Financial Institutions Ratings
Lloyds Banking Group PLC – AT1 rating report

Security ratings

Outlook	Stable
7% GBP 1.48bn fixed rate reset AT1 perpetual subordinated contingent convertible securities	BB+
7.625% GBP 1.49bn fixed rate reset AT1 perpetual subordinated contingent convertible securities	BB+
7.875% GBP 750m fixed rate reset AT1 perpetual subordinated contingent convertible securities	BB+
6.375% EUR 750m fixed rate reset AT1 perpetual subordinated contingent convertible securities	BB+
7.5% USD 1.68bn fixed rate reset AT1 perpetual subordinated contingent convertible securities	BB+

The ratings have not been solicited by the issuer; the analysis is based solely on public information.

Rating rationale

Scope rates at BB+, Stable the above referenced Additional Tier 1 securities issued by Lloyds Banking Group PLC. The ratings are based on the following considerations:

- Senior unsecured debt (MREL eligible): A, Stable Outlook
- Minimum notches down from the senior unsecured debt rating: 4
- Additional notches: 1

In accordance with our rating methodology, the starting point for notching down when rating capital instruments is the senior unsecured debt rating. The minimum four notches reflect the deeply subordinated status of AT1 capital instruments in the priority of claims, their going concern loss absorbing features and investors' exposure to coupon-cancellation risks. Please refer to Scope's *Bank Capital Instruments Rating Methodology* published in May 2018 for more details.

The additional notch for these securities primarily reflects the relatively demanding stance of the UK regulator, e.g. requesting 7% fully loaded triggers on AT1 securities, the presumed conversion of AT1 securities when CET1 triggers are breached (as illustrated in bank stress test scenarios), and comparatively higher Pillar 2 requirements.

The release of this rating report does not constitute a rating action. Last rating action was assigned on 9 October 2014. For further information on the last rating action and regulatory information please click here.

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Issuer credit profile

Lloyds Bank PLC is the primary operating company of Lloyds Banking Group PLC. The Issuer Rating of A+ for Lloyds Bank PLC reflects the group's leading domestic retail and commercial banking franchise, particularly in current accounts, retail deposits and mortgages. Over the last several years, management has successfully 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 generate higher and more stable bottom-line earnings.

Given the domestic nature of its business, the uncertainty around Brexit poses risks to Lloyds' asset quality and earnings. The group's strong franchise and prudential metrics, however, position Lloyds well to weather these potential headwinds.

Summary terms

Issuer	Lloyds Banking Group PLC
Issue Date	**April 2014**
Amount	GBP 1.48bn
Coupon	• 7% fixed until first call date, reset every 5 years thereafter • From first call date at a rate equal to the 5-year mid-swap rate + 5.06% • Payable quarterly in arrear
Format	Perpetual subordinated contingent convertible securities, callable 2019 and every five years thereafter
ISIN	XS1043550307

Issue Date	April 2014
Amount	GBP 1.49bn
Coupon	• 7.625% fixed until first call date, reset every 5 years thereafter • From first call date at a rate equal to the 5-year mid-swap + 5.01% • Payable quarterly in arrear
Format	Perpetual subordinated contingent convertible securities, callable 2023 and every five years thereafter
ISIN	XS1043552188

Issue Date	April 2014
Amount	GBP 750m
Coupon	• 7.875% fixed until first call date, reset every 5 years thereafter • From the first call date at a rate equal to the 5-year mid-swap rate + 4.83% • Payable quarterly in arrear
Format	Perpetual subordinated contingent convertible securities, callable 2029 and every five years thereafter
ISIN	XS1043552261

Issue Date	April 2014
Amount	EUR 750m
Coupon	• 6.375% fixed until first call date, reset every 5 years thereafter • From first call date at a rate equal to the 5-year mid-swap rate + 5.29% • Payable quarterly in arrear
Format	Perpetual subordinated contingent convertible securities, callable 2020 and every five years thereafter
ISIN	XS1043545059

Issue Date	April 2014
Amount	USD 1.68bn
Coupon	• 7.5% fixed until first call date, reset every 5 years thereafter • From first call date at a rate equal to the 5-year mid-swap rate + 4.76% • Payable quarterly in arrear
Format	Perpetual subordinated contingent convertible securities, callable 2024 and every five years thereafter
ISIN	US539439AG42

Main Risks	
Coupon Cancellation	• Fully discretionary • Mandatory if there are insufficient distributable items to pay coupons on these securities, parity securities and any junior securities • Mandatory if payments on common equity, AT1 securities and variable compensation exceed the Maximum Distributable Amount • For the USD 1.68bn issue, also subject to Solvency Condition
Principal Loss Absorption	• Full and automatic conversion into ordinary shares upon trigger breach at conversion price subject to conversion shares offer • Subject to write off or conversion on the occurrence of a bail-in or if issuer becomes subject to resolution
Trigger for Principal Loss Absorption	Consolidated group CET1 < 7% on fully loaded basis

Source: Prospectuses, Scope Ratings

Key risks

A. Coupon cancellation

Key risk: Coupon cancellation

Coupon payments on the AT1 securities are fully discretionary and are subject to distribution restrictions

Coupons are mandatorily cancelled if there are insufficient distributable items (based on issuer accounts on an unconsolidated basis) to pay coupons on these securities, parity securities and any junior securities. We do not see distributable items as a limiting factor for Lloyds to pay coupons. At 31 December 2017, Lloyds Banking Group PLC had available distributable reserves of approximately GBP 8.5bn.

Combined buffer requirement (CBR)

Article 141 of CRD IV imposes certain restrictions on discretionary distributions (dividends, variable remuneration and payments on AT1 securities) when the combined buffer requirement (CBR) is not met. The CBR is comprised of the capital conservation buffer, the countercyclical buffer and systemic risk buffers as applicable.

To determine whether the maximum distributable amount (MDA) needs to be calculated a bank should meet both Pillar 1 and Pillar 2 capital requirements as well as the CBR. For UK banks, Pillar 2 requirements are referred to as Pillar 2A requirements. At least 56% of the requirement must be met with CET1 capital and no more than 25% with Tier 2 capital. We note that the Pillar 2 requirements of UK banks are often higher than those of ECB-supervised banks, even when comparing only the CET1 component.

As of Q1 2018, Lloyds's Pillar 2A requirement was 5.4%, of which at least 3% should be met with CET1 capital.

Lloyds' combined buffer is comprised of the 2.5% capital conservation buffer and since June 2018 a countercyclical capital buffer for UK exposures. The UK countercyclical capital buffer rate is expected to increase to 1% (November 2018) from the current 0.5%.

From 2019, Lloyds will also be subject to a systemic risk buffer as it is a domestic systemically important bank. The buffer will be calculated at the level of the ring-fenced bank and while not finalised may be as high as 2.5%.

By 2019, we estimate that Lloyds may need to maintain a CET1 ratio of 13.5%, a Tier 1 capital ratio above 16%, and a total capital ratio greater than 19% to avoid distribution restrictions on its AT1 securities (Table 1). Our estimates include a systemic risk buffer of 2.5%, a 1% countercyclical buffer and assumes that the Pillar 2A requirement does not change.

At this time, Lloyds targets a CET1 ratio of around 14%, based on the view that the level of required CET1 capital is currently around 13% plus a management buffer of around 1%. Considering the group's earnings capabilities, Scope believes that management would be able to adjust capital levels as needed to meet potentially higher requirements. Management guides to ongoing capital generation of 170-200 bps per annum.

Table 1: Estimated capital requirements

	2017	Q1 2018	2019
Required CET1 associated with distribution restrictions:	**8.3%**	**10.4%**	**13.5%**
Combined buffer (CBR)			
- Capital conservation	1.25%	1.88%	2.50%
- Systemic	0.00%	0.00%	2.50%
- Countercyclical	0.00%	1.00%	1.00%
Pillar 2A CET1 requirement	2.50%	3.00%	3.00%
Pillar 1 CET1 requirement	4.50%	4.50%	4.50%
Lloyds Banking Group PLC CET1, fully loaded (%)	14.1%	14.1%	~14% target
Distance to CET1 requirement incl. CBR (%)	**5.8%**	**3.7%**	
Distance to CET1 requirement incl. CBR (GBP bn)	**12.2**	**7.8**	
Lloyds Banking Group PLC Tier 1, fully loaded (%)	16.6%	16.6%	
Required Tier 1 incl. CBR (%)	10.6%	12.9%	16.0%
Distance to Tier 1 requirement incl. CBR (%)	**6.0%**	**3.7%**	
Lloyds Banking Group PLC total capital, fully loaded (%)	18.5%	19.1%	
Required total capital, incl. CBR (%)	13.7%	16.3%	19.4%
Distance to total capital requirement incl. CBR (%)	**4.8%**	**2.8%**	
RWAs (GBP bn)	211	211	

Notes: Estimated systemic risk buffer of 2.5%. Estimated countercyclical buffer is based on 1% countercyclical buffer rate for the UK.
Source: Company data, Scope Ratings

B. Principal loss absorption

Key risk: Principal loss absorption

The mechanism for loss absorption is full conversion into shares.

The securities have one trigger:
- Consolidated group CET1 ratio < 7% on fully loaded basis.

There is full conversion into shares when the trigger level is breached. The trigger level is breached when Lloyds' consolidated group CET1 ratio is less than 7% on a fully loaded basis. We note that AT1 capital instruments issued by UK banks generally have fully loaded CET1 triggers while non-UK banks have transitional CET1 triggers. In addition, investors in the securities are subject to write-down or conversion risks if Lloyds becomes subject to resolution or the regulator exercises its bail-in powers.

Distance to trigger

As of Q1 2018, Lloyds' fully loaded CET1 ratio was 14.1%, well above the 7% trigger level in the securities. Considering the group's CET1 ratio target of around 14%, we expect the gap to trigger level to remain solid.

Table 2: Distance to trigger

	2017	Q1 2018	2019
Trigger level	7.0%	7.0%	7.0%
Lloyds Banking Group PLC CET1, fully loaded (%)	14.1%	14.1%	~14% target
Distance to trigger (%)	**7.1%**	**7.1%**	
Distance to trigger (GBP bn)	**14.9**	**14.9**	

Source: Company data, Scope Rating

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