Lloyds Banking Group plc
Issuer Rating Report

STABLE OUTLOOK
A+

Overview

Scope rates various entities and securities of the Lloyds group. The Issuer Rating of Lloyds Banking Group plc is A+. The ratings on the group's senior unsecured MREL debt and AT1 securities are A and BB+, respectively. All ratings have a Stable Outlook.

Scope also assigns an Issuer Rating of A+ to Lloyds Bank plc, the group's UK ring-fenced sub-group comprising the majority of the group's banking activities. The ratings on the institution's senior unsecured non-MREL debt and short-term debt are A+ and S-1+, respectively. All ratings have a Stable Outlook.

Further, Scope assigns an Issuer Rating of A with Stable Outlook to Lloyds Bank Corporate Markets plc (LBCM), the group's non-ring-fenced bank.

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 banking and insurance provider in the UK, with ambitions to further grow in the areas of financial planning and retirement, general insurance and protection.
- Management has substantially reduced the risks (asset quality, funding) associated with the acquisition of HBOS at the peak of the financial crisis. Credit fundamentals have materially strengthened, with Lloyds now a lower-risk UK-focused retail and commercial bank.
- Earnings are at a solid level and after the 30 August 2019 deadline for PPI claims passes, this material drag on the group's profitability should disappear. Lloyds has incurred over GBP 20bn in PPI provisions to date. For 2019, management has lowered its guidance for RoTE to around 12% due to below the line charges, including PPI provisions (1H 2019: GBP 650m). Beyond 2019, Lloyds continues to target a RoTE of 14% to 15%.
- Due to the group's domestic focus, we cautiously regard the still uncertain consequences of the UK's planned 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.
- The Issuer Rating of Lloyds Bank Corporate Markets plc (LBCM) is one notch below that of Lloyds Group and Lloyds Bank. The rating differential is due to its less diversified and higher-risk business profile and potentially less central role in the group's strategy.

Ratings & Outlook

Issuer Rating	A+
Senior unsecured MREL debt rating	A
Additional Tier 1 securities rating	BB+
Senior unsecured non-MREL debt rating (Lloyds Bank plc)	A+
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.
- Uncertain UK macro environment due to ongoing Brexit discussions

Rating change drivers

Inability to effectively manage potential consequences stemming from Brexit. As a primarily domestic bank, Lloyds' performance is dependent to a large extent on the health of the UK economy. While the situation remains highly uncertain, we expect the group's strong franchise and earnings capabilities to weather a slowdown in the UK economy.

Higher and more stable bottom-line earnings. Over the last few years, the gap between underlying and statutory profitability has been narrowing, with underlying RoTE at 16.3% and statutory RoTE at 11.5% in 1H 2019. Future earnings should be supported by the group's focus on meeting "heightened customer expectations for ease of access, personalisation and relevance."

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.

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.

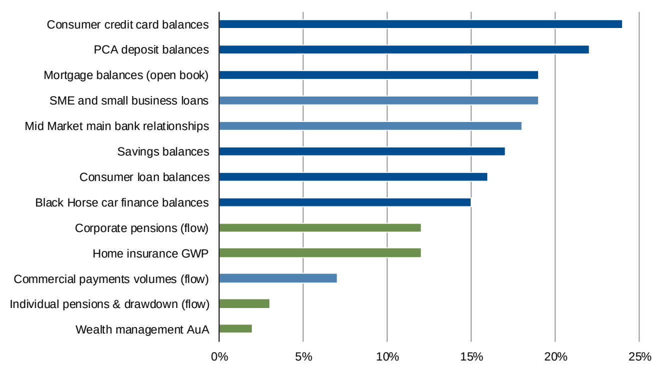
As detailed in the Group Strategic Review 3 (GSR3), Lloyds plans to invest more than GBP 3bn during 2018-2020 to further transform the group to meet the challenges posed by technology, a changing competitive environment and evolving customer behaviour; as of 30 June 2019, GBP 1.5bn has been spent. While 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 (1H 2019: 9.8m mobile users). Recently, Lloyds was the first bank to add credit cards and savings to its open banking platform. Lloyds is also able to offer a unique "single customer view" to customers who have both banking and insurance relationships with the group. This is currently available to 4m customers and the goal is to expand this to 9m by the end of 2020.

Lloyds enjoys strong market positions and is active primarily in lower risk retail and commercial banking activities (Figure 1). Management continues to target loan growth in business segments where it is under-represented, such as SMEs, mid-market and motor finance.

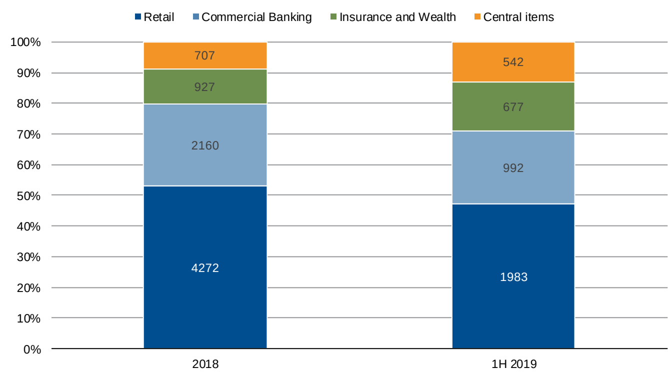
Lloyds also plans to grow its insurance and wealth business, which accounts for an increasing proportion of group profit (Figure 2). Since 2011, the insurance business has paid about GBP 7bn in cumulative dividends to the group. To further develop its financial planning and retirement capabilities, Lloyds has established a joint venture with Schroders, a global asset management company.

Figure 1: Market shares in various products (%)



Note: Market shares as of May 2019 YTD except (i) Mid Market, home insurance and individual pensions (1Q 19) and (ii) Corporate pensions and wealth management (FY 18). Source: Company data

Figure 2: Underlying profit by business (GBP m)



Source: Company data, Scope Ratings

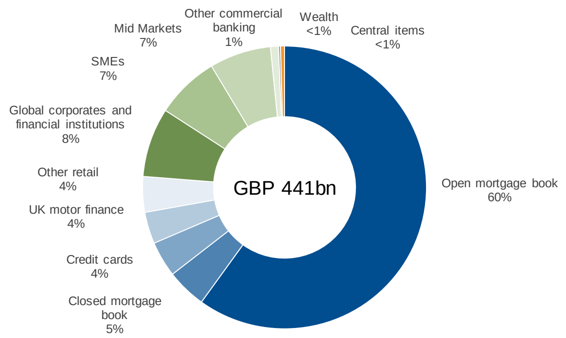
Management's commitment to a low risk profile

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 assets have declined to GBP 3bn at 1H 2019, from GBP 194bn in 2010. As well, the loan book has been repositioned. Single name exposures have been reduced and riskier exposures have been replaced by selective growth in target segments such as SMEs, UK motor finance and credit cards. Over 75% of lending is secured, and mortgages with an average LTV of 43% account for 65% of the total loan book (Figure 3).

Overall asset quality has also improved. Problem loans were concentrated in the run-off portfolios (largely the Irish mortgage book which has been sold and the corporate and specialist finance portfolios). Since 2018, the run-off portfolio is no longer reported separately.

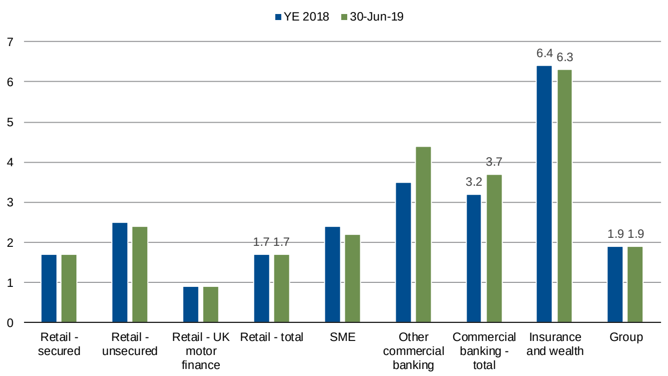
Despite economic uncertainty, the group does not see signs of impairments in its loan portfolio. At 30 June 2019, stage 3 loans totalled GBP 9.6bn on an underlying basis and accounted for 1.9% of total loans (Figure 4). These figures include stage 3 loans associated with GBP 14.6bn in purchased or originated credit-impaired assets; a fixed pool mortgages that were purchased at a deep discount as part of the HBOS acquisition. For 2019, management continues to guide to a net asset quality ratio of less than 30 bps (1H 2019: 26 bps).

Figure 3: Loan portfolio breakdown



Note: Data as of 1H 2019.
Source: Company data, Scope Ratings

Figure 4: Stage 3 loans (%)



Note: Data as of 1H 2019 on an underlying basis.
Source: Company data, Scope Ratings

Consistent capital generation

During 2018-2020, the group expects to generate 170-200 bps of CET1 capital per annum before dividends (2012-2017: average c.180bps). For 2019, due to below the line charges such as PPI provisions and restructuring costs, management now expects capital build to be at the lower end of the range.

The group considers its CET1 capital need to be about 12.5%, plus a management buffer of around 1%. Since 1 January 2019, the group's Pillar 2A CET1 requirement has been set at 2.7%. As well, the group's ring-fenced sub-group is subject to a 2% systemic risk buffer which equates to a 1.7% buffer at group level. Further, the countercyclical buffer rate for UK exposures has been 1% since November 2018, which translates into a 0.9% countercyclical buffer for the group. As of 1H 2019, the group's CET1 ratio was 13.9% or 14% pro forma the GBP 100m interim dividend paid by the insurance business in July 2019.

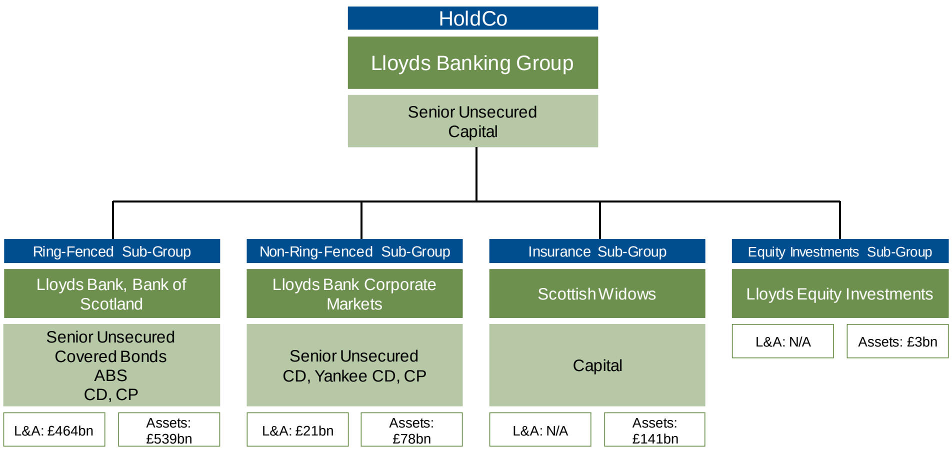
Well positioned for future requirements

At 1H 2019, the group's transitional MREL ratio was 32.2% (comprised of total capital and holding company senior debt), which is in excess of the 2020 interim requirement of 25.8% including buffers. The total capital ratio was 21.6% on a transitional basis and 19.1% on a fully loaded basis. The transitional MREL figure includes externally issued regulatory capital in operating entities, as until 2022, they can count towards the group's MREL.

From 2022, Lloyds will need to meet an estimated loss absorbing capacity requirement of about 30% (MREL plus buffers). Lloyds expects to issue about GBP 5bn of MREL-eligible senior debt per annum to fulfil the requirement, with these securities largely refinancing maturing operating company liabilities.

Meanwhile, the group's ring-fenced banks continue to issue on a secured (covered bonds, ABS) and unsecured (operating company senior) basis. In 1H 2019, a funding programme was established for the group's non-ring-fenced bank, LBCM.

Figure 5: Group issuing structure



Notes: L&A = loans and advances. Data as of 30 June 2019, except for Scottish Widows which is as of YE 2018.
Source: Company data, Scope Ratings

Uncertain UK macro environment due to ongoing Brexit discussions

Over 90% of the group's business is in the UK. Hence, Lloyds' performance is dependent to a large extent on the health of the UK economy. There are still many uncertainties surrounding Brexit, but it is becoming increasingly clear that the UK economy has already suffered, with growth below potential.

Since YE 2018, Lloyds has updated its economic assumptions for determining the allowance for expected credit losses (ECL). Reflecting actual conditions, house price and GDP growth have been adjusted slightly lower while unemployment has been increased slightly. The scenario weightings remain unchanged with the base case, upside and downside scenarios each weighted at 30% and the severe downside scenario weighted at 10%. The effect of the revised economic assumptions led to a GBP 50m increase in the ECL allowance while the total ECL allowance was GBP 3.5bn as of 30 June 2019.

Lloyds Banking Group's AT1 securities: key features and risks

We have rated the AT1 securities of Lloyds Banking Group at BB+/Stable.

In accordance with our rating methodology for capital instruments, the starting point for notching down when rating capital instruments is the senior unsecured MREL debt rating of A. 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.

The additional notch for these securities reflects the relatively demanding stance of the UK regulator; e.g. requesting 7% fully loaded CET1 triggers on AT1 securities, explicit reference to the conversion of AT1 securities in bank stress tests as needed, and comparatively high Pillar 2 requirements.

Figure 6: Lloyds Banking Group's CRD IV compliant AT1 instruments rated by Scope

ISIN	Coupon %	Currency	Issue amount	Issue date	Next call date	Trigger level
XS1043545059	6.375	EUR	750	01/04/14	27/06/2020	7%
XS1043552188	7.625	GBP	1,494	01/04/14	27/06/2023	7%
US539439AG42	7.5	USD	1,675	07/04/14	27/06/2024	7%
XS1043552261	7.875	GBP	750	01/04/14	27/06/2029	7%
US539439AU36	7.5	USD	1,500	10/10/18	27/09/2025	7%
US53944YAJ29	6.75	USD	500	01/06/19	27/06/2026	7%

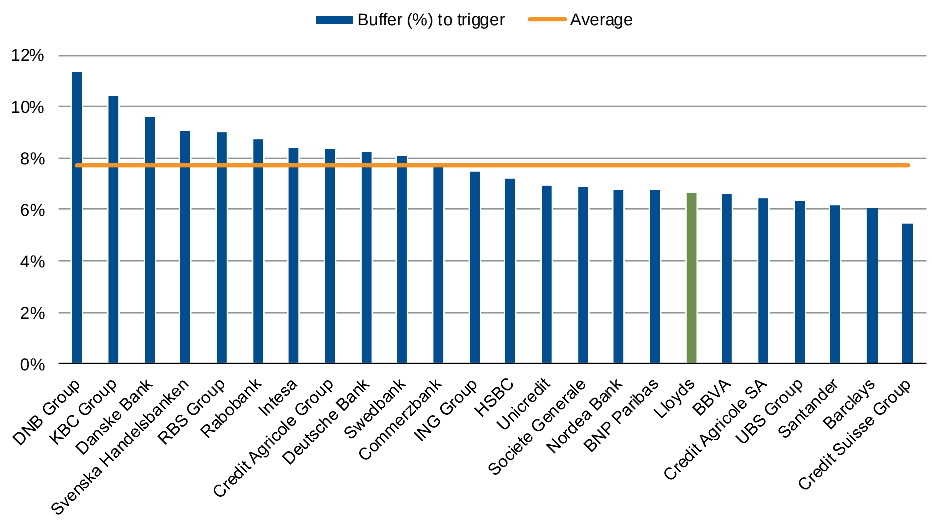
Source: Company data, Scope Ratings

As of 2Q 2019, Lloyd's CET1 ratio was 13.9% or 14% pro forma a dividend from the insurance business paid in July 2019. This translates into a comfortable gap of 7% to the write-down trigger.

Meanwhile, the distance to the MDA trigger is subject to some interpretation. Since January 2019, the group's ring-fenced sub-group has been subject to a 2% systemic risk buffer, corresponding to a buffer of 1.7% at group level. As this buffer has not been applied at the level of the group, Lloyds has calculated its MDA trigger at 10.6% which excludes the 1.7% buffer.

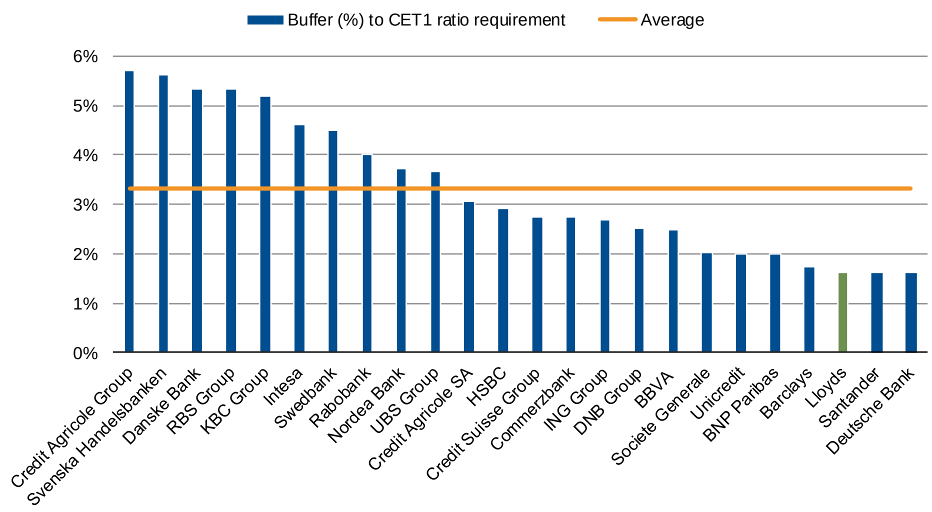
In our assessment, we would be more comfortable including the 1.7% buffer believing that the group should meet all requirements, bringing the MDA trigger to 12.3%. Hence the distance to the MDA trigger would be 1.6% on this basis and below the average of around 3% for larger European banks (Figure 8).

Figure 7: Distance to trigger, selected European banks



Note: Data as of 2Q 2019. For banks with securities containing different trigger levels, the highest is used.
Source: Company data, Scope Ratings

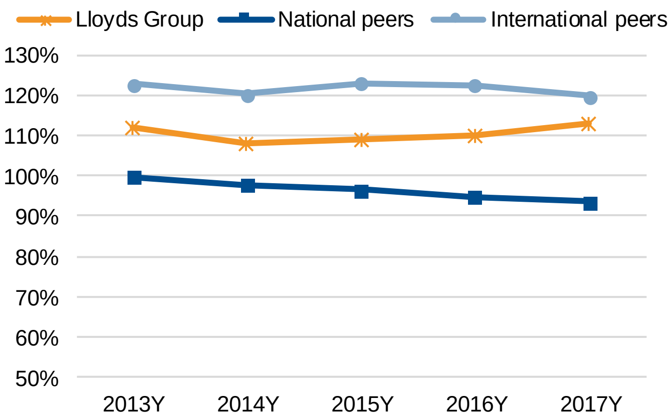
Figure 8: Distance to MDA level, selected European banks



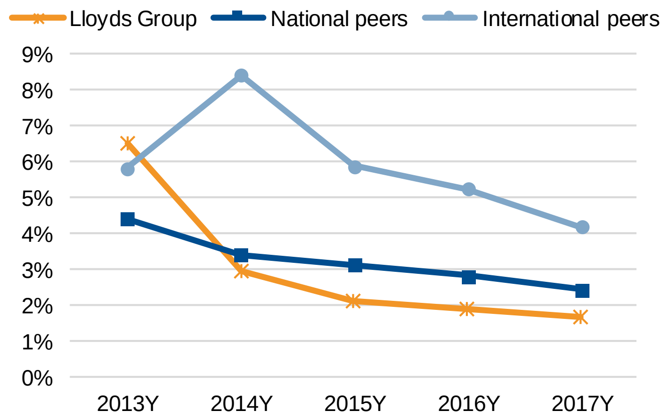
Notes: Data as of 2Q 2019. For Lloyds, the systemic risk buffer applied to the ring-fenced sub-group has been included. Refer to the previous page for further details.
Source: Company data, Scope Ratings

I. Appendix: Peer comparison

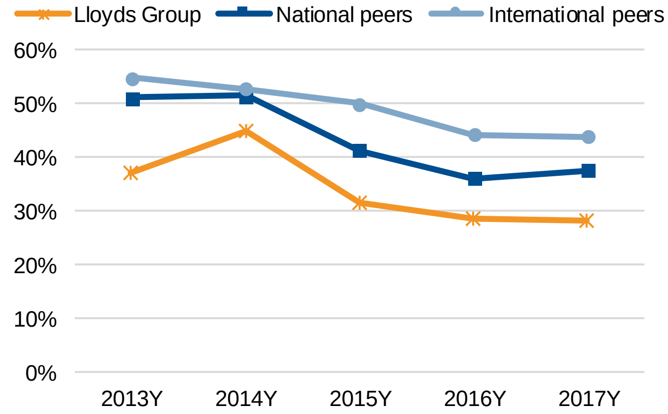
Loans % Deposits



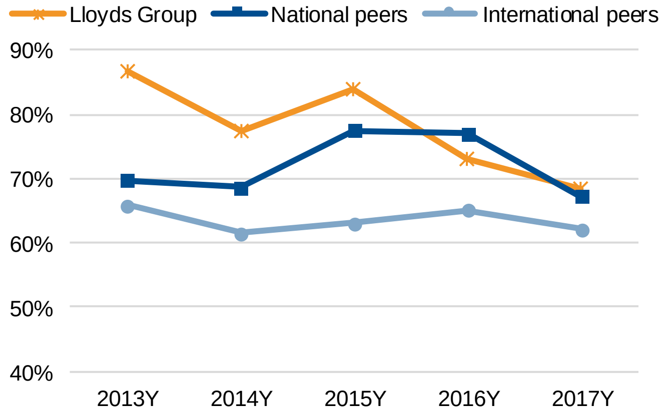
Stage 3 loans % Loans



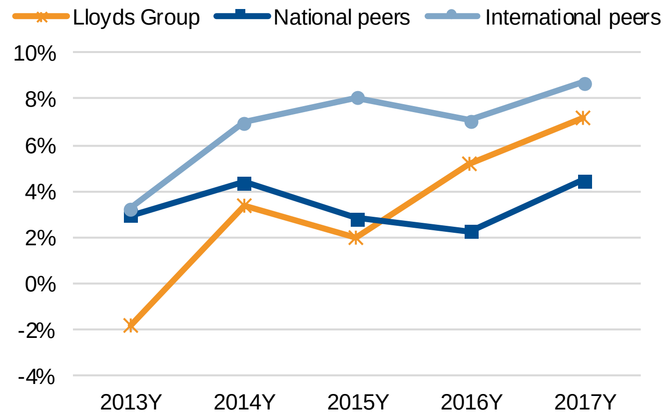
Loan loss reserves % Stage 3 loans



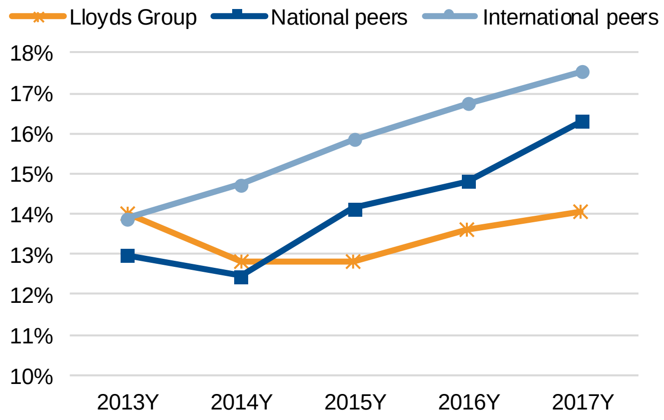
Costs % Income



Return on average equity (%)



CET1 ratio (%, transitional)



National peers: Lloyds Banking Group, RBS Group, HSBC Holdings, Barclays plc, Nationwide Building Society.
International peers: 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

	2015Y	2016Y	2017Y	2018Y	2019H1
Balance sheet summary (GBP m)					
Assets					
Cash and interbank assets	87,296	77,666	67,501	64,619	69,439
Total securities	193,860	214,154	202,863	171,301	184,737
of which, derivatives	29,467	36,138	25,834	23,595	26,148
Net loans to customers	485,284	488,431	502,474	522,708	521,087
Other assets	40,248	37,542	39,271	38,970	46,985
Total assets	**806,688**	**817,793**	**812,109**	**797,598**	**822,248**
Liabilities					
Interbank liabilities	17,642	16,932	30,388	30,956	35,276
Senior debt	128,366	127,806	121,643	119,859	NA
Derivatives	26,301	34,924	26,124	21,373	23,026
Deposits from customers	418,326	415,460	418,124	418,066	421,692
Subordinated debt	23,312	19,831	17,922	17,656	17,809
Other liabilities	145,761	154,025	148,765	139,489	NA
Total liabilities	**759,708**	**768,978**	**762,966**	**747,399**	**773,193**
Ordinary equity	41,234	43,020	43,551	43,434	43,448
Equity hybrids	5,355	5,355	5,355	6,491	5,406
Minority interests	391	440	237	274	201
Total liabilities and equity	**806,688**	**817,793**	**812,109**	**797,598**	**822,248**
Common equity tier 1 capital	28,544	29,284	29,647	30,167	28,767
Income statement summary (GBP m)					
Net interest income	11,318	9,274	10,912	13,396	4,639
Net fee & commission income	1,810	1,689	1,583	1,462	734
Net trading income	3,349	19,203	12,033	-3,740	11,789
Other income	944	-13,383	-6,015	7,422	-8,212
Operating income	**17,421**	**16,783**	**18,513**	**18,540**	**8,950**
Operating expenses	14,610	12,277	12,688	11,729	5,655
Pre-provision income	**2,811**	**4,506**	**5,825**	**6,811**	**3,295**
Credit and other financial impairments	390	752	688	936	579
Other impairments	0	0	8	1	NA
Non-recurring items	117	0	0	105	0
Pre-tax profit	**1,644**	**4,238**	**5,275**	**5,960**	**2,897**
Discontinued operations	0	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	688	1,724	1,728	1,560	672
Net profit attributable to minority interests	96	101	90	98	32
Net profit attributable to parent	**860**	**2,413**	**3,457**	**4,302**	**2,193**

Source: SNL

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

	2015Y	2016Y	2017Y	2018Y	2019H1
Funding and liquidity					
Net loans/ deposits (%)	108.8%	110.2%	113.0%	116.0%	117.4%
Liquidity coverage ratio (%)	100.0%	NA	124.9%	127.7%	130.0%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/ assets (%)	60.2%	59.7%	61.9%	65.5%	63.4%
Problem loans/ gross customer loans (%)	2.1%	1.8%	1.7%	4.3%	4.2%
Loan loss reserves/ problem loans (%)	31.6%	28.4%	28.1%	14.9%	15.8%
Net loan growth (%)	-5.1%	0.6%	2.9%	4.0%	-0.6%
Problem loans/ tangible equity & reserves (%)	20.8%	17.9%	17.0%	44.3%	45.3%
Asset growth (%)	-5.6%	1.4%	-0.7%	-1.8%	6.2%
Earnings and profitability					
Net interest margin (%)	1.4%	1.2%	1.4%	1.7%	1.2%
Net interest income/ average RWAs (%)	4.9%	4.2%	5.1%	6.4%	4.5%
Net interest income/ operating income (%)	65.0%	55.3%	58.9%	72.3%	51.8%
Net fees & commissions/ operating income (%)	10.4%	10.1%	8.6%	7.9%	8.2%
Cost/ income ratio (%)	83.9%	73.2%	68.5%	63.3%	63.2%
Operating expenses/ average RWAs (%)	6.4%	5.5%	5.9%	5.6%	5.5%
Pre-impairment operating profit/ average RWAs (%)	1.2%	2.0%	2.7%	3.3%	3.2%
Impairment on financial assets / pre-impairment income (%)	13.9%	16.7%	11.8%	13.7%	17.6%
Loan loss provision/ average gross loans (%)	0.1%	0.1%	0.1%	0.2%	0.2%
Pre-tax profit/ average RWAs (%)	0.7%	1.9%	2.4%	2.8%	2.8%
Return on average assets (%)	0.1%	0.3%	0.4%	0.5%	0.5%
Return on average RWAs (%)	0.4%	1.1%	1.6%	2.1%	2.1%
Return on average equity (%)	2.0%	5.2%	7.2%	9.0%	8.9%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	12.8%	13.6%	14.1%	14.3%	13.7%
Common equity tier 1 ratio (%, transitional)	12.8%	13.6%	14.1%	14.6%	13.9%
Tier 1 capital ratio (%, transitional)	16.4%	17.0%	17.2%	18.2%	16.7%
Total capital ratio (%, transitional)	21.5%	21.4%	21.2%	22.9%	21.6%
CRR leverage ratio (%)	4.8%	4.9%	4.9%	5.1%	4.7%
Asset risk intensity (RWAs/ total assets, %)	27.6%	26.4%	26.0%	25.9%	25.1%
Market indicators					
Price/ book (x)	1.4x	1.1x	1.3x	1.0x	1.1x
Price/ tangible book (x)	2.8x	1.0x	0.8x	0.6x	NA
Dividend payout ratio (%)	283.0%	101.7%	76.3%	64.2%	NA

Source: SNL

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