FitchRatings

Banks
Universal Commercial Banks
United Kingdom

Lloyds Banking Group plc

Update

Key Rating Drivers

Leading Domestic Franchise: Lloyds Banking Group's (LBG) ratings reflect its leading domestic retail and SME banking franchise, strong record of pre-impairment profitability, as well as its solid capitalisation and funding. LBG's credit strength is correlated with the UK operating environment, for which Fitch Ratings believes downside risks have subsided. The agency expects LBG's earnings, asset quality and capitalisation will continue to support the group's 'a' Viability Rating (VR), despite the remaining uncertainties about the coming quarters.

Solid Operating Profitability: Loan impairment charges (LICs) should decline significantly in 2021 after a surge in 2020, reflecting the improved economic outlook, borrowers' resilience during the pandemic, government support measures, and the group's conservative provisioning policy. A benign outlook for LICs should help LBG's profitability recover gradually to its strong pre-pandemic levels, despite continued pressure from lower margins, modest earning asset growth, and only a gradual recovery in fee-generating customer activity.

Sound Asset Quality; Some Deterioration: We expect further pressure on the group's Stage 3 loans, particularly from sectors which faced economic restrictions and from unsecured retail lending. The group's exposure to both sectors has decreased since the onset of the pandemic.

Strategy Benefits Only Gradual: The group's updated strategy should improve income diversification and cost efficiency, adding resilience in a prolonged low-interest rate environment. However, the benefits will be gradual and offset by higher restructuring and investments in the near term.

Strong Capitalisation: We expect the group's common equity Tier 1 (CET1) capital ratio to remain strong on a fully-loaded basis and in excess of management's target of about 13.5%. The high 15.5% CET1 ratio reported at end-2Q21 is likely to be pressured by higher shareholder distribution and by RWAs inflation in 2022 but capitalisation is likely to continue to benefit from solid profitability and stable risk-weighted assets (RWAs) in 2021.

Stable Funding Profile: LBG's funding and liquidity profile is strong, thanks to the group's large and stable deposit base derived from its leading retail franchise. Deposit inflows since the onset of the pandemic have pushed the group's loans/deposits ratio below 100%, but a proportion of these deposits may prove transitory.

Rating Sensitivities

Setbacks to Economic Recovery: The ratings could be downgraded in the event of an unexpected severe setback to the economic outlook or if the financial repercussions of rising unemployment and economic disruptions due to the pandemic are worse than assumed.

Prolonged Financial Weakness: A downgrade could be triggered by an increase in the four-year average Stage 3 loan ratio to above 3% without a clear path to reduction; if capitalisation deteriorates sharply with the CET1 ratio breaching the management's target of about 13.5%; or if there is prolonged earnings weakness resulting in operating profit below 1.5% of RWAs. Ratings are also sensitive to an increase in risk appetite or risk controls shortcomings. LBG's VR could be downgraded if the holding company's double leverage increases above 120%.

Medium-Term Upside: As the economic uncertainty subsides, LBG's ratings could be upgraded if its through-the-cycle earnings generation, asset quality volatility and capitalisation are comparable with higher-rated international peers'. High indebtedness of the UK private sector means the VRs of domestic retail banks in the UK are constrained in the 'a' category.

Ratings

Foreign Currency	
Long-Term IDR	A
Short-Term IDR	F1
Viability Rating	a
Support Rating	5
Support Rating Floor	NF

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 (February 2020)

Non-Bank Financial Institutions Rating Criteria (February 2020)

Related Research

Fitch Revises Lloyds Banking Group's Outlook to Stable; Affirms at 'A' (July 2021)

Global Economic Outlook (June 2021)

Improved Economic Prospects Drive Large UK Banks' Stable OE Outlooks (July 2021)

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Issuer and Debt Ratings

Fitch assesses LBG on a consolidated basis as it is managed as a group and is highly integrated. LBG acts as the group holding company, and its VR is equalised with that of the main operating subsidiaries, Lloyds Bank plc (LB), and Bank of Scotland Plc (BOS), reflecting LBG's role in the group and moderate holding company double leverage, comfortably below 120%. Fitch assigns a common VR to LB and BOS due to their size and integration.

LBG's Long-Term Issuer Default Rating (IDR) is driven by and at the same level as its VR, as its consolidated qualifying junior debt buffer is expected to remain below 10% of RWAs. LB and BOS's Long-Term IDRs are notched up from their VRs to reflect additional protection to external senior creditors afforded by the internal minimum requirements for own funds and eligible liabilities (MREL) debt buffers. We also incorporate this benefit into the IDRs of HBOS plc (HBOS), Lloyds Bank Corporate Markets Public Limited Company (LBCM) and Lloyds Bank Corporate Markets Wertpapierhandelsbank GmbH (LBCMW). The latter have not been assigned VRs and their IDRs reflect a very high probability of institutional support from LBG if needed. The Short-Term IDRs of 'F1' for all entities are the lower option mapping to the Long-Term IDRs in line with our assessment of the group's funding and liquidity profile, which we score 'a'.

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	-	-	-
Support Rating	5	5	5	1	1	1
Support Rating Floor	NF	NF	NF	-	-	-
Derivative Counterparty Rating	A(dcr)	A+(dcr)	A+(dcr)	-	A+(dcr)	-

Source: Fitch Ratings

The senior unsecured debt ratings and derivative counterparty ratings of these entities, where assigned, are in line with the respective Long-Term IDRs.

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

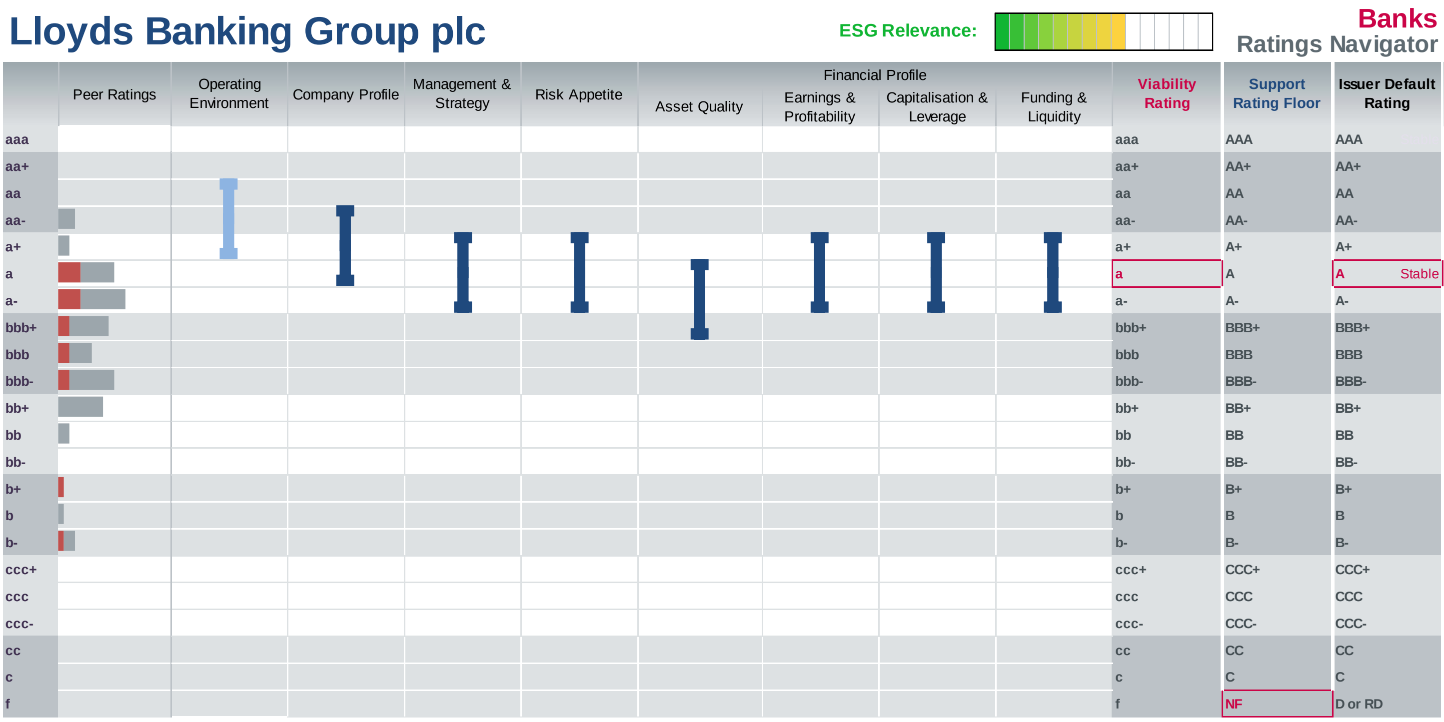
Additional Tier 1 and legacy Tier 1 and preferred stock issued by LBG, LB and BOS are four notches below the anchor VRs, two each for loss severity and incremental non-performance risk. Our assessment is based on the group operating with a CET1 ratio comfortably above maximum distributable amount thresholds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

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-	BBB-	BBB-	-	-
Additional Tier 1 debt	BBB-	BBB-	-	-	-

Source: Fitch Ratings

Ratings Navigator



Significant Changes

Rating Outlook Stabilised Linked to Operating Environment

Fitch revised the Outlooks on LBG and its banking subsidiaries to Stable from Negative in July 2021. The revision of the Outlooks primarily reflects the revision of the outlook on Fitch's operating environment score for UK banks with predominantly domestic operations to stable from negative. This followed the recent revision of the Outlook on the UK's 'AA-' Long-Term IDR to Stable, and Fitch's improved expectations for the UK's economic recovery.

We now believe that the challenges to the UK economy from the coronavirus pandemic have subsided sufficiently to remove the negative outlook on the UK operating environment score. Businesses have adapted better to working within the economic restrictions, and private consumption and investment have been resilient, resulting in an upward revision of Fitch's real GDP growth estimate and forecast for 2020 and 2021 to -9.8% and +6.6%, respectively, with growth moderating to 5.0% in 2022. We expect the unemployment rate to average just 5.4% in 2021, supported by the extension of income and job-support schemes and the continuation of fiscal and pandemic-related loan support to businesses.

Stabilised Trend on Asset Quality Score Despite Uncertainties

In line with a more benign outlook for the operating environment, we have also revised the outlook on LBG's asset quality to stable. We expect its Stage 3 loan ratio to remain consistent with 'a' category asset quality, although it will likely increase above the 1.9% seen at end-2Q21, to 2% or 3% over 2021-2022, according to Fitch’s assumptions.

We continue to view sectors facing economic restrictions and unsecured retail lending as most vulnerable, while noting that the group's exposure to both has decreased since the onset of the pandemic. In the commercial exposure, impacted sectors make up a relatively modest amount of credit exposures with around GBP8.2 billion drawn balances at end-2Q20 (GBP15.2

Bar Chart Legend

Vertical bars – VR range of Rating Factor

Bar Colors – Influence on final VR

- Higher influence
- Moderate influence
- Lower influence

Bar Arrows – Rating Factor Outlook

⇧ Positive ⇩ Negative

⇳ Evolving ▫ Stable

including undrawn balances) equivalent to 10% of commercial loans and under 2% of total loans.

Payment holidays have largely matured, with 93% of related loan repayments having resumed at end-2Q21. Payment holidays still in force, together with matured and extended or delinquent ones represented 1% of loans, and the vast majority are mortgage loans which mitigates the associated loss potential.

Profitability to Improve Mainly on LICs

We have revised the outlook on LBG's earnings score to stable as we expect LBG to report operating profit/RWAs in excess of 2% over the next two years, based on pre-provision operating profit assumptions broadly consistent with the management's guidance, and slightly more conservative assumptions on LICs. Lloyds' profitability prospects have risen owing to the improved UK economic outlook and demand dynamics in 1H21.

We expect LICs to decline significantly in 2021 after a surge in 2020, supported by the improved economic outlook, by borrowers' resilience during the pandemic, partly due to government support schemes, and by LBG’s conservative provisioning policy. The group supplemented modelled credit losses with management overlays of GBP1.2 billion at end-1H21, which may be gradually released as the uncertainty subsides. In 1H21 the bank reported net releases of LICs of GBP0.66 billion, reflecting the improved economic outlook and recoveries on restructured commercial exposure.

The bank’s management has updated its guidance that the group will report 10% return on tangible equity (1H21: 14.2%) in 2021, with a LICs/gross loans ratio (cost of risk) of below 10bp and excluding an expected benefit, mostly on deferred tax assets, from higher UK corporation tax. The bank expects to maintain operating cost discipline in 2021, while restructuring costs will rise above the GBP0.5 billion seen in 2020.

Solid Capitalisation, Funding and Liquidity

We have stabilised the outlook on our assessment of capitalisation as the group's capitalisation improved to 15.5% fully-loaded CET1 ratio at end-1H21 (excluding IFRS9 transitional and software intangibles benefits) from an already high 14.5% at end-2020 and we expect it to remain within management’s guidance. On an IFRS9 phased-in basis the ratio was 16.7%, well in excess of requirements (around 11%). The bank has guided to slightly reduced RWAs in 2021 relative to 2020, and regulatory headwinds in 2022, which we include in our expectations, as well as increased and progressive dividends and 30bp CET1 reduction at completion of an acquisition.

The group's loans/deposits ratio is running below historical levels at 95% based on Fitch's calculation after an increase in customer deposits since the pandemic. To an extent these deposits are transitory and may decrease once spending picks up, something which the bank also factors in conservatively by leaving significant deposits unhedged or reinvested at short durations.

Liquidity is well managed and robust supported by a large pool of high-quality liquid assets, a significant proportion of which are in the form of cash and cash equivalents.

Summary Financials and Key Ratios

	30 Jun 21		31 Dec 20	31 Dec 19	31 Dec 18
	6 Months - Interim (USDm)	6 Months - Interim (GBPm)	Year end (GBPm)	Year end (GBPm)	Year end (GBPm)
Summary income statement					
Net interest and dividend income	6,062	4,373.0	10,749.0	10,180.0	13,396.0
Net fees and commissions	961	693.0	1,160.0	1,406.0	1,462.0
Other operating income	4,177	3,013.0	3,217.0	6,529.0	3,924.0
Total operating income	11,200	8,079.0	15,126.0	18,115.0	18,782.0
Operating costs	6,791	4,899.0	9,656.0	10,220.0	10,980.0
Pre-impairment operating profit	4,408	3,180.0	5,470.0	7,895.0	7,802.0
Loan and other impairment charges	-1,005	-725.0	4,155.0	1,296.0	936.0
Operating profit	5,413	3,905.0	1,315.0	6,599.0	6,866.0
Other non-operating items (net)	n.a.	n.a.	-89.0	-2,206.0	-906.0
Tax	55	40.0	-161.0	1,387.0	1,560.0
Net income	5,358	3,865.0	1,387.0	3,006.0	4,400.0
Other comprehensive income	-1,079	-778.0	110.0	-1,126.0	-113.0
Fitch comprehensive income	4,280	3,087.0	1,497.0	1,880.0	4,287.0
Summary balance sheet					
Assets					
Gross loans	627,062	452,328.0	445,960.0	443,647.0	447,525.0
- Of which impaired	11,944	8,616.0	9,089.0	8,754.0	9,215.0
Loan loss allowances	6,477	4,672.0	5,760.0	3,259.0	3,150.0
Net loans	620,585	447,656.0	440,200.0	440,388.0	444,375.0
Interbank	9,997	7,211.0	8,060.0	8,220.0	5,781.0
Derivatives	30,766	22,193.0	29,613.0	26,369.0	21,632.0
Other securities and earning assets	403,513	291,072.0	295,608.0	279,962.0	240,153.0
Total earning assets	1,064,861	768,132.0	773,481.0	754,939.0	711,941.0
Cash and due from banks	109,471	78,966.0	73,257.0	55,130.0	54,663.0
Other assets	45,178	32,589.0	24,531.0	23,824.0	30,994.0
Total assets	1,219,509	879,687.0	871,269.0	833,893.0	797,598.0
Liabilities					
Customer deposits	657,728	474,449.0	450,651.0	411,790.0	416,248.0
Interbank and other short-term funding	62,643	45,187.0	72,268.0	68,046.0	73,791.0
Other long-term funding	104,930	75,691.0	82,563.0	91,403.0	84,758.0
Trading liabilities and derivatives	54,073	39,005.0	34,963.0	36,217.0	30,325.0
Total funding	879,374	634,332.0	640,445.0	607,456.0	605,122.0
Other liabilities	264,779	190,997.0	178,706.0	174,504.0	138,269.0
Preference shares and hybrid capital	11,614	8,378.0	8,611.0	10,033.0	10,499.0
Total equity	63,742	45,980.0	43,507.0	41,900.0	43,708.0
Total liabilities and equity	1,219,509	879,687.0	871,269.0	833,893.0	797,598.0
Exchange rate		USD1 = GBP0.721345	USD1 = GBP0.745156	USD1 = GBP0.76211	USD1 = GBP0.78768

Source: Fitch Ratings, Fitch Solutions, LBG

Summary Financials and Key Ratios

	30 Jun 21	31 Dec 20	31 Dec 19	31 Dec 18
Ratios (annualised as appropriate)				
Profitability				
Operating profit/risk-weighted assets	3.9	0.7	3.2	3.3
Net interest income/average earning assets	1.3	1.7	1.7	2.1
Non-interest expense/gross revenue	60.6	63.8	56.4	58.5
Net income/average equity	17.6	3.2	7.0	10.2
Asset quality				
Impaired loans ratio	1.9	2.0	2.0	2.1
Growth in gross loans	1.4	0.5	-0.9	-0.7
Loan loss allowances/impaired loans	54.2	63.4	37.2	34.2
Loan impairment charges/average gross loans	-0.3	0.9	0.3	0.2
Capitalisation				
Common equity Tier 1 ratio	16.7	16.2	13.6	14.6
Fully loaded common equity Tier 1 ratio	15.9	15.0	13.3	14.6
Tangible common equity/tangible assets	4.2	4.0	4.0	4.5
Basel leverage ratio	5.2	5.8	4.8	5.1
Net impaired loans/common equity Tier 1	11.8	10.1	19.8	20.1
Funding and liquidity				
Loans/customer deposits	95.3	99.0	107.7	107.5
Liquidity coverage ratio	131.0	136.0	137.0	130.0
Customer deposits/funding	75.9	72.5	69.6	70.1
Net stable funding ratio	n.a.	n.a.	n.a.	n.a.

Source: Fitch Ratings, Fitch Solutions, LBG

Sovereign Support Assessment

LBG's, LB's and BOS's Support Ratings and Support Rating Floors reflect Fitch's view that senior creditors cannot rely on extraordinary support from the UK authorities in the event the banks become non-viable, given resolution legislations and planning.

Support Rating Floor			Value
Typical D-SIB SRF for sovereign's rating level (assuming high propensity)			
Actual country D-SIB SRF			NF
Support Rating Floor:			**NF**
Support Factors	Positive	Neutral	Negative
Sovereign ability to support system			
Size of banking system relative to economy			✓
Size of potential problem	✓		
Structure of banking system			✓
Liability structure of banking system		✓	
Sovereign financial flexibility (for rating level)	✓		
Sovereign propensity to support system			
Resolution legislation with senior debt bail-in			✓
Track record of banking sector support		✓	
Government statements of support			✓
Sovereign propensity to support bank			
Systemic importance		✓	
Liability structure of bank		✓	
Ownership		✓	
Specifics of bank failure		✓	
Policy banks			
Policy role			
Funding guarantees and legal status			
Government ownership			

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	Company Profile; Management & Strategy; Risk Appetite; 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	Company Profile; Management & Strategy; Risk Appetite	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; Company Profile; Management & Strategy; Risk Appetite	4
Labor Relations & Practices	2	Impact of labor negotiations, including board/employee compensation and composition	Company Profile; Management & Strategy	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	Company Profile; Financial Profile	1

Governance (G)

General Issues	G Score	Sector-Specific Issues	Reference	G Scale
Management Strategy	3	Operational implementation of strategy	Management & Strategy	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	Management & Strategy; Earnings & Profitability; Capitalisation & Leverage	4
Group Structure	3	Organizational structure; appropriateness relative to business model; opacity; intra-group dynamics; ownership	Company Profile	3
Financial Transparency	3	Quality and frequency of financial reporting and auditing processes	Management & Strategy	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 the entity, 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.