Lloyds Banking Group PLC Issuer Rating Report

STABLE OUTLOOK
A+

Overview

On 18 July 2018, Scope took rating actions on the ratings of various Lloyds Banking Group PLC entities to reflect organisational and legal changes made to implement UK ring-fencing requirements. For further details on Scope's views on ring-fencing, please refer to the report *UK Bank Ring-Fencing: Credit and Rating Implications* (February 2018).

Scope assigned a first-time Issuer Rating of A+ to Lloyds Banking Group PLC. Further, the outstanding ratings of Lloyds Banking Group PLC were affirmed: senior unsecured debt (MREL eligible) rating of A and AT1 securities ratings of BB+.

The outstanding ratings of Lloyds Bank PLC were also affirmed: Issuer Rating of A+, senior unsecured debt (not MREL eligible) rating of A+, and short-term debt rating of S-1+. Lloyds Bank PLC is the group's ring-fenced sub-group and comprises the bulk of the group's banking activities.

In addition, a new Issuer Rating of A was assigned to Lloyds Bank Corporate Markets PLC (LBCM), the group's future non-ring-fenced bank. The one-notch differential between LBCM's Issuer Rating and its parent's is based on the former's potentially less central role in the group's strategy and on its inherently more volatile business mix.

Note: The ratings were not solicited by the issuer. Both ratings and analysis are based solely on publicly available information. The issuer has participated in the process.

Highlights

- Lloyds Banking Group PLC (Lloyds) enjoys a leading retail and commercial banking franchise in the UK. The group pursues a multi-brand and multi-channel strategy, maintaining the largest domestic branch network as well as being the largest domestic digital bank. In addition, the group is the only integrated UK banking and insurance provider, with ambitions to further grow in the areas of retirement and investment and general insurance and protection.
- Management over the last several years has substantially reduced the risks (asset quality, funding) stemming from the acquisition of HBOS at the peak of the financial crisis. Lloyds is now a lower-risk UK-focused retail and commercial bank. Legacy issues, primarily PPI and conduct matters, have significantly diminished but continue to affect earnings. We expect these costs to decline further, allowing the group to close the gap between underlying and statutory profitability.
- Due to the group's domestic focus, we cautiously regard the still unknown consequences of the UK's exit from the EU. However, considering the group's strong business franchise and sound financial profile, we see Lloyds being solidly positioned against potential headwinds.

Ratings & Outlook

Issuer Rating	A+
Senior unsecured debt (not MREL eligible) rating (Lloyds Bank PLC)	A+
Senior unsecured debt (MREL eligible) rating	A
Additional Tier 1 securities rating	BB+
Short-term debt rating (Lloyds Bank PLC)	S-1+
Outlook	Stable

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Rating drivers (summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- A strong domestic retail and commercial banking franchise underpinned by a focus on improving the customer experience.
- Management's commitment to a low risk profile.
- Legacy costs continue to hamper performance but are expected to decline.
- Uncertain consequences of the UK's exit from the EU, particularly on the UK economy and housing market.

Rating change drivers

Higher and more stable bottom-line earnings. Over the last few years, the gap between underlying and statutory profitability has decreased, with underlying RoTE at 16.3% and statutory RoTE at 12.1% in 1H 2018. From 2019, Lloyds targets a statutory RoTE of 14% to 15% and a cost income ratio in the low 40s exiting 2020 and including remediation costs.

Change in strategy which materially increases the risk profile of the group, such as the easing of credit standards and disciplined pricing to gain market share, or aggressive expansion in higher risk/return activities such as investment banking or new geographic markets**.**

Failure to effectively manage potential consequences stemming from Brexit. We expect the group's strong franchise and earnings capabilities to withstand a slowdown in the UK economy.

Rating drivers (details)

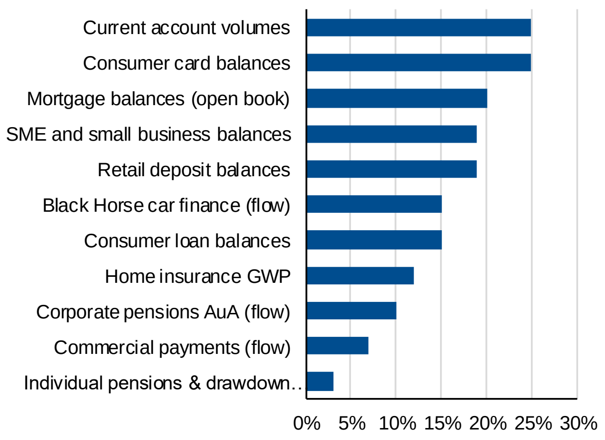
A strong domestic retail and commercial banking franchise underpinned by a focus on improving the customer experience.

Lloyds is a leading retail and commercial bank in the UK, with a multi-brand and multi-channel strategy. The group is also the only integrated banking and insurance provider in the UK. Its well-known brands include Lloyds, Halifax, Bank of Scotland and Scottish Widows.

As detailed in the Group Strategic Review 3 (GSR3), Lloyds plans to invest more than GBP 3bn during 2018-2020 to further transform the group to meet the challenges posed by technology, a changing competitive environment and evolving customer behaviour. While refocusing its branch network to meet more complex banking needs, the group intends to maintain the largest branch network in the UK with about a 20% market share. As well, the group aims to remain the largest digital bank in the UK, with Open Banking functionality.

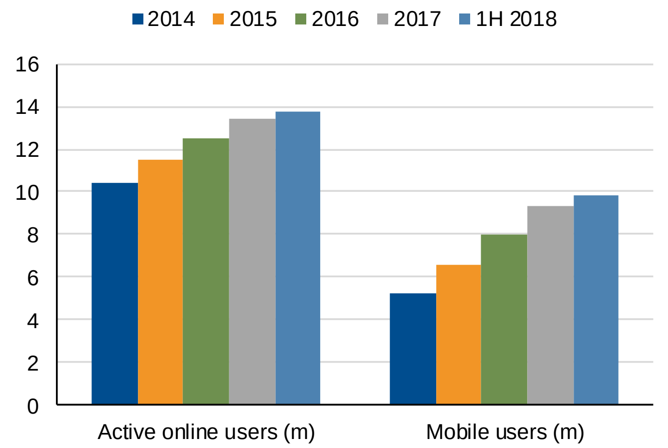
Lloyds enjoys strong market positions and is active primarily in lower risk retail and commercial banking activities. The group has identified within its customer base 10 million customers where management believes Lloyds is under represented and sees further opportunities for growth. During 2018-2020, the group also plans to grow its insurance and wealth businesses and to increase net lending to start-ups, SMEs and Mid Markets commercial clients by GBP 6bn.

Figure 1: Market shares in various products (%)



Note: All market shares as at FY17 except for individual pensions & drawdown (9M17). Source: Company data, Scope Ratings

Figure 2: Increasing number of online and mobile users



Source: Company data, Scope Ratings

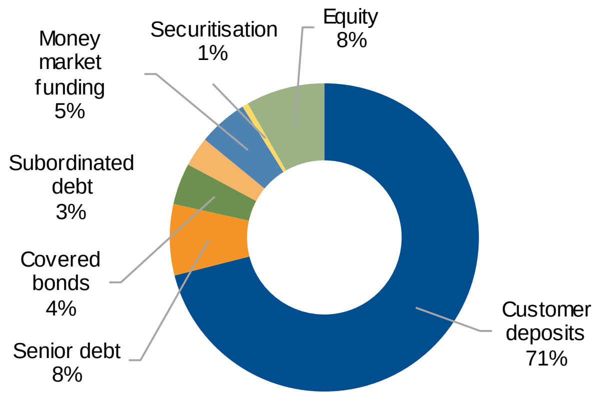
Management's commitment to a low risk profile.

Management has delivered on the strategy set out in June 2011 to transform the group into a simpler, lower-risk, customer focused UK retail and commercial bank. Run-off net external assets had reduced to GBP 9.1bn at end-2017 and the group's capital and funding position have strengthened to sound levels. As well, the loan book has shown solid growth in target areas (e.g. UK motor finance, credit cards, SMEs) while overall asset quality has continued to improve.

Problem loans were concentrated in the run-off portfolios (largely the group's Irish mortgage book and corporate and specialist finance portfolios) which represented less than 2% of total group loans and advances at end-2017. Since 2018, the run-off portfolio has been incorporated into the Commercial Banking, Retail and Central Items divisions. At 1H 2018, stage 3 loans accounted for 1.8% of total loans, down from 1.9% at 1

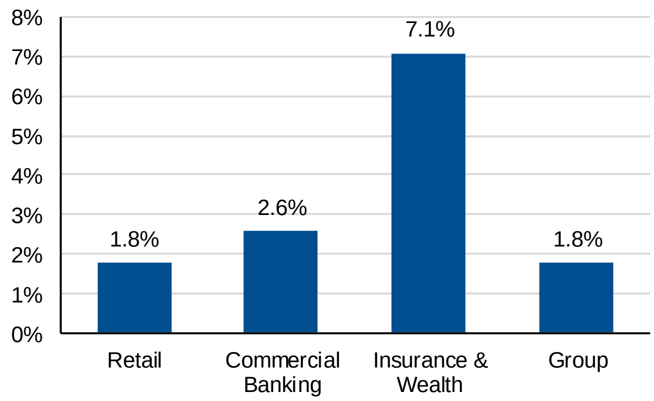
January 2018. Management has guided to a through the cycle asset quality ratio of 35bps, with the expectation that this will be less than 30bps during 2018-2020. In 1H 2018, the asset quality ratio was 20bps.

Figure 3: Total funding breakdown



Note: Total funding of GBP 589bn as of 1H 2018, of which GBP 122bn was wholesale funding. Source: Company data, Scope Ratings

Figure 4: Stage 3 loans % Total



Note: Data as of 1H 2018. Source: Company data, Scope Ratings

Consistent capital generation

Management currently considers its CET1 capital need to be about 13%, plus a management buffer of around 1%. In July 2018, Lloyds Pillar 2A CET1 requirement was reduced to 2.6% from 3%. When the UK's ring-fencing regime will be in force from 1 January 2019, the Pillar 2A CET1 requirement is expected to increase to 2.7%. From November 2018, the countercyclical buffer for UK exposures will increase to 1% from 0.5%.

During 2018-2020, the group expects to generate 170-200 bps of CET1 capital per annum before dividends (2012-2017: average c.180bps). Management's current capital return framework is based on a progressive and sustainable ordinary dividend, with surplus capital being returned through share buybacks.

Well positioned for future requirements

In 2022, Lloyds will need to meet estimated loss absorbing capacity requirements (MREL plus buffers) of about 30%. At 1H 2018, the group's pro-forma transitional MREL ratio was 29.7% (comprised of total capital and holding company senior debt). Lloyds expects to issue GBP 4-5bn of MREL-eligible senior debt per annum to fulfil requirements, with these securities largely refinancing maturing operating company liabilities.

We note that the Bank of England published a consultation paper in July 2018 which proposes that domestic systemically important banks like Lloyds be subject to a leverage ratio buffer from 2019. As of H1 2018, the group's pro-forma UK leverage ratio was 5.3%, a level which should comfortably accommodate the proposed leverage ratio buffer.

Legacy conduct costs continue to hamper performance but are expected to decline.

While Lloyds returned to profitability in 2014, bottom line earnings have continued to be negatively impacted by various items, including PPI, restructuring and other legacy costs. Positively, the gap between underlying returns and statutory returns has been declining as these items become less material (Figure 5).

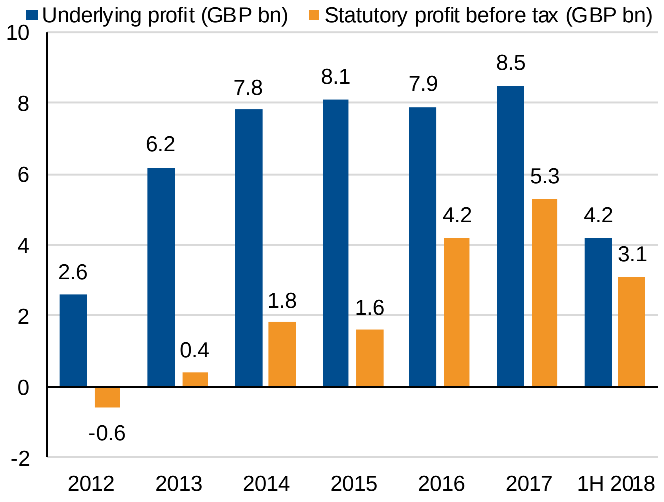
In 2017, the underlying RoTE was 15.6% while the statutory RoTE had improved to 8.9% from 6.6% in 2016. Returns were negatively impacted by GBP 1.7bn in PPI provisions, GBP 0.9bn in other conduct provisions and GBP 0.6bn in restructuring costs.

Other conduct charges included those related to the HBOS Reading fraud and retail conduct matters. At 1H 2018, the statutory RoTE was 12.1%.

During 1H 2018, Lloyds made further PPI provisions of GBP 500m (totalling over GBP 19bn to date) to cover claims volumes of approximately 13,000 per week until the August 2019 deadline, compared to a previous run rate assumption of 11,000. As the deadline approaches, the final increase in claim volumes remains highly uncertain and further provisions may be required.

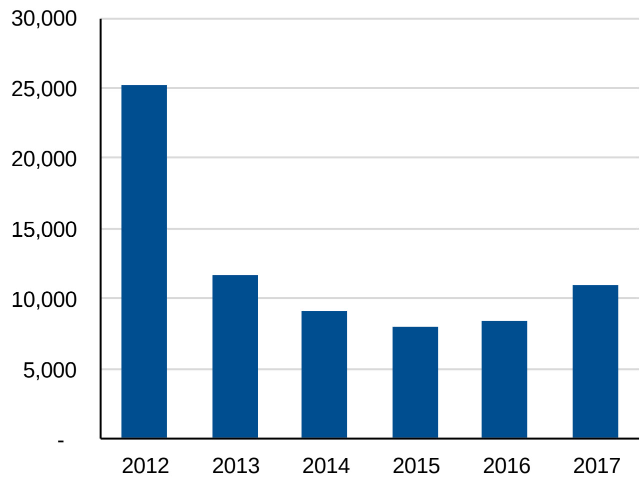
As of 1H 2018, Lloyds held GBP 2.3bn in provisions for PPI and GBP 1bn in provisions for other regulatory matters.

Figure 5: Underlying vs. statutory profit



Source: Company data, Scope Ratings

Figure 6: Weekly reactive PPI claims



Source: Company data, Scope Ratings

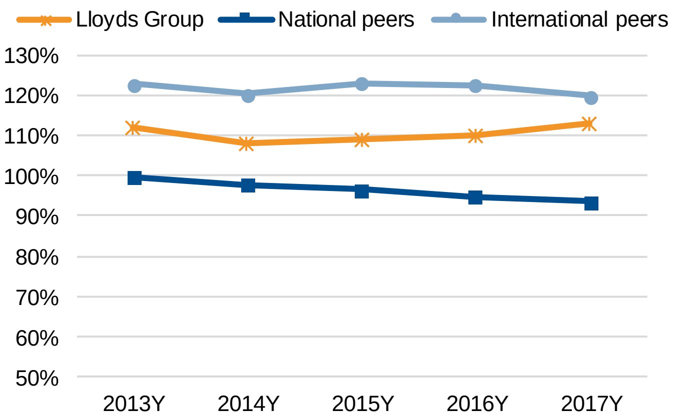
Uncertain consequences of the UK's exit from the EU, particularly on the UK economy and housing market.

With the reduction in non-core assets, Lloyds is now largely a UK domestic bank with over 60% of credit exposures being to retail mortgages. Hence, the group's performance is dependent to a large degree on the health of the UK economy. There are still many uncertainties surrounding Brexit and the impact will likely be evident only over time.

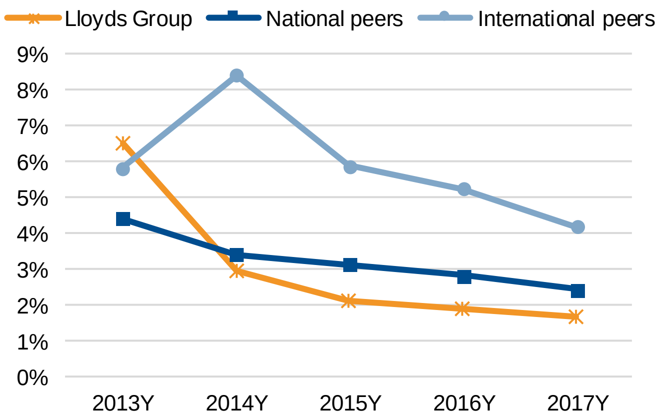
To date, the economy has shown relative resilience and the large UK banks, including Lloyds, have not seen a deterioration in domestic asset quality. The impact on future business investment and consumer confidence has been more material. In its June 2018 Financial Stability Report, the Bank of England (BoE) highlighted the risks that highly indebted households could augment any economic downturn and that a decline in foreign investor sentiment for UK assets (commercial real estate and leveraged loans were noted for having a large foreign investor presence) could lead to falls in UK asset prices. At the same time, the BoE judged that apart from those related to Brexit, domestic risks remained in the "standard region overall" and decided to set the UK countercyclical buffer rate at 1%, unchanged since November 2017.

I. Appendix: Peer comparison

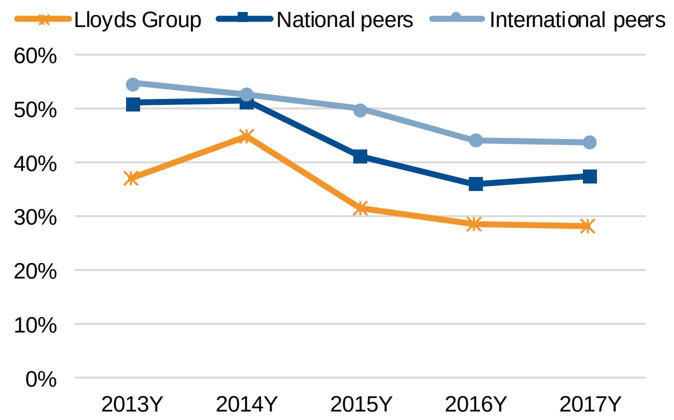
Amortised loans % Deposits



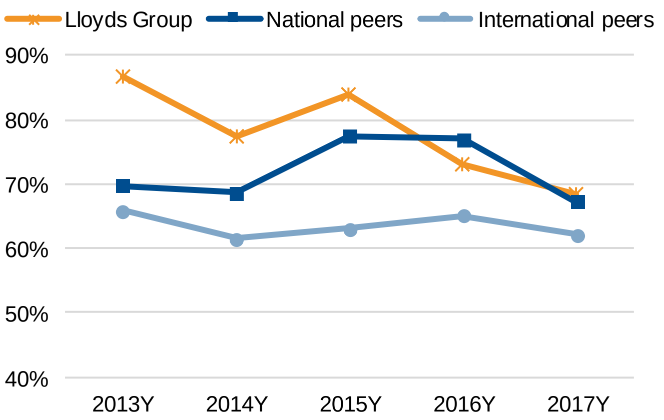
NPLs % Loans



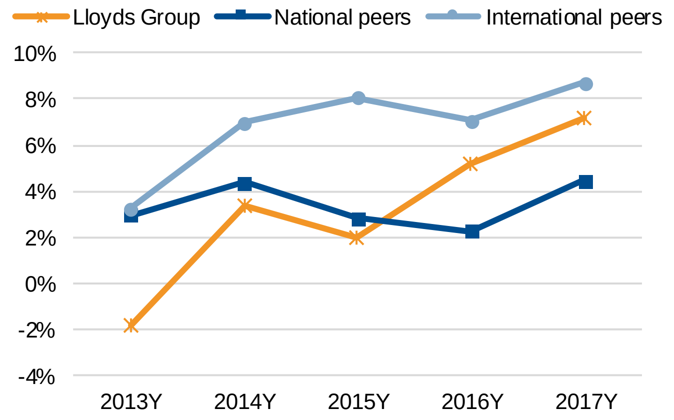
Loan loss reserves % NPLs



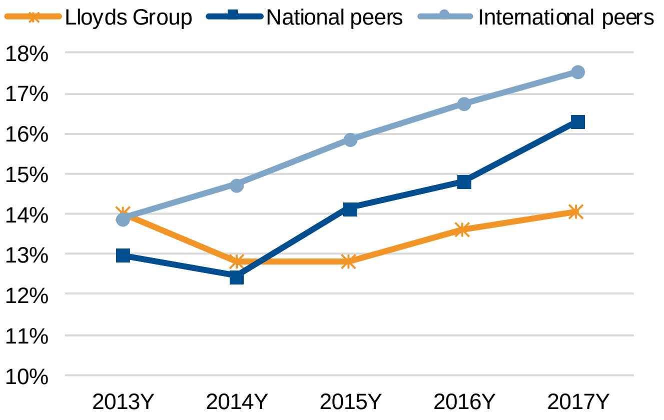
Costs % Income



Return on average equity (%)



CET1 ratio (%, transitional)



National peers: RBS Group, Lloyds Banking Group, HSBC Holdings, Barclays PLC, Nationwide Building Society.
International peers: RBS Group, Lloyds Banking Group, Nationwide Building Society, BPCE, Banque Postale, Credit Agricole, ABN Amro, Rabobank, Intesa, Commerzbank, Danske, CaixaBank, Handelsbanken, SEB, Swedbank, DNB, Bank of Ireland, Allied Irish.
Source: SNL

II. Appendix: Selected Financial Information – Lloyds Banking Group PLC

	2014Y	2015Y	2016Y	2017Y	2018H1
Balance sheet summary (GBP m)					
Assets					
Cash and interbank assets	86,032	87,296	77,666	67,501	79,075
Total securities	209,040	193,860	214,154	202,863	194,252
of which, derivatives	36,128	29,467	36,138	25,834	26,955
Net loans to customers	511,217	485,284	488,431	502,474	505,919
Other assets	48,607	40,248	37,542	39,271	50,533
Total assets	**854,896**	**806,688**	**817,793**	**812,109**	**829,779**
Liabilities					
Interbank liabilities	11,866	17,642	16,932	30,388	31,783
Senior debt	132,984	128,366	127,806	121,643	NA
Derivatives	33,187	26,301	34,924	26,124	25,561
Deposits from customers	447,067	418,326	415,460	418,124	421,609
Subordinated debt	26,042	23,312	19,831	17,922	17,637
Other liabilities	153,847	145,761	154,025	148,765	NA
Total liabilities	**804,993**	**759,708**	**768,978**	**762,966**	**781,236**
Ordinary equity	43,335	41,234	43,020	43,551	42,940
Equity hybrids	5,355	5,355	5,355	5,355	5,355
Minority interests	1,213	391	440	237	248
Total liabilities and equity	**854,896**	**806,688**	**817,793**	**812,109**	**829,779**
Core tier 1/Common equity tier 1 capital	30,689	28,544	29,284	29,647	29,794
Income statement summary (GBP m)					
Net interest income	10,660	11,318	9,274	10,912	6,007
Net fee & commission income	2,257	1,810	1,689	1,583	698
Net trading income	9,777	3,349	19,203	12,033	1,522
Other income	-5,061	944	-13,383	-6,015	1,153
Operating income	**17,633**	**17,421**	**16,783**	**18,513**	**9,380**
Operating expense	13,660	14,610	12,277	12,688	5,998
Pre-provision income	**3,973**	**2,811**	**4,506**	**5,825**	**3,382**
Credit and other financial impairments	752	390	752	688	456
Other impairments	0	0	0	8	0
Non-recurring items	-1,459	-777	484	146	191
Pre-tax profit	**1,762**	**1,644**	**4,238**	**5,275**	**3,117**
Discontinued operations	0	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	263	688	1,724	1,728	850
Net profit attributable to minority interests	87	96	101	90	37
Net profit attributable to parent	**1,412**	**860**	**2,413**	**3,457**	**2,230**

Source: SNL

III. Appendix: Selected Financial Information – Lloyds Banking Group PLC

	2014Y	2015Y	2016Y	2017Y	2018H1
Funding and liquidity					
Net loans/deposits (%)	108.0%	108.8%	110.2%	113.0%	111.2%
Liquidity coverage ratio (%)	NA	NA	NA	124.9%	129.0%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/assets (%)	59.8%	60.2%	59.7%	61.9%	61.0%
NPLs/net loans (%)	3.0%	2.1%	1.9%	1.7%	1.8%
Loan-loss reserves/NPLs (%)	44.8%	31.6%	28.4%	28.1%	35.3%
Net loan growth (%)	-0.6%	-5.1%	0.6%	2.9%	1.4%
NPLs/tangible equity and reserves (%)	27.4%	20.8%	17.9%	17.0%	18.8%
Asset growth (%)	1.5%	-5.6%	1.4%	-0.7%	4.4%
Earnings and profitability					
Net interest margin (%)	1.3%	1.4%	1.2%	1.4%	1.6%
Net interest income/average RWAs (%)	4.2%	4.9%	4.2%	5.1%	5.7%
Net interest income/operating income (%)	60.5%	65.0%	55.3%	58.9%	64.0%
Net fees & commissions/operating income (%)	12.8%	10.4%	10.1%	8.6%	7.4%
Cost/income ratio (%)	77.5%	83.9%	73.2%	68.5%	63.9%
Operating expenses/average RWAs (%)	5.3%	6.4%	5.5%	5.9%	5.7%
Pre-impairment operating profit/average RWAs (%)	1.5%	1.2%	2.0%	2.7%	3.2%
Impairment on financial assets /pre-impairment income (%)	18.9%	13.9%	16.7%	11.8%	13.5%
Loan-loss provision charges/net loans (%)	0.2%	0.1%	0.1%	0.1%	0.2%
Pre-tax profit/average RWAs (%)	0.7%	0.7%	1.9%	2.4%	3.0%
Return on average assets (%)	0.2%	0.1%	0.3%	0.4%	0.6%
Return on average RWAs (%)	0.6%	0.4%	1.1%	1.6%	2.2%
Return on average equity (%)	3.3%	2.0%	5.2%	7.2%	9.3%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	12.8%	12.8%	13.6%	14.1%	14.1%
Common equity tier 1 ratio (%, transitional)	12.8%	12.8%	13.6%	14.1%	14.1%
Tier 1 capital ratio (%, transitional)	16.5%	16.4%	17.0%	17.2%	17.1%
Total capital ratio (%, transitional)	22.0%	21.5%	21.4%	21.2%	21.6%
Leverage ratio (%)	4.9%	4.8%	4.9%	4.9%	4.8%
Asset risk intensity (RWAs/total assets, %)	28.0%	27.6%	26.4%	26.0%	25.4%
Market indicators					
Price/book (x)	1.3x	1.3x	1.0x	1.1x	1.1x
Price/tangible book (x)	1.4x	1.4x	1.1x	1.3x	1.2x
Dividend payout ratio (%)	NA	283.0%	101.7%	76.3%	NA

Source: SNL

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