Paragon Group of Companies PLC ('the Group') and was set up to provide finance for its mortgage loan assets, by issuing mortgage backed floating rate loan notes and using the proceeds to purchase mortgage loans from other Group companies

Its principal activities are the provision of first mortgage loans. There have been no significant changes in the Company's principal activities in the year under review. The directors are not aware, at the date of this report, of any likely major changes in the Company's activities in the next year.

As shown in the Company's profit and loss account on page 5, the Company's net interest income decreased by 4% over the prior year. This was principally due to a fall in the mortgage loan book during the year, although the majority of the decline in the mortgage loan book happened at the end of the current year. Profit after tax has fallen from £2,411,000 to £1,911,000.

The balance sheet on page 6 of the financial statements shows that the Company's financial position at the year end. Loans to customers has decreased by 25% due to customers redeeming their accounts during the year. As a result the asset backed loan notes have reduced by 20% during the year. Details of amounts owed from and to other group companies are shown in notes 14 and 18.

The company has entered into derivative contracts in order to provide an economic hedge against its exposure to fixed rate loans to customers. Although these instruments provide an economic hedge the prescriptive nature of the requirements of FRS 26 means that hedge accounting cannot always be achieved. This has led to the company recognising a fair value net gain of £730,000, in the year (2006 £152,000). This represents a timing difference and cumulative gains and losses recognised will tend to zero over time.

The Group manages its operations on a centralised basis. For this reason, the Company's directors believe that further key performance indicators for the Company are not necessary or appropriate for an understanding of the development, performance or position of the business. The performance of the Group's mortgage lending operation, which includes the Company, is discussed in the Group's Annual Report, which does not form part of this Report.

### **INDEPENDENT FUNDING AND OPERATING ARRANGEMENTS**

The consolidated financial statements of The Paragon Group of Companies PLC for the year ended 30 September 2007, approved by the Group directors on 22 November 2007, indicated a material uncertainty relating to Group funding arrangements and in particular a proposed rights issue. The proposed rights issue received shareholder approval on 28 January 2008.

In assessing the appropriateness of the going concern assumption for this subsidiary company, the directors have given consideration to the independent funding of the company, and its ability to continue operations independently of the Group. The Company's assets are match funded to maturity, with the cash payments that the Company can be required to make limited to the cash available within the Company, and there are agreements in place for the provision of stand-by operating arrangements with a financial institution, to enable the Company to continue trading, should the current Group operating arrangements run into financial or other difficulties.

Accordingly the directors have concluded that there is no material uncertainty relating to the funding or operations of the Company. For this reason the directors consider that the going concern assumption remains appropriate in preparing the financial statements of the Company.

### **PRINCIPAL RISKS AND UNCERTAINTIES**

The Company is a securitisation company and has been structured so as to avoid, in as far as is possible all forms of financial risk. An analysis of the Company's exposure to risk, including financial risk, is set out in note 3.

**DIRECTORS' REPORT (CONTINUED)**

**ENVIRONMENT**

The Group recognises the importance of its environmental responsibilities, monitors its impact on the environment, and designs and implements policies to reduce any damage that might be caused by the Group's activities. The Company operates in accordance with Group policies, which are described in the Group's Annual Report which does not form part of this Report.

**EMPLOYEES**

The Company has no employees. All operational services are provided by employees of the Group. The Group's employment policies are described in its annual report which does not form part of this report.

**DIRECTORS**

The directors throughout the year and subsequently were

N Keen  
R D Shelton  
J G Gemmell  
A Mehmet  
J P J Fairrie (resigned 20 July 2007)  
M H Filer (appointed 26 July 2007)

**CREDITOR PAYMENT POLICY**

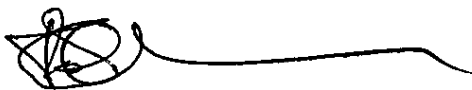
The Company agrees terms and conditions with its suppliers. Payment is then made on the terms agreed, subject to the appropriate terms and conditions being met by the supplier. The trade creditor days figure has not been stated as the measure is not appropriate to the business.

**AUDITORS**

The directors have taken all necessary steps to make themselves and the Company's auditors aware of any information needed in preparing the audit of the Annual Report and Financial Statements for the year, and, as far as each of the directors is aware, there is no relevant audit information of which the auditors are unaware.

A resolution for the re-appointment of Deloitte & Touche LLP as the auditors of the Company is to be proposed at the forthcoming Annual General Meeting.

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



J G Gemmell  
Secretary,  
28 January 2008

**STATEMENT OF DIRECTORS' RESPONSIBILITIES**

**in relation to Financial Statements**

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). The financial statements are required by law to give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing these financial statements, the directors are required to

- select suitable accounting policies and then apply them consistently,
- make judgments and estimates that are reasonable and prudent,
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements,
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

## **INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF PARAGON MORTGAGES (NO. 9) PLC**

We have audited the financial statements of Paragon Mortgages (No 9) PLC for the year ended 30 September 2007 which comprise the profit and loss account, the balance sheet, the statement of total recognised gains and losses, the statement of movement in shareholders' funds and the related notes 1 to 21. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the company's members, as a body, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

### **Respective responsibilities of directors and auditors**

The directors' responsibilities for preparing the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements.

In addition we report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read the Directors' Report and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies within it.

### **Basis of audit opinion**

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

### **Opinion**

In our opinion:

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the company's affairs as at 30 September 2007 and of its profit for the year then ended,
- the financial statements have been properly prepared in accordance with the Companies Act 1985, and
- the information given in the Directors' Report is consistent with the financial statements.

*Neil K. Lunn. LLP*

**Deloitte & Touche LLP**

Chartered Accountants and Registered Auditors

Birmingham, United Kingdom

28 January 2008

# PARAGON MORTGAGES (NO. 9) PLC

## PROFIT AND LOSS ACCOUNT

Year ended 30 September 2007

	Note	2007 £000	2006 £000
Interest receivable			
Mortgages		38,024	40,033
Other		3,985	1,321
		<u>42,009</u>	<u>41,354</u>
Interest payable and similar charges	4	(36,176)	(35,275)
Net interest income		<u>5,833</u>	<u>6,079</u>
Other operating income		719	297
Total operating income		<u>6,552</u>	<u>6,376</u>
Operating expenses		(4,427)	(2,995)
Provisions for losses	6	(324)	(89)
		<u>1,801</u>	<u>3,292</u>
Fair value net gain	7	730	152
Operating profit, being profit on ordinary activities before taxation	8	<u>2,531</u>	<u>3,444</u>
Tax on profit on ordinary activities	9	(620)	(1,033)
Profit on ordinary activities after taxation	16	<u><u>1,911</u></u>	<u><u>2,411</u></u>

All activities derive from continuing operations

# PARAGON MORTGAGES (NO. 9) PLC


## BALANCE SHEET

30 September 2007

	Note	£000	2007 £000	£000	2006 £000
<b>ASSETS EMPLOYED</b>					
<b>FIXED ASSETS</b>					
Financial assets	10		472,586		623,399
<b>CURRENT ASSETS</b>					
Debtors falling due within one year	14	3,701		151	
Investments		37,000		18,040	
Cash at bank		10,651		8,803	
			51,352		26,994
			523,938		650,393
<b>FINANCED BY</b>					
<b>SHAREHOLDERS' FUNDS</b>					
Called up share capital	15	12		12	
Cash flow hedge reserve	16	(61)		(71)	
Profit and loss account	16	5,595		3,684	
			5,546		3,625
<b>PROVISIONS FOR LIABILITIES AND CHARGES</b>					
	17		1,944		1,340
<b>CREDITORS</b>					
Amounts falling due within one year	18	10,019		9,570	
Amounts falling due after more than one year	18	506,429		635,858	
			516,448		645,428
			523,938		650,393

These financial statements were approved by the Board of Directors on 28 January 2008

Signed on behalf of the Board of Directors



R D Shelton  
Director

# **PARAGON MORTGAGES (NO. 9) PLC**

## **STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES**

**Year ended 30 September 2007**

	<b>Note</b>	<b>2007 £000</b>	<b>2006 £000</b>
Profit attributable to members of the Company		1,911	2,411
Cash flow hedge gain / (loss) taken to equity		10	(2)
Tax on items taken directly to equity		-	-
Total recognised gains and losses for the year		<u>1,921</u>	<u>2,409</u>
Change in accounting policy on adoption of FRS 25 and FRS 26	16	<u>-</u>	<u>1,564</u>
Total Gains and losses recognised since last Annual Report and Financial Statements		<u><u>1,921</u></u>	<u><u>3,973</u></u>

## **STATEMENT OF MOVEMENT IN SHAREHOLDERS' FUNDS**

	<b>Note</b>	<b>2007 £000</b>	<b>2006 £000</b>
Profit attributable to shareholders		1,911	2,411
Dividends		-	(500)
Cash flow hedge gain / (loss) taken to equity		10	(2)
Net movement in shareholders' funds		<u>1,921</u>	<u>1,909</u>
Change in accounting policy on adoption of FRS 25 and FRS 26	16	<u>-</u>	<u>1,564</u>
Opening shareholders' funds		<u>3,625</u>	<u>152</u>
Closing shareholders' funds		<u><u>5,546</u></u>	<u><u>3,625</u></u>

## NOTES TO THE ACCOUNTS

**Year ended 30 September 2007**

### **1 ACCOUNTING POLICIES**

The financial statements are prepared in accordance with applicable UK accounting standards. The particular accounting policies adopted are described below. They have been applied consistently throughout the current and preceding year.

#### **Independent funding and operating arrangements**

The consolidated financial statements of The Paragon Group of Companies PLC for the year ended 30 September 2007, approved by the Group directors on 22 November 2007, indicated a material uncertainty relating to Group funding arrangements and in particular a proposed rights issue. The proposed rights issue received shareholder approval on 28 January 2008.

In assessing the appropriateness of the going concern assumption for this subsidiary company, the directors have given consideration to the independent funding of the company, and its ability to continue operations independently of the Group. The Company's assets are match funded to maturity, with the cash payments that the Company can be required to make limited to the cash available within the Company, and there are agreements in place for the provision of stand-by operating arrangements with a financial institution, to enable the Company to continue trading, should the current Group operating arrangements run into financial or other difficulties.

Accordingly the directors have concluded that there is no material uncertainty relating to the funding or operations of the Company. For this reason the directors consider that the going concern assumption remains appropriate in preparing the financial statements of the Company.

#### **Accounting convention**

The financial statements are prepared under the historical cost convention, except as required in the valuation of certain financial instruments which are carried at fair value.

#### **Loans to customers**

Loans to customers are considered to be 'loans and receivables' as defined by Financial Reporting Standard 26 – 'Financial Instruments: Measurement' (FRS 26). They are therefore accounted for on the amortised cost basis.

Such loans are valued at inception as amount of initial advance, which is the fair value at that time, inclusive of procurement fees paid to brokers or other business providers and less initial fees paid by the customer. Thereafter they are valued at this amount less the cumulative amortisation calculated using the Effective Interest Rate ('EIR') method. The loan balances are then reduced where necessary by a provision for balances which are considered to be impaired.

The EIR method spreads the expected net income arising from a loan over its expected life. The EIR is that rate of interest which, at inception, exactly discounts the expected future cash payments and receipts arising from the loan to the initial carrying amount.

The Company's policy is to hedge against any exposure to fixed rate loan assets.

#### **Impairment of loans and receivables**

Loans and receivables are reviewed for indications of possible impairment throughout the year and at each balance sheet date, in accordance with FRS 26. Where loans exhibit objective evidence of impairment, the carrying value of the loans is reduced to the net present value of their expected future cash flows, including the value of the potential realisation of any security, discounted at the original EIR. Loans are assessed collectively, compared by risk characteristics and account is taken of any impairment arising due to events which are believed to have taken place but have not been specifically identified at the balance sheet date.

#### **Current assets - investments**

Balances shown as current asset investments in the balance sheet comprise short-term deposits with banks with maturities of more than 7 days and not more than 90 days.

**NOTES TO THE ACCOUNTS**

**Year ended 30 September 2007**

**1. ACCOUNTING POLICIES (CONTINUED)**

**Transactions with other Group companies**

The Company has taken advantage of the exemption granted by Financial Reporting Standard 8 - 'Related Party Disclosures' and does not therefore provide details of transactions with other Group companies as it is a wholly owned subsidiary of The Paragon Group of Companies PLC, the accounts of which are publicly available

**Current tax**

Current tax, including UK corporation, is provided at amounts expected to be paid (or recovered) using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date

**Deferred taxation**

Deferred taxation is provided in full on timing differences that result in an obligation at the balance sheet date to pay more tax, at a future date, at rates expected to apply when they crystallise based on current tax rates and law. Timing differences arise from the inclusion of items of income and expenditure in taxation computations in periods different from those in which they are included in financial statements. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recovered. Deferred tax assets and liabilities are not discounted.

**Borrowings**

Borrowings are carried in the balance sheet on the amortised cost basis. The initial value recognised includes the principal amount received less any discount on issue or costs of issuance.

Interest and all other costs of the funding are expensed to the profit and loss account as interest payable over the term of the borrowing on an Effective Interest Rate basis.

**Derivative financial instruments**

Derivative instruments utilised by the Company comprise currency swaps and interest rate swaps. All such instruments are used for hedging purposes to alter the risk profile of the existing underlying exposure of the Company in line with the Company's risk management policies.

The Company does not enter into speculative derivative contracts.

All derivatives are carried in the balance sheet at fair value, as assets where the value is positive or as liabilities where the value is negative. Fair value is based on market prices, where a market exists. If there is no active market, fair value is calculated using present value models which incorporate assumptions based on market conditions and are consistent with accepted economic methodologies for pricing financial instruments. Changes in the fair value of derivatives are recognised in the profit and loss account, except where such amounts are permitted to be taken to equity as part of the accounting for a cash flow hedge.

**NOTES TO THE ACCOUNTS**

**Year ended 30 September 2007**

**1. ACCOUNTING POLICIES (CONTINUED)**

**Hedging**

For all hedges, the Company documents, at inception, the relationship between the hedging instruments and the hedged items, as well as its risk management strategy and objectives for undertaking the transaction. The Company also documents its assessment, both at hedge inception and on an ongoing basis, of whether the hedging arrangement put in place are considered to be 'highly effective' as defined by FRS 26.

For a fair value hedge, as long as the hedging relationship is deemed 'highly effective' and meets the hedging requirements of FRS 26, any gain or loss on the hedging instrument recognised in income can be offset against the fair value loss or gain arising from the hedged item for the hedged risk. For macro hedges (hedges of interest rate risk for a portfolio of loan assets) this fair value adjustment is disclosed in the balance sheet alongside the hedged item, for other hedges the adjustment is made to the carrying value of the hedged asset or liability. Only the net ineffectiveness of the hedge is charged or credited to income. Where a fair value hedge relationship is terminated, or deemed ineffective, the fair value adjustment is amortised over the remaining term of the underlying item.

Where a derivative is used to hedge the variability of cash flows of an asset or liability, it may be designated as a cash flow hedge so long as this relationship meets the hedging requirements of FRS 26. For such an instrument the effective portion of the change in the fair value of the derivative is taken initially to equity, with the ineffective part taken to profit or loss. The amount taken to equity is released to the profit and loss account at the same time as the hedged item affects the profit and loss account. Where a cash flow hedge relationship is terminated, or deemed ineffective, the amount taken to equity will remain there until the hedged transaction is recognised, or is no longer highly probable.

**Fee and commission income**

Other income includes administration fees charged to borrowers, which are credited when the related service is performed.

**Foreign currency**

Foreign currency transactions, assets and liabilities are accounted for in accordance with Financial Reporting Standard 23 – 'The Effects of Changes in Foreign Exchange Rates'. The functional currency of the Company is pound sterling. Transactions which are not denominated in sterling are translated into sterling at the spot rate of exchange on the date of the transaction. Monetary assets and liabilities which are not denominated in sterling are translated at the closing rate on the balance sheet date.

Gains and losses on retranslation are included in interest payable or interest receivable depending on whether the underlying instrument is an asset or a liability, except where deferred in equity in accordance with cash flow hedging provisions of FRS 26.

**Cashflow statement**

The Company has taken advantage of the exemption granted by Financial Reporting Standard 1 - 'Cashflow Statements' and does not therefore provide a cashflow statement as it is a wholly owned subsidiary of The Paragon Group of Companies PLC, the accounts of which are publicly available.

**NOTES TO THE ACCOUNTS**

**Year ended 30 September 2007**

**2. CRITICAL ACCOUNTING ESTIMATES**

Certain balances reported in the financial statements are based wholly or in part on estimates or assumptions made by the directors. There is, therefore, a potential risk that they may be subject to change in future periods. The most significant of these are

**Impairment losses on loans to customers**

Impairment losses on loans are calculated based on statistical models. The key assumptions revolve around estimates of future cash flows from customer's accounts, their timing and, for secured accounts, the expected proceeds from the realisation of the property. 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 the current conditions.

The accuracy of the impairment calculations would therefore be affected by unexpected changes to the economic situation, variances between the models used and the actual results or assumptions which differ from the actual outcomes.

In particular, if the impact of economic factors such as employment levels on customers is worse than is implicit in the model then the number of accounts requiring provision might be greater than suggested by the model, while falls in house prices, over and above any assumed by the model might increase the provision required in respect of accounts currently provided.

**Effective interest rates**

In order to determine the effective interest rate applicable to loans an estimate must be made of the expected life of each loan and hence the cash flows relating thereto. These estimates are based on historical data and reviewed regularly. The accuracy of the effective interest rate applied would therefore be compromised by any differences between actual borrower behaviour and that predicted.

**Fair values**

Where financial assets and liabilities are carried at fair value, in the majority of cases this can be derived by reference to quoted market prices. Where such a quoted price is not available the valuation is based on 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.

**NOTES TO THE ACCOUNTS**

**Year ended 30 September 2007**

**3. FINANCIAL RISK MANAGEMENT**

The Company's operations are financed principally by floating rate, asset backed loan notes and, to a lesser extent, by a mixture of share capital and loans from other group companies. The Company issues financial instruments to finance the acquisition of its portfolio of loans to customers and uses derivative financial instruments to hedge interest rate risk arising from fixed rate lending. In addition, various financial instruments, for example debtors, prepayments and accruals, arise directly from the Company's operations.

The principal risks arising from the Company's financial instruments are credit risk, liquidity risk and interest rate risk. The board of the Company's holding company reviews and agrees policies for all companies in the Group managing each of these risks and they are summarised below. These policies have remained unchanged throughout the year and since the year end.

**Credit risk**

The Company's credit risk is primarily attributable to its loans to customers. The maximum credit risk at 30 September 2007 approximates to the carrying value of loans to customers (note 12). There are no significant concentrations of credit risk due to the large number of customers included in the portfolios.

The Company acquired mortgages from Paragon Mortgages Limited and Mortgage Trust Services PLC, fellow group companies which place strong emphasis on good credit management at the time of underwriting new loans.

The acquired mortgages are secured by first charges over residential properties in the United Kingdom. Despite this security, in assessing credit risk an applicant's ability to repay the loan remains the overriding factor in the decision to lend by the originating lender. Additionally, each mortgage has the benefit of one or more life assurance policies and certain mortgages have the benefit of a mortgage guarantee indemnity insurance policy.

Paragon Finance PLC and Mortgage Trust Services PLC continues to administer the mortgages on behalf of Paragon Mortgages (No. 9) PLC and the collections process is the same as that utilised for all companies in the group.

In order to control credit risk relating to counterparties to the Company's financial instruments, the board of the Company's holding company determines on a group basis, which counterparties the group of companies will deal with, establishes limits for each counterparty and monitors compliance with those limits.

**NOTES TO THE ACCOUNTS**

**Year ended 30 September 2007**

**3. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Liquidity risk**

The Company's assets are principally financed by asset backed loan notes issued through the securitisation process. Details of the Company's borrowings are given in note 19. Securitisation effectively eliminates the Company's liquidity risk by matching the maturity profile of the Company's funding to the profile of the assets to be funded.

**Interest rate risk**

The Company's policy is to maintain floating rate liabilities and match these with floating rate assets by the use of interest rate swap or cap agreements.

The rates payable on the asset backed loan notes issued by the Company are reset quarterly on the basis of LIBOR, USD or EURIBOR. The interest rates charged on the Company's variable rate loan assets are determined by reference to, inter alia, the Company's funding costs and the rates being charged on similar products in the market. Generally this ensures the matching of changes in interest rates on the Company's loan assets and borrowings and any exposure arising on the interest rate resets is relatively short term.

In part, the Company's interest rate hedging objectives are achieved by the controlled mismatching of the dates on which instruments mature, redeem or have their interest rates reset. The table below summarises these repricing mismatches. For the purposes of the table, loan assets, borrowings and derivatives are allocated to time bands by reference to the earlier of the next contractual interest rate repricing date and the maturity dates. For those fixed rate loan assets where the customer has contracted to make regular repayments of both capital and interest, the assets have been allocated across the time bands in the table by reference to the contracted repayments. The analysis takes no account of early terminations which are likely to occur in practice. In determining the amount of hedging required, the Company makes assumptions about the level of regular capital repayments and early terminations of its loan assets. The actual interest rate sensitivity will therefore be determined by reference to subsequent customer and management decisions and is expected to be less sensitive than shown.

NOTES TO THE ACCOUNTS

Year ended 30 September 2007

3. FINANCIAL RISK MANAGEMENT (CONTINUED)

	3 months or less	More than 3 months but not more than 6 months	More than 6 months but not more than 1 year	More than 1 year but not more than 5 years	More than 5 years	Non interest bearing	Total
At 30 September 2007	£000	£000	£000	£000	£000	£000	£000
Financial assets	321,562	8,439	67,582	75,003	-	-	472,586
Debtors	-	-	-	-	-	3,701	3,701
Investments	37,000	-	-	-	-	-	37,000
Cash at bank and in hand	10,651	-	-	-	-	-	10,651
Total assets	369,213	8,439	67,582	75,003	-	3,701	523,938
Shareholders' funds	-	-	-	-	-	(5,546)	(5,546)
Asset backed loan notes	(490,907)	-	-	-	-	-	(490,907)
Derivative financial liability	(3,202)	-	-	-	-	-	(3,202)
Subordinated loan	(12,320)	-	-	-	-	-	(12,320)
Other liabilities	-	-	-	-	-	(11,963)	(11,963)
Total liabilities and shareholders' funds	(506,429)	-	-	-	-	(17,509)	(523,938)
Notional swap principal	136,750	(19,000)	(45,230)	(72,520)	-	-	-
Interest rate repricing gap	(466)	(10,561)	22,352	2,483	-	(13,808)	-
Cumulative gap	(466)	(11,027)	11,325	13,808	13,808	-	-

NOTES TO THE ACCOUNTS

Year ended 30 September 2007

3. FINANCIAL RISK MANAGEMENT (CONTINUED)

	3 months or less	More than 3 months but not more than 6 months	More than 6 months but not more than 1 year	More than 1 year but not more than 5 years	More than 5 years	Non interest bearing	Total
<b>At</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>
<b>30 September 2006</b>							
Financial assets	299,690	25,997	186,481	110,440	791	-	623,399
Debtors	-	-	-	-	-	151	151
Investments	18,040	-	-	-	-	-	18,040
Cash at bank and in hand	8,803	-	-	-	-	-	8,803
<b>Total assets</b>	<b>326,533</b>	<b>25,997</b>	<b>186,481</b>	<b>110,440</b>	<b>791</b>	<b>151</b>	<b>650,393</b>
Shareholders' funds	-	-	-	-	-	(3,625)	(3,625)
Asset backed loan notes	(616,666)	-	-	-	-	-	(616,666)
Derivative financial liability	(6,872)	-	-	-	-	-	(6,872)
Subordinated loan	(12,320)	-	-	-	-	-	(12,320)
Other liabilities	-	-	-	-	-	(10,910)	(10,910)
<b>Total liabilities and shareholders' funds</b>	<b>(635,858)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>(14,535)</b>	<b>(650,393)</b>
Notional swap principal	300,980	(7,020)	(187,410)	(105,950)	(600)	-	-
Interest rate repricing gap	(8,345)	18,977	(929)	4,490	191	(14,384)	-
Cumulative gap	(8,345)	10,632	9,703	14,193	14,384	-	-

The Company monitors the interest rate risk exposure on its loan assets and asset backed loan notes and ensures compliance with the requirements of the trustees in respect of the notes

## NOTES TO THE ACCOUNTS

Year ended 30 September 2007

## 3 FINANCIAL RISK MANAGEMENT (CONTINUED)

## Currency risk

All of the Group's assets and liabilities are denominated in sterling with the exception of the asset backed loan notes denominated in euros and US dollars, described in note 19. Although FRS 26 requires that they be accounted for as currency liabilities and valued at their spot rates, it was a condition of the issue of these notes that the interest rate and currency swaps were put in place for the duration of the borrowing, having the effect of converting the liability to a LIBOR linked floating rate sterling borrowing. As a result the Company has no material exposure to foreign currency risk.

The equivalent sterling principal amounts of notes in issue under these arrangements, and their carrying values at 30 September 2007 and 30 September 2006 are

	2007	2007	2006	2006
	Equivalent	Carrying	Equivalent	Carrying
	sterling	value	sterling	value
	principal		principal	
	£000	£000	£000	£000
US dollar notes	22,668	19,805	29,884	28,459
Euro notes	229,091	233,638	281,138	278,047

## Use of derivative financial instruments

The Company uses derivative financial instruments for risk management purposes. Such instruments are used only to limit the exposure of the Company to movements in market interest or exchange rates, as described above.

It is, and has been throughout the year under review, the Company's policy that no trading in financial instruments shall be undertaken, and hence all of the Company's derivative financial instruments are for commercial hedging purposes. These are used to protect the Company from exposures principally arising from fixed rate lending or borrowing and borrowings denominated in foreign currencies. Hedge accounting is applied where appropriate, though it should be noted that some derivatives, while forming part of an economic hedge relationship, do not qualify for this accounting treatment under FRS 26 either because natural accounting offsets are expected, or obtaining hedge accounting would be especially onerous.

The Company has designated a number of derivatives as fair value hedges. In particular this treatment is used for hedging the interest rate risk of groups of fixed rate prepayable loan assets with interest rate derivatives on a portfolio basis. The Company believes this solution is the most appropriate as it is consistent with the economic hedging approach taken by the Company to these assets.

The Company has also designated cash flow hedging relationships, principally arising from currency borrowings, where a specified foreign exchange basis swap, set up as part of the terms of the borrowing is used.

## Fair values of financial assets and financial liabilities

Fair values have been determined for all derivatives, listed securities and any other financial assets and liabilities for which an active and liquid market exists. The fair values of cash at bank and in hand, bank loans and overdrafts and asset backed loan notes are not materially different from their book values because all the assets mature within three months of the year end and the interest rates charged on financial liabilities reset on a quarterly basis.

Derivative financial instruments are stated at their fair values. The fair values of the interest rate swaps and caps have been determined by reference to prices available from the markets on which these instruments are traded.

The fair value of loans to customers is considered to be not materially different to the amortised cost value at which they are disclosed.

NOTES TO THE ACCOUNTS

Year ended 30 September 2007

4. INTEREST PAYABLE AND SIMILAR CHARGES

	2007	2006
	£000	£000
Asset backed loan notes	34,483	33,537
Internal funding costs	282	268
Interest on fee letter	234	310
Interest rate swap	-	67
Subordinated loan interest	1,177	1,093
	<u>36,176</u>	<u>35,275</u>

5. DIRECTORS AND EMPLOYEES

Directors' remuneration from the Company during the year is stated in note 8

The only employees during the year or the preceding year were the directors as disclosed on page 2

6. PROVISIONS FOR LOSSES

	2007	2006
	£000	£000
Impairment of financial assets		
First mortgage loans	<u>324</u>	<u>89</u>

7. FAIR VALUE NET GAIN

The fair value net gain of £730,000 (2006 £152,000) represents the accounting volatility on derivative instruments which are matching risk exposure on an economic basis. 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 gain is primarily due to timing differences in income recognition between the derivative instruments and the economically hedged assets and liabilities.

NOTES TO THE ACCOUNTS

Year ended 30 September 2007

8. OPERATING PROFIT, BEING PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION

	2007 £000	2006 £000
Operating profit is after charging		
Directors' fees	4	5
Auditors' remuneration – audit services	7	7

Non audit fees provided to the group are disclosed in the accounts of the parent company and the exemption from disclosure of fees payable to the Company's auditors in respect on non-audit services in these financial statements has been taken

9. TAX ON PROFIT ON ORDINARY ACTIVITIES

a) Tax charge for the year

	2007 £000	2006 £000
Current tax		
Corporation tax	16	362
Deferred tax (note 17)		
Origination and reversal of timing differences	743	671
Rate change	(139)	-
	604	671
	620	1,033

b) Factors affecting the current tax charge

	£000	£000
Profit before tax	2,531	3,444
UK corporation tax at 30% (2006 30%) based on the profit for the year	759	1,033
Effects of		
Movement on short term timing differences	(743)	(671)
	16	362

The United Kingdom government has enacted provisions reducing the standard rate of corporation tax to 28% with effect from 1 April 2008. Therefore the standard rate of corporation tax applicable to the Group will be 29% in the year ending 30 September 2008 and 28% thereafter. The expected impact of this change on the values at which deferred tax amounts are expected to crystallise has been accounted for in the year

NOTES TO THE ACCOUNTS

Year ended 30 September 2007

10. FINANCIAL ASSETS

	2007	2006
	£000	£000
Loans to customers (note 12)	468,781	622,932
Fair value adjustments from portfolio hedging	(157)	(1,098)
Derivative financial assets (note 13)	3,962	1,565
	<u>472,586</u>	<u>623,399</u>

11. LOANS AND RECEIVABLES

Loans and receivables at 30 September 2007 and 30 September 2006, which are all denominated and payable in sterling, were first mortgages which are secured on residential property within the United Kingdom

Mortgage loans have a contractual term of up to thirty years, the borrower is entitled to settle the loan at any point and in most cases such settlement does take place. All borrowers are required to make monthly payments, except where an initial deferred period is included in the contractual terms.

The average rate of interest being charged on customer accounts and the average rate at which income is being recognised under the effective interest rate method at 30 September 2007 and 30 September 2006 was,

	Average rate charged to customers		Average effective interest rate	
	2007	2006	2007	2006
Mortgage loans	6.13%	5.72%	6.8%	6.14%

The interest rate repricing profile of the above loans is shown in note 3. All the mortgage loans are pledged as collateral for liabilities at 30 September 2007 and 30 September 2006.

12. LOANS TO CUSTOMERS

These comprise mortgage loans secured on residential properties in the United Kingdom and are categorised as loans and receivables as defined by FRS 26 (note 11).

	2007	2006
	£000	£000
Balance at 1 October 2006	622,932	682,699
Adoption of FRS 25 and 26	-	2,330
Additions	12,413	20,628
Other debits	39,041	40,827
Repayments and redemptions	(205,605)	(123,552)
Balance at 30 September 2007	<u>468,781</u>	<u>622,932</u>

Other debits include primarily interest charged to customers on loans outstanding, impairment movements on these loans and other changes in the amortised cost of the assets caused by the effective interest rate method.

NOTES TO THE ACCOUNTS

Year ended 30 September 2007

13. DERIVATIVE FINANCIAL ASSETS AND LIABILITIES

All of the Company's financial derivatives are held for economic hedging purposes, although not all may be designated for hedge accounting in accordance with the provisions on FRS 26. The analysis below therefore splits derivatives between those accounted for as hedges and those which, while representing an economic hedge do not qualify for this treatment.

	2007	2007	2007	2006	2006	2006
	Notional	Assets	Liabilities	Notional	Assets	Liabilities
	amount			amount		
	£000	£000	£000	£000	£000	£000
<b>Derivatives in accounting hedge relationships</b>						
<i>Fair value hedges</i>						
Interest rate swaps	-	-	-	298,978	1,559	(175)
	-	-	-	298,978	1,559	(175)
<i>Cash flow hedges</i>						
Foreign exchange basis swaps	251,759	2,543	(3,058)	311,022	-	(6,671)
Interest swaps	-	-	-	1,000	6	-
	251,759	2,543	(3,058)	312,022	6	(6,671)
	251,759	2,543	(3,058)	611,000	1,565	(6,846)
<b>Other derivatives</b>						
Interest rate swaps	138,049	1,419	(144)	2,399	-	(26)
<b>Total recognised derivative assets / (liabilities)</b>	<b>389,808</b>	<b>3,962</b>	<b>(3,202)</b>	<b>613,399</b>	<b>1,565</b>	<b>(6,872)</b>

14. DEBTORS

	2007	2006
	£000	£000
Amounts falling due within one year		
Amounts due from Group companies	3,552	109
Prepayments and accrued income	149	42
	<u>3,701</u>	<u>151</u>

The fair value of the above items are not considered to be materially different to their carrying values.

NOTES TO THE ACCOUNTS

Year ended 30 September 2007

15. CALLED UP SHARE CAPITAL

	2007 £	2006 £
Authorised		
50,000 ordinary shares of £1 each	50,000	50,000
Allotted		
49,998 ordinary shares of £1 each (25p called up and paid)	12,500	12,500
2 ordinary shares of £1 each (fully paid)	2	2
	12,502	12,502

16. RESERVES

	Profit and loss account £000	Cash flow hedge reserve £000	Total reserves £000
At 30 September 2005	140	-	140
FRS 25 and 26 transition	2,330	(98)	2,232
Deferred tax on FRS 25 and 26 adjustments	(697)	29	(668)
Change of accounting policy on adoption of FRS 25 and 26	1,633	(69)	1,564
At 1 October 2005	1,773	(69)	1,704
Profit for the financial year	2,411	-	2,411
Movement in fair value of hedging derivatives	-	(2)	(2)
Dividend	(500)	-	(500)
At 30 September 2006	3,684	(71)	3,613
Profit for the financial year	1,911	-	1,911
Movement in fair value of hedging derivatives	-	10	10
At 30 September 2007	5,595	(61)	5,534

An interim dividend of £nil per share was paid during the year (2006 £10.00 per share) No final dividend is proposed (2006 £nil)

NOTES TO THE ACCOUNTS

Year ended 30 September 2007

17. PROVISIONS FOR LIABILITIES AND CHARGES

Deferred tax

The movements in the net liability for deferred tax are as follows,

	2007 £000	2006 £000
Balance at 1 October 2006	1,340	-
Adoption of FRS 25 and 26	-	669
Charge to equity	-	-
Profit and loss charge	743	671
Rate change (note 9)	(139)	-
Balance at 30 September 2007	<u>1,944</u>	<u>1,340</u>

The net deferred tax liability for which provision has been made is analysed as follows

Other timing differences	<u>1,944</u>	<u>1,340</u>
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The deferred tax which arose on adoption of FRS 25 and FRS 26 includes £635,000 relating to the changes in carrying value of loan assets on the adoption of the effective interest rate method and the FRS 26 rules on impairment and £34,000 arising on the recognition of financial derivatives at fair value

NOTES TO THE ACCOUNTS

Year ended 30 September 2007

18. CREDITORS

	2007 £000	2006 £000
Amounts falling due within one year		
Amounts due to Group companies	5,341	4,449
Corporation tax	10	423
Accruals and deferred income	4,668	4,698
	<u>10,019</u>	<u>9,570</u>

Included with the accruals and deferred income is an amount of £439,000 (2006 £490,000) due to fellow subsidiaries of The Paragon Group of Companies PLC

	2007 £000	2006 £000
Amounts falling due after more than one year		
Asset backed loan notes	490,907	616,666
Derivative financial liabilities (note 13)	3,202	6,872
Intercompany subordinated loan	12,320	12,320
	<u>506,429</u>	<u>635,858</u>

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

A maturity analysis and further details of the asset backed loan notes are given in note 19.

## NOTES TO THE ACCOUNTS

### Year ended 30 September 2007

#### 19. BORROWINGS

The Mortgage Backed Floating Rate Notes are secured over a portfolio comprising variable rate mortgage loans secured by first charges over residential properties in the United Kingdom. The Notes are subject to mandatory redemption in part on each interest payment Date in an amount equal to the principal received or recovered in respect of the mortgage. The maturity date of the notes matches the maturity date of the underlying assets. It is likely that a substantial proportion of these notes will be repaid within five years.

The Company has the option to repay all of the notes at an earlier date (the 'call date'), at the outstanding principal amount.

Interest is payable at a fixed margin above

- the London Interbank Offered Rate ('LIBOR') on notes denominated in sterling,
- the London Interbank Offered Rate ('US Dollar LIBOR') on notes denominated in US dollars, and
- the Euro Interbank Offered Rate ('EURIBOR') on notes denominated in euros

The margin has a step-up to a higher rate from May 2010.

All payments in respect of the notes are required to be made in the currency in which they are denominated.

Notes in issue at 30 September 2007 and 30 September 2006 were

Notes	Maturity date	Call date	Principal outstanding		Note margin	
			2007	2006	Current	Step up
			£m	£m		
'Aa'	May 2041	May 2009	231.4	305.0	0.18%	0.36%
'Ba'	May 2041	May 2009	7.0	7.0	0.29%	0.58%
'Ca'	May 2041	May 2009	3.0	3.0	0.52%	1.04%
			\$m	\$m		
'Ac'	May 2041	May 2009	40.1	52.9	0.18%	0.36%
			€m	€m		
'Ab'	May 2041	May 2009	237.4	312.9	0.18%	0.36%
'Bb'	May 2041	May 2009	29.5	29.5	0.29%	0.58%
'Cb'	May 2041	May 2009	66.0	66.0	0.52%	1.04%

There is a Subordinated Loan Facility under which an amount was drawn down by the Company to establish the First Loss Fund, which is repayable to Mortgage Trust Services PLC and Paragon Loan Finance (No. 2) PLC on the earlier of the last Interest Payment Date in May 2041 or the first day on which there are no Notes outstanding, except that on any Interest Payment Date sums borrowed will be repaid to the extent of any amount released from the First Loss Fund. Interest is payable at the rate of 4% above the London Interbank Offered Rate for three month sterling deposits.

There are no amounts of committed but undrawn facilities at 30 September 2007 and September 2006.

**NOTES TO THE ACCOUNTS**

**Year ended 30 September 2007**

**20. ULTIMATE PARENT COMPANY**

The Company's immediate and ultimate parent company and ultimate controlling party is The Paragon Group of Companies PLC, a company registered in England and Wales. Copies of the Company's financial statements are available from that company's registered office at St Catherine's Court, Herbert Road, Solihull, West Midlands, B91 3QE.

**21. ADOPTION OF FRS 25 AND FRS 26**

Details of the impact of the adoption of FRS 25 and FRS 26 with effect from 1 October 2005 are included in note 1 of the annual report and accounts for the year ended 30 September 2006.