FitchRatings

Banks
Universal Commercial Banks
United Kingdom

Lloyds Banking Group plc

Update

Key Rating Drivers

Solid Business Profile: Lloyds Banking Group plc's (LBG) ratings reflect its strong business profile in the UK where it holds leading retail and business-banking franchises. It also reflects consistently strong profitability, and solid capitalisation and funding profiles.

Resilient Asset Quality: LBG's loan quality remained healthy throughout the pandemic, due to government-support measures, and pressures on loan affordability have yet to feed into asset performance. Fitch Ratings expects LBG's impaired loans (Stage 3) ratio to deteriorate only modestly from 1.8% at end-1H22, and mainly from higher-risk portfolios, such as unsecured consumer finance and SME lending, rather than in the low-risk mortgage loan book (end-1H22: 68% of loans).

Consistently Strong Profitability: Underlying profitability has been consistently strong and we expect LBG's four-year average operating profit to remain above 2.5% of risk-weighted assets (RWAs) over the rating horizon (1H22: 3.5%). Profitability benefits from strong revenue generation, which has been further supported by rising interest rates and only modest increases in loan impairment charges (LICs). LBG's aim is to diversify income and to maintain its sound cost efficiency, thus also supporting earnings resilience.

Strong Capitalisation: LBG' capitalisation is strong with a common equity Tier 1 (CET1) ratio of 14.7% at end-1H22 (14.8% when including its interim insurance dividend), supported by strong profitability and RWAs optimisation, despite a reduction of 230bp on 1 January 2022 for regulatory RWAs inflation. We expect the CET1 ratio to gradually fall towards, but remain above, the bank management's target of about 13.5% through higher capital returns.

Stable Funding Profile: LBG's funding and liquidity profile is sound, supported by a large deposit base, due to a leading retail franchise and good access to wholesale-funding markets. Deposit inflows during the pandemic have improved the loans/deposits ratio in recent years to under 100%, but a portion of these may reduce given affordability pressures. We expect some low-cost deposits to move into higher-yielding accounts as interest rates continue to rise.

Rating Sensitivities

Operating Environment: LBG's ratings have material headroom at the current level, given LBG's strong business profile and performance metrics. However, its Viability Rating (VR) could be downgraded on an unexpected severe setback to the economic outlook.

Financial Metrics: We estimate LBG's average four-year impaired loans ratio to remain at around 2% over the next two years. The VR could be downgraded if the four-year ratio is expected to rise above 3% without a clear path to reduction. Significant weakening in operating profit (below 1.5% of RWAs on a sustained basis) and the CET1 ratio remaining materially below the bank's current target of about 13.5% would also result in a VR downgrade.

Increased Capital Targets: An upgrade of LBG's VR would most likely result from an upgrade of the capitalisation and leverage score. We could upgrade this score if the CET1 ratio remains at or above the bank's current target, and if this is supported by a continued record of strong profitability and healthy asset quality and in the absence of a more aggressive risk appetite. LBG's VR and IDR could be downgraded if the holding company's double leverage increases above 120%.

Ratings

Foreign Currency	
Long-Term IDR	A
Short-Term IDR	F1
Viability Rating	a
Government Support Rating	ns
Sovereign Risk	
Long-Term Foreign-Currency IDR	AA-
Long-Term Local-Currency IDR	AA-
Country Ceiling	AAA

Outlooks

Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Local-Currency IDR	Stable

Applicable Criteria

Bank Rating Criteria (November 2021)

Related Research

Fitch Affirms Lloyds Banking Group at 'A'; Outlook Stable (January 2022)
Lloyds Banking Group plc (February 2022)
Rate Rise Benefits Vary Among UK Banks (June 2022)
Major UK Banks' Resilient Performance Increases Rating Headroom (January 2022)
Global Economic Outlook (June 2022)

Analysts

Huseyin Sevinc
+44 20 3530 1027
huseyin.sevinc@fitchratings.com

Claudia Nelson
+44 20 3530 1191
claudia.nelson@fitchratings.com

Issuer Ratings (Including Main Issuing Entities)

Rating level	LBG	LB	BOS	HBOS plc	LBCM	LBCMW
Long-Term IDR/Outlook	A/Stable	A+/Stable	A+/Stable	A+/Stable	A+/Stable	A+/Stable
Short-Term IDR	F1	F1	F1	F1	F1	F1
Viability Rating	a	a	a	-	-	-
GSR[a]/ SSR[b]	ns[a]	ns[a]	ns[a]	a[b]	a[b]	a[b]
Derivative counterparty Rating	-	-	-	-	A+(dcr)	-

Lloyds Bank plc (LB), Bank of Scotland plc (BOS) and HBOS are the ring-fenced entities of the group and Lloyds Bank Corporate Markets (LBCM) and Lloyds Bank Corporate Markets Wertpapierhandelsbank (LBCMW) are the group's non-ring-fenced entities.
[a] Government Support Rating [b] Shareholder Support Rating
Source: Fitch Ratings

Viability Ratings: Fitch assesses LBG on a consolidated basis as it is managed as a group and its operations are highly integrated. LBG acts as the holding company for the group, and its VR is equalised with that of main operating subsidiaries, reflecting LBG's role in the group and moderate holding company double leverage, which is comfortably below 120%. The ratings of LBCM, LBCMW and HBOS plc are based on support from LBG.

Long-Term IDRs: The Long-Term IDRs of all operating subsidiaries are notched up from the group's and their own VR (where assigned). This is because of the presence of a large (more than 10% of RWAs) buffer of qualifying junior debt and senior holding company debt down-streamed in a subordinated manner, underpinned by minimum requirements for eligible liabilities (MREL) regulations and requirements. These could be made available to protect their senior obligations from default in the event of the failure of any of the group companies.

DCRs: LBCM's Derivative Counterparty Rating is at the same level as its Long-Term IDR because derivative counterparties have no preferential status over other senior obligations in a resolution in the UK.

Short-Term IDRs: The Short-Term IDRs are the lower of two options mapping to the Long-Term IDRs, in line with our assessment of the group's funding and liquidity profile, which we score 'a'.

Debt Class Ratings

Rating level	LBG	LB	BOS	HBOS plc	LBCM
Senior unsecured debt	A/F1	A+/F1	A+/F1	A+/F1	A+/F1
Tier 2 subordinated debt	BBB+	BBB+	BBB+	BBB+	-
Legacy upper Tier 2	BBB	BBB	BBB	BBB	-
Legacy innovative Tier 1 non-discretionary/preference stock	BBB-	-	-	-	-
Additional Tier 1 debt	BBB-	-	-	-	-

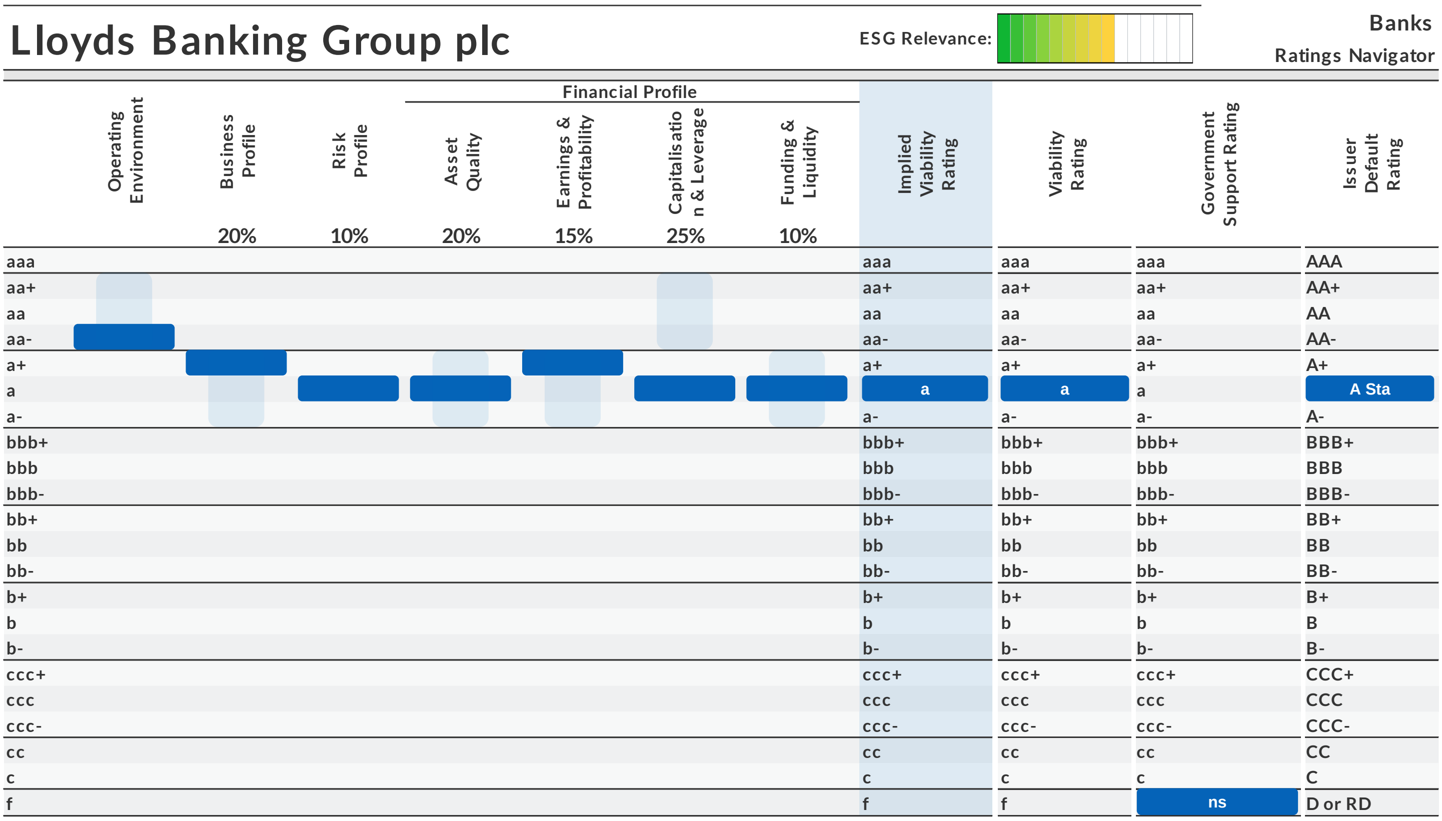
Source: Fitch Ratings

Senior unsecured debt and programme ratings are equalised with their respective issuers' IDRs.

Tier 2 subordinated debt issued by LBG, LB, BOS and HBOS is rated two notches below their respective issuer VRs (LBG's VR in the case of HBOS). This is the baseline notching under our criteria, reflecting high loss severity for this type of debt. The ratings of legacy upper Tier 2 subordinated debt issued by LBG, LB, HBOS and BOS are notched down three times, twice for loss severity and once for incremental non-performance risk.

Additional Tier 1 and legacy Tier 1 and preferred stock issued by LBG are four notches below its anchor VR, two each for loss severity and incremental non-performance risk. Our assessment is based on the group operating with a CET1 ratio comfortably above maximum distributable amount (MDA) thresholds, which we expect to continue.

Ratings Navigator



The Key Rating Driver (KRD) weightings used to determine the implied VR are shown as percentages at the top. In cases where the implied VR is adjusted upwards or downwards to arrive at the VR, the KRD associated with the adjustment reason is highlighted in red. The shaded areas indicate the benchmark-implied scores for each KRD.

The operating-environment score of 'aa-' is at the lower end of the implied range because it is constrained by the UK sovereign rating of 'AA-'/Stable (negative).

The capitalisation-and-leverage score of 'a' is below the 'aa' category implied score, due to the following adjustment reason: historical and future metrics (negative).

Significant Changes

Operating Environment on Stable; Increasing Macroeconomic Pressures

In June 2022, Fitch revised its forecast for UK GDP growth down to 3.8% in 2022 and 1.1% in 2023, after a strong rebound in 2021 (7.4%), and additional downward revisions are likely in our September Global Economic Outlook (GEO). The war in Ukraine has led to higher international energy prices and global supply-chain disruptions have pushed up inflation significantly. The Bank of England (BOE) has raised interest rates six times since December 2021 to 1.75% in August and we forecast rates to reach 3% in this tightening cycle, up from 2.5% expected in the June GEO.

The June 2022 RICS UK Residential Survey results point to a softening in demand of housing transactions although pricing trends remain fairly firm. Mortgage lending growth is shifting towards refinancing and away from new house purchases, as housing transactions return to more normal levels.

The unemployment rate has declined to 3.7%, the lowest level since the 1970s. This is despite employment still being 280,000 below pre-pandemic levels.

The impact of the pandemic on asset quality has been more modest than anticipated but we expect to see slight deterioration from 2023, due to higher interest rates and increasing pressures on affordability for households.

Profitability Supported by Higher Interest Rates

LBG has continued to report strong returns, with a higher-than-peers operating profit of 3.5% of RWAs in 1H22. Operating income increased 6% yoy in 2Q22 primarily due to materially stronger net interest income (NII; 151% yoy) thanks to higher rates and still low cost of funding, and despite continuing mortgage lending pricing pressures. Based on Fitch calculations, operating expenses fell 14% yoy in 2Q22 as cost efficiencies offset inflationary pressures.

Despite the good evolution in NII and costs, operating profit only grew 2% yoy in 2Q22 due to lower non-interest income (on a statutory basis) and higher, albeit still low, LICs. Higher interest rates will significantly support LBG's 2022 return on tangible equity target of about 13%, although we expect the upside sensitivity will diminish as the pass-through rate on deposits increases.

LICs remained low in 2Q22 at 17bp of average loans on an annualised basis as asset quality remained resilient with limited new arrears. We expect the impaired loans ratio (end-June 2022: 1.8%) to deteriorate from 2023 due to pressures on affordability, in particular across consumer and SME borrowers. However, the deterioration should be moderate and LBG retains GBP0.4 billion of provisions against cost of living pressures and GBP0.5 billion of unused pandemic-related overlays.

Following a material decline of close to 200bp in 1Q22 due to regulatory impacts, LBG's CET1 ratio increased by 50bp in 2Q22 to 14.7% at end-June 2022 (14.8% when including interim dividend from the insurance business) thanks to profit generation and RWAs optimisation. We expect the CET1 ratio to gradually fall towards the management's target of about 13.5% as the bank continues with the distribution of excess capital. LBG's strong profitability and current excess capital ratios provide headroom against economic uncertainty.

Summary Financials and Key Ratios

	30 Jun 22		31 Dec 21	31 Dec 20	31 Dec 19
	6 months (USDm) Reviewed - unqualified	6 months (GBPm) Reviewed - unqualified	Year end (GBPm) Audited - unqualified	Year end (GBPm) Audited - unqualified	Year end (GBPm) Audited - unqualified
Summary income statement					
Net interest and dividend income	8,719	7,200.0	9,366.0	10,749.0	10,180.0
Net fees and commissions	903	746.0	1,423.0	1,160.0	1,406.0
Other operating income	941	777.0	5,535.0	3,217.0	6,529.0
Total operating income	10,563	8,723.0	16,324.0	15,126.0	18,115.0
Operating costs	5,676	4,687.0	10,802.0	9,656.0	10,220.0
Pre-impairment operating profit	4,887	4,036.0	5,522.0	5,470.0	7,895.0
Loan and other impairment charges	454	375.0	-1,380.0	4,155.0	1,296.0
Operating profit	4,433	3,661.0	6,902.0	1,315.0	6,599.0
Other non-operating items (net)	n.a.	n.a.	n.a.	-89.0	-2,206.0
Tax	1,011	835.0	1,017.0	-161.0	1,387.0
Net income	3,422	2,826.0	5,885.0	1,387.0	3,006.0
Other comprehensive income	-3,144	-2,596.0	-950.0	110.0	-1,126.0
Fitch-defined comprehensive income	279	230.0	4,935.0	1,497.0	1,880.0
Summary balance sheet					
Assets					
Gross loans	556,952	459,948.0	452,387.0	445,960.0	443,647.0
- Of which impaired	9,802	8,095.0	8,694.0	9,089.0	8,754.0
Loan loss allowances	4,666	3,853.0	3,820.0	5,760.0	3,259.0
Net loans	552,287	456,095.0	448,567.0	440,200.0	440,388.0
Interbank	9,497	7,843.0	7,001.0	8,060.0	8,220.0
Derivatives	36,005	29,734.0	22,051.0	29,613.0	26,369.0
Other securities and earning assets	332,768	274,810.0	306,733.0	295,608.0	279,962.0
Total earning assets	930,557	768,482.0	784,352.0	773,481.0	754,939.0
Cash and due from banks	105,006	86,717.0	76,420.0	73,257.0	55,130.0
Other assets	42,635	35,209.0	25,753.0	24,531.0	23,824.0
Total assets	1,078,198	890,408.0	886,525.0	871,269.0	833,893.0
Liabilities					
Customer deposits	579,070	478,213.0	476,344.0	450,651.0	411,790.0
Interbank and other short-term funding	88,591	73,161.0	66,851.0	72,268.0	68,046.0
Other long-term funding	81,786	67,541.0	69,394.0	82,563.0	91,403.0
Trading liabilities and derivatives	56,024	46,266.0	26,221.0	34,963.0	36,217.0
Total funding and derivatives	805,470	665,181.0	638,810.0	640,445.0	607,456.0
Other liabilities	212,092	175,152.0	192,414.0	178,706.0	174,504.0
Preference shares and hybrid capital	6,642	5,485.0	8,055.0	8,611.0	10,033.0
Total equity	53,994	44,590.0	47,246.0	43,507.0	41,900.0
Total liabilities and equity	1,078,198	890,408.0	886,525.0	871,269.0	833,893.0
Exchange rate		USD1 = GBP0.82583	USD1 = GBP0.74438	USD1 = GBP0.745156	USD1 = GBP0.76211

Source: Fitch Ratings

Summary Financials and Key Ratios

	30 Jun 22	31 Dec 21	31 Dec 20	31 Dec 19
Ratios (annualised as appropriate)				
Profitability				
Operating profit/RWAs	3.5	3.5	0.7	3.2
Net interest income/average earning assets	1.9	1.3	1.7	1.7
Non-interest expense/gross revenue	53.7	66.2	63.8	56.4
Net income/average equity	12.4	13.0	3.2	7.0
Asset quality				
Impaired loans ratio	1.8	1.9	2.0	2.0
Growth in gross loans	1.7	1.4	0.5	-0.9
Loan loss allowances/impaired loans	47.6	43.9	63.4	37.2
Loan impairment charges/average gross loans	0.2	-0.3	0.9	0.3
Capitalisation				
Common equity Tier 1 ratio	14.7	17.3	16.2	13.6
Tangible common equity/tangible assets	3.9	4.3	4.0	4.0
Basel leverage ratio	4.7	5.2	5.3	4.8
Net impaired loans/common equity Tier 1	13.8	14.4	10.1	19.8
Funding and liquidity				
Gross loans/customer deposits	96.2	95.0	99.0	107.7
Liquidity coverage ratio	142.0	135.0	136.0	137.0
Customer deposits/total non-equity funding	74.2	75.8	72.5	69.6

Source: Fitch Ratings

Government/Shareholder Support

The GSRs of LBG, LB and BOS reflect Fitch's view that senior creditors cannot rely on extraordinary support from the UK authorities in the event these issuers become non-viable. This is due to UK legislation and regulations that provide a framework requiring senior creditors to participate in losses in a failure.

Commercial Banks: Government Support	
Typical D-SIB GSR for sovereign's rating level (assuming high propensity)	A or A-
Actual jurisdiction D-SIB GSR	ns
Government Support Rating	**ns**
Government ability to support D-SIBs	
Sovereign Rating	AA-/ Stable
Size of banking system	Negative
Structure of banking system	Negative
Sovereign financial flexibility (for rating level)	Positive
Government propensity to support D-SIBs	
Resolution legislation	Negative
Support stance	Negative
Government propensity to support bank	
Systemic importance	Neutral
Liability structure	Neutral
Ownership	Neutral

The colours indicate the weighting of each KRD in the assessment.
Higher influence Moderate influence Lower influence

Environmental, Social and Governance Considerations

FitchRatings **Lloyds Banking Group plc** Banks Ratings Navigator

Credit-Relevant ESG Derivation

Lloyds Banking Group plc has 5 ESG potential rating drivers

- Lloyds Banking Group plc has exposure to compliance risks including fair lending practices, mis-selling, repossession/foreclosure practices, consumer data protection (data security) but this has very low impact on the rating.
- Governance is minimally relevant to the rating and is not currently a driver.

			Overall ESG Scale
key driver	0	issues	5
driver	0	issues	4
potential driver	5	issues	3
not a rating driver	4	issues	2
	5	issues	1

Environmental (E)

General Issues	E Score	Sector-Specific Issues	Reference	E Scale
GHG Emissions & Air Quality	1	n.a.	n.a.	5
Energy Management	1	n.a.	n.a.	4
Water & Wastewater Management	1	n.a.	n.a.	3
Waste & Hazardous Materials Management; Ecological Impacts	1	n.a.	n.a.	2
Exposure to Environmental Impacts	2	Impact of extreme weather events on assets and/or operations and corresponding risk appetite & management; catastrophe risk; credit concentrations	Business Profile (incl. Management & governance); Risk Profile; Asset Quality	1

Social (S)

General Issues	S Score	Sector-Specific Issues	Reference	S Scale
Human Rights, Community Relations, Access & Affordability	2	Services for underbanked and underserved communities: SME and community development programs; financial literacy programs	Business Profile (incl. Management & governance); Risk Profile	5
Customer Welfare - Fair Messaging, Privacy & Data Security	3	Compliance risks including fair lending practices, mis-selling, repossession/foreclosure practices, consumer data protection (data security)	Operating Environment; Business Profile (incl. Management & governance); Risk Profile	4
Labor Relations & Practices	2	Impact of labor negotiations, including board/employee compensation and composition	Business Profile (incl. Management & governance)	3
Employee Wellbeing	1	n.a.	n.a.	2
Exposure to Social Impacts	2	Shift in social or consumer preferences as a result of an institution's social positions, or social and/or political disapproval of core banking practices	Business Profile (incl. Management & governance); Financial Profile	1

Governance (G)

General Issues	G Score	Sector-Specific Issues	Reference	G Scale
Management Strategy	3	Operational implementation of strategy	Business Profile (incl. Management & governance)	5
Governance Structure	3	Board independence and effectiveness; ownership concentration; protection of creditor/stakeholder rights; legal /compliance risks; business continuity; key person risk; related party transactions	Business Profile (incl. Management & governance); Earnings & Profitability; Capitalisation & Leverage	4
Group Structure	3	Organizational structure; appropriateness relative to business model; opacity; intra-group dynamics; ownership	Business Profile (incl. Management & governance)	3
Financial Transparency	3	Quality and frequency of financial reporting and auditing processes	Business Profile (incl. Management & governance)	2
				1

How to Read This Page
ESG scores range from 1 to 5 based on a 15-level color gradation. Red (5) is most relevant and green (1) is least relevant.

The Environmental (E), Social (S) and Governance (G) tables break out the individual components of the scale. The right-hand box shows the aggregate E, S, or G score. General Issues are relevant across all markets with Sector-Specific Issues unique to a particular industry group. Scores are assigned to each sector-specific issue. These scores signify the credit-relevance of the sector-specific issues to the issuing entity's overall credit rating. The Reference box highlights the factor(s) within which the corresponding ESG issues are captured in Fitch's credit analysis.

The Credit-Relevant ESG Derivation table shows the overall ESG score. This score signifies the credit relevance of combined E, S and G issues to the entity's credit rating. The three columns to the left of the overall ESG score summarize the issuing entity's sub-component ESG scores. The box on the far left identifies some of the main ESG issues that are drivers or potential drivers of the issuing entity's credit rating (corresponding with scores of 3, 4 or 5) and provides a brief explanation for the score.

Classification of ESG issues has been developed from Fitch's sector ratings criteria. The General Issues and Sector-Specific Issues draw on the classification standards published by the United Nations Principles for Responsible Investing (PRI) and the Sustainability Accounting Standards Board (SASB).

Sector references in the scale definitions below refer to Sector as displayed in the Sector Details box on page 1 of the navigator.

CREDIT-RELEVANT ESG SCALE

How relevant are E, S and G issues to the overall credit rating?	
5	Highly relevant, a key rating driver that has a significant impact on the rating on an individual basis. Equivalent to "higher" relative importance within Navigator.
4	Relevant to rating, not a key rating driver but has an impact on the rating in combination with other factors. Equivalent to "moderate" relative importance within Navigator.
3	Minimally relevant to rating, either very low impact or actively managed in a way that results in no impact on the entity rating. Equivalent to "lower" relative importance within Navigator.
2	Irrelevant to the entity rating but relevant to the sector.
1	Irrelevant to the entity rating and irrelevant to the sector.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit neutral or have only a minimal credit impact on LBG, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.