MOODY'S INVESTORS SERVICE

CREDIT OPINION

11 December 2019

Update

Rate this Research

RATINGS

Domicile	United Kingdom
Long Term CRR	Not Assigned
Long Term Debt	A3
Type	Senior Unsecured - Fgn Curr
Outlook	Negative
Long Term Deposit	Not Assigned

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Lloyds Banking Group plc

Update following outlook change to negative from stable

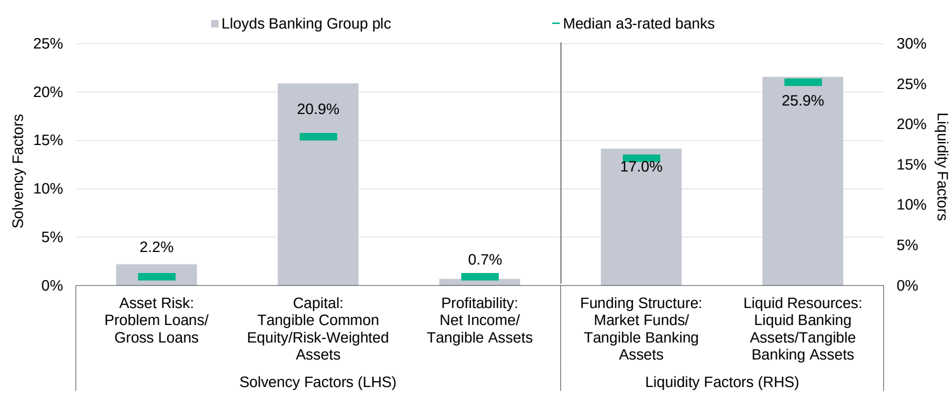
Summary

The A3 senior unsecured debt rating of Lloyds Banking Group plc (LBG) reflects (1) the group's standalone creditworthiness, expressed in an a3 Baseline Credit Assessment (BCA); (2) moderate loss-given-failure, which does not result in any uplift under our Advanced Loss Given Failure (LGF) analysis; and (3) our assessment of a low probability of support from the Government of United Kingdom (Aa2 negative), which also does not result in any uplift.

LBG's a3 BCA takes into account the group's low asset risk, stable core earnings and strong current levels of capital, which are, however, more susceptible to deterioration in a stress scenario than that of most of its peers because of the group's exposures to unsecured consumer loans and buy-to-let mortgages, as well as our expectation that problem loan impairments will increase.

LBG's insurance subsidiary Scottish Widows Limited (Scottish Widows, IFRS A2 stable) provides earnings diversification to the group's banking activities carried out by the ring-fenced bank Lloyds Bank plc (Lloyds Bank, Aa3/Aa3 negative, a3/a3[1]), and non-ring-fenced banks Lloyds Bank Corporate Markets plc (LBCM, A1/A1 stable, baa3/baa1).

Exhibit 1
Rating Scorecard - Key financial ratios



Source: Moody's Investors Service

Credit strengths

» Low asset risk

» Strong capital

» Stable core earnings

» Stable retail funding

Credit challenges

» Likely increase in loan impairments

» Capital susceptible to stress

» Lingering conduct costs

Outlook

The outlook on LBG's senior unsecured debt rating is negative. The outlook reflects our view that (1) the UK's economic and fiscal strength are likely to be weaker going forward, and more susceptible to shocks than what we previously assumed, and (2) UK public institutions have weakened, as they have struggled to cope with the magnitude of policy challenges that they currently face, including those that relate to fiscal policy.

Factors that could lead to an upgrade

The BCA of LBG could be upgraded if (1) the prospects for the UK's economy and institutions either stabilise or improve, and (2) its capital buffers increase and profitability improves. An upgrade of the BCA would lead to an upgrade of all long-term ratings of LBG.

LBG's senior unsecured debt rating could also be upgraded following a significant increase in the stock of subordinated debt issued by LBG or externally by Lloyds Bank.

Factors that could lead to a downgrade

The BCA of LBG could be downgraded following (1) a deterioration of the UK operating environment, or (2) a material decline in the group's capital metrics. A downgrade of the BCA would result in the downgrade of all long-term ratings.

The ratings of LBG could also be downgraded following a reduction in its stock of externally issued unsecured debt.

Key indicators

Exhibit 2

Lloyds Banking Group plc (Consolidated Financials) [1]

	06-19[2]	12-18[2]	12-17[2]	12-16[2]	12-15[2]	CAGR/Avg.[3]
Total Assets (GBP Billion)	776.3	754.6	771.5	762.0	758.0	0.7[4]
Total Assets (USD Billion)	988.0	961.1	1,043.6	941.5	1,117.2	(3.4)[4]
Tangible Common Equity (GBP Billion)	43.1	42.5	41.7	41.9	42.5	0.4[4]
Tangible Common Equity (USD Billion)	54.9	54.2	56.4	51.7	62.6	(3.7)[4]
Problem Loans / Gross Loans (%)	2.2	2.1	1.7	1.9	2.1	2.0[5]
Tangible Common Equity / Risk Weighted Assets (%)	20.9	20.6	19.8	19.4	19.1	20.0[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	20.7	20.2	17.9	19.2	21.1	19.8[5]
Net Interest Margin (%)	1.3	1.9	1.5	1.3	1.5	1.5[5]
PPI / Average RWA (%)	4.0	3.7	3.0	2.7	1.5	3.0[6]
Net Income / Tangible Assets (%)	0.7	0.5	0.7	1.2	0.2	0.7[5]
Cost / Income Ratio (%)	57.6	59.7	66.3	67.1	81.0	66.3[5]
Market Funds / Tangible Banking Assets (%)	17.6	17.0	18.7	16.5	16.0	17.1[5]
Liquid Banking Assets / Tangible Banking Assets (%)	23.2	25.9	22.6	23.9	23.4	23.8[5]
Gross Loans / Due to Customers (%)	103.4	104.1	107.6	107.4	106.7	105.8[5]

[1]All figures and ratios are adjusted using Moody's standard adjustments. [2]Basel III - fully-loaded or transitional phase-in; IFRS. [3]May include rounding differences due to scale of reported amounts. [4]Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime. [5]Simple average of periods presented for the latest accounting regime. [6]Simple average of Basel III periods presented.

Source: Moody's Investors Service; Company Filings

Profile

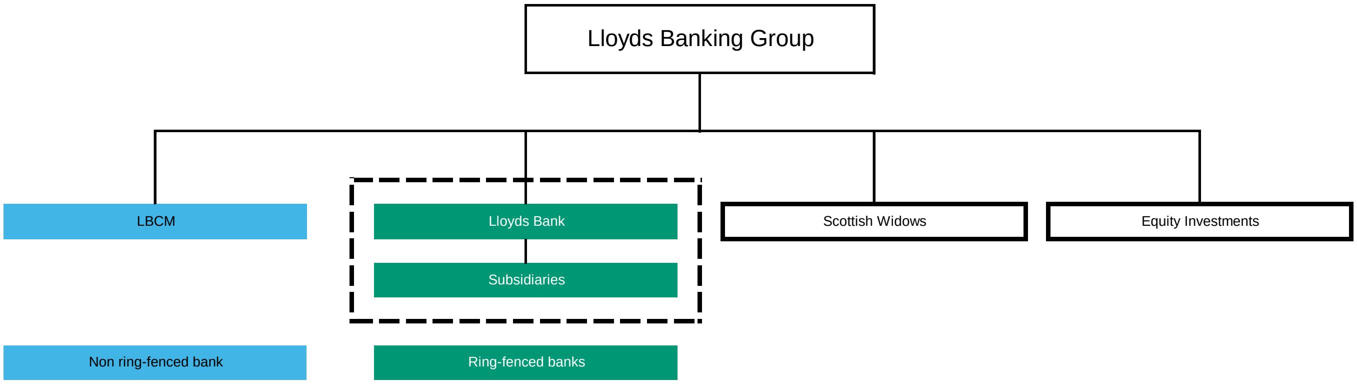
Lloyds Banking Group plc (LBG) is the holding company of a leading UK-based financial services group providing a wide range of banking and financial services, focused on personal and commercial customers. The group's main business activities are retail and commercial banking, as well as general insurance and life, pensions and investment provision carried out by Scottish Widows and its subsidiaries. The group operates the largest retail banking network of the UK via different brands (mainly Lloyds Bank, Halifax, Bank of Scotland), and has a large and diversified customer base.

In 2019 LBG launched a strategic partnership with Schroders plc, which includes the creation of a joint-venture for affluent clients to which LBG has been transferring around £13 billion assets from its existing retail division, and the acquisition of a 19.9% stake in Cazenove Capital.

The changes stemming from the implementation of the UK's structural reform (so-called ring-fencing) in LBG's corporate structure were modest. Most of LBG's banking activities, including more than 95% of the loan portfolio and most of the retail, small and medium-sized enterprise business, and corporate deposits, remained concentrated in the ring-fenced Lloyds Bank. In 2018, capital markets activities, business outside of the European Economic Area and lending to financial institutions were transferred to a non-ring-fenced entities, Lloyds Bank Corporate Markets plc (LBCM). LBCM accounts for around 5% of the group's lending and about 10% of risk-weighted assets (RWA).

In the current structure, Lloyds Bank, Scottish Widows and LBCM are all directly owned by LBG.

Exhibit 3
Lloyds Banking Group's simplified structure



Sources: Moody's Investors Service, LBG

Detailed credit considerations

The financial data in the following sections are sourced from LBG's consolidated financial statements, unless otherwise stated.

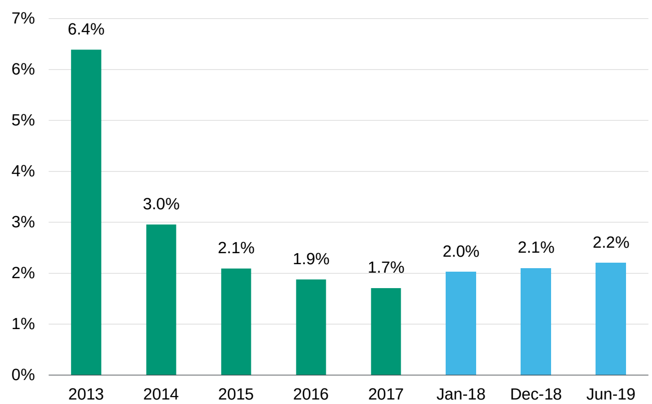
Low asset risk, but impairments will increase

We assign an a3 Asset Risk score, one notch below the Macro-Adjusted score, taking into account LBG's moderate exposure to buy-to-let mortgages and unsecured consumer credit products.

In June 2019, we calculated that Stage 3 loans, as classified under IFRS9, were 2.2% of the total loan book[2]. Stage 2 loans were 9% as of the same date, in line with that of its peers. LBG has significantly reduced its stock of impaired loans, largely reflecting the disposal of run-off assets.

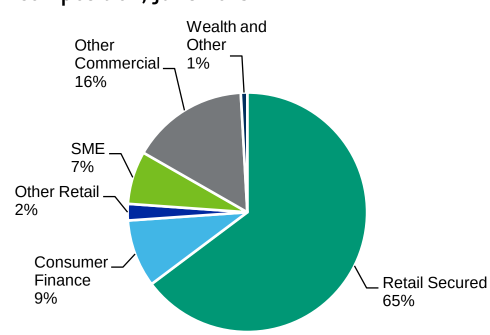
We expect the macroeconomic environment in the UK to weaken, with real GDP growth at 1% in 2020 and 2021[3], leading to a likely mild increase in LBG's stock of problem loans.

Exhibit 4
Problem loans as a percentage of gross loans



Problem loan data from 2018 are classified under IFRS9; previous figures were reported under IAS39. For December 2018 and June 2019 we also include the purchased or originated credit-impaired that LBG classifies under Stage 3.
Source: LBG's financial reports

Exhibit 5
Loan book composition, June 2019



Source: LBG's financial reports

The bank remains focused on the prime UK residential mortgage business, a segment with low risk. Within UK residential mortgages, 18% are buy-to-let loans, which represents a higher proportion than for some of LBG's peers[4]. Furthermore, following the acquisition of credit card provider MBNA Ltd from Bank of America, N.A. (Aa3/Aa3 stable, baa1/baa1), LBG has increased its presence in unsecured consumer finance.

As is the case for other large UK banks, LBG remains exposed to conduct and litigation risks. In particular, up to September 2019, LBG booked a total of £21.9 billion of provisions against mis-selling of payment protection insurance (PPI) products (see also section "Stable core earnings"). As the deadline for complaints of August 2019 has expired, we expect PPI-related charges to gradually decline.

LBG is not exposed to conduct-risk costs in the acquired MBNA credit card portfolio because of an indemnity provided by MBNA's previous shareholder, Bank of America.

In line with its business model, LBG's market risk is limited, with market risk representing just 1.0% of total RWA (operational risk accounted for 12%). Value at risk (VaR) is low; according to the European Banking Authority (EBA) transparency exercise, LBG's stressed VaRs were 0.3% and 0.2% of tangible common equity in December 2017 and in June 2018 respectively.

LBG has a low-risk sovereign bond book, although it is highly concentrated in the UK. According to EBA data, in June 2018, LBG's largest sovereign exposures were to the UK (83.2%) and the US (14.8%). The group invests the remaining 2% of its sovereign exposure in other highly rated countries: Sweden, Germany, France, Canada and Belgium.

Strong capital, but susceptible to stress

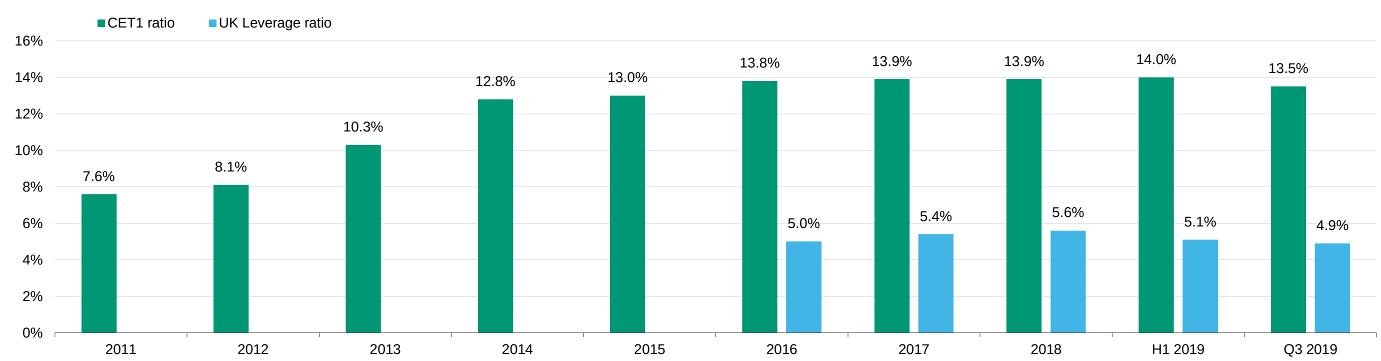
LBG's capitalisation is a key strength. Our assigned score for Capital is aa2, one notch below the group's Macro-Adjusted score to reflect the bank's reduction in capital in Q3 2019.

LBG reported a Common Equity Tier 1 (CET1) capital ratio of 13.5% in September 2019 (after dividend accrual), which is strong and in line with the bank's guidance of c.12.5% plus a c.1% management buffer. LBG's pro forma leverage ratio, as calculated under the current UK framework, was 4.9% in September 2019; LBG's leverage ratio, represents a material decline from December 2018 (5.6%), reflecting high PPI-related charges, share buy-back, and a reduction in the stock of additional tier 1 instruments.

We expect the risk-weighted capital ratios to remain broadly stable, reflecting the group's guidance.

Exhibit 6

LBG's fully loaded CET1 ratio has marginally decreased



Ratios are after dividend accrual. 2018 also after buyback.
Source: LBG's financial reports

The impact of the stress tests carried out by the EBA and by the Bank of England resulted in a significant drop in the CET1 ratio in a stressed scenario, reflecting a higher-than-average exposure to unsecured consumer credit products, and a legacy residential mortgage portfolio with weak underwriting standards. In particular, under the 2018 Bank of England's stress test, LBG's CET1 ratio fell by 4.7 percentage points in a stressed scenario after management actions and before triggering a conversion of the additional tier 1 instruments. In this stress test, LBG's UK residential mortgage portfolio had a 3.4% charge rate, which compares with a 1% average charge rate for other lenders. In the stressed scenario, LBG's retail unsecured lending exposure drove 40% of the losses[5].

LBG's 20.9% Moody's-adjusted tangible common equity/RWA as of June 2019 incorporates the entire equity of Scottish Widows, as well as high-trigger contingent capital instruments. There are however limitations to capital fungibility within the group. In particular, the dividend policy of Scottish Widows is subject to its own independent board, and it requires supervisory approval. Nevertheless, we believe that in times of stress within the banking business, LBG will be able to upstream a significant amount of dividends from Scottish Widows; in the event of extreme stress, LBG may also dispose of its insurance subsidiary, providing capital benefit.

Stable core earnings; conduct-risk-related costs are volatile, although they are declining

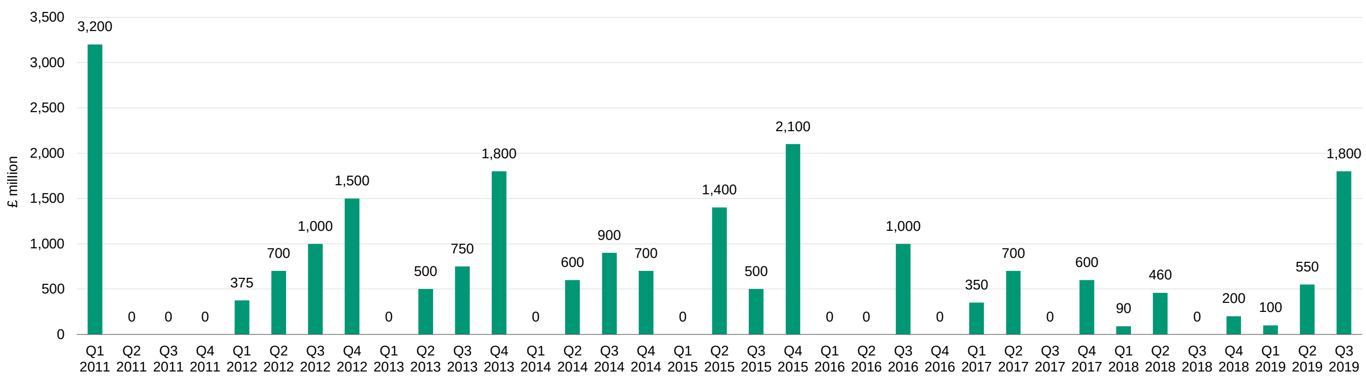
LBG has strong returns, although they are have been depressed by high conduct costs. The group also benefits from the revenue diversification provided by its commercial lending book and its life and non-life insurance subsidiaries. We assign a baa2 Profitability score, in line with the Macro-Adjusted score, to reflect, on the one hand, the need to make large investments in technology and our expectation of a mild increase in the cost of risk, and on the other, good earnings diversification.

The group reported a 2.89% net interest margin in H1 2019, 4 basis points below the 2.93% reported in 2018. Recently, LBG has been able to largely offset a lower interest income related to the strong competition in the UK mortgage market with (1) the incorporation of credit card issuer MBNA in May 2017, which has a higher risk/return profile than the rest of the group's loan book; and (2) a lower cost of funding, reflecting an improved risk profile, despite the purchase of MBNA; and (3) a small increase in interest rates.

LBG has focused heavily on efficiency, reaching a cost-to-income ratio (as reported by the group and including remediation costs but not PPI-related charges) of 46.5% for the first nine months of 2019 (47.5% in the previous year), one of the lowest among UK banks. At the same time, the group has been making very large investments in technology. In its 2018-20 plan, the group committed to invest more than £3 billion in three years, a 40% increase from the previous plan. Taking into account the fast-changing environment and technology-driven risks, we think that LBG, like many other European banks, may need to make further investments beyond what is included in its current strategic plans.

Charges for PPI will decrease, as consumers can no longer claim against PPI since August 2019. Since 2011, LBG has booked PPI-related charges of £21.9 billion. PPI provisions for the first nine months of 2019 were £2.5 billion, of which £1.8 billion in Q3 2019. The Q3 charge reflects a materially higher-than-expected volume of information requests ahead of the August 2019 deadline.

Exhibit 7
PPI charges since 2011



Source: LBG's financial reports

LBG's loan-loss charges remain low, at 27 basis points of the group's loan book (gross of allowance) in H1 2019. Based on our base-case economic assumptions, we expect LBG's cost of risk to remain low, in line with the group's loan book composition. At the same time, the expected slowdown in the UK economy will likely lead to a mild increase.

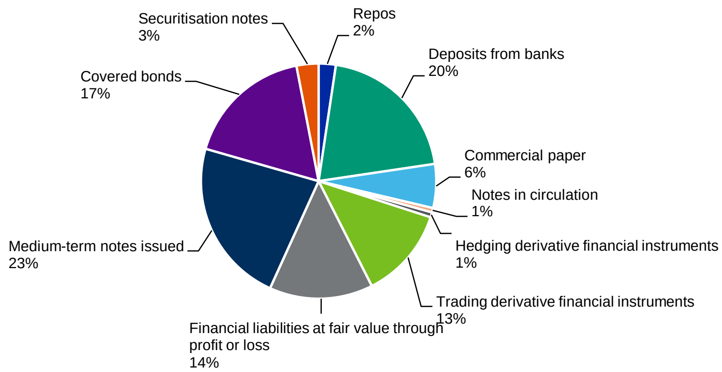
Stable funding

We assign a baa1 Combined Liquidity score, reflecting a baa1 score for both Funding Structure and Liquid Resources. The scores are one notch below their respective Macro-Adjusted scores to reflect that the liquid resources as a percentage of tangible banking assets (as per our definition) have reduced since December 2018, and market funding will increase in line with LBG's funding plan.

LBG benefits from its stable and granular retail deposit base. In the UK, its market share for personal current accounts is 22%, the highest in the country. LBG's loan-to-deposit ratio, which includes certificates of deposits, stood at 107% in September 2019, which is sound.

LBG's reliance on wholesale funding is significant, representing 17.6% of tangible banking assets as of June 2019, up from December 2018 (17.0%), but still lower than that of LBG's main UK peers. LBG's market funding composition is granular; however, market funding maturing within one year is high at 43% of total market funds. The group expects a 25.4% MREL in 2022, excluding buffers; in September 2019, LBG's pro forma MREL ratio was 32.5% (transitional).

Exhibit 8
Market funds composition



Values are as reported by LBG as of June 2019
Source: Moody's Investors Service

The group's eligible assets to be included in the 130% liquidity coverage ratio as of December 2018 are 3.9x the wholesale maturities in the next 12 months; this is a key mitigating factor for the group's high reliance on wholesale funding.

LBG reported a high stock of liquid assets as of December 2018, equivalent to 25.9% of its tangible banking assets. The group had intentionally increased its liquidity ahead of ring-fencing to provide additional buffers, and we expect its liquid assets to remain broadly stable.

ESG Considerations

In line with our general view for the banking sector, LBG has a low exposure to Environmental risks and moderate exposure to Social risks. See our Environmental risks heatmap and Social risks heatmap for further information.

In terms of social considerations, LBG has incurred substantial provisions related to the mis-selling of PPI. We expect PPI charges to gradually reduce to zero; nevertheless, as the bank continues to process the information requests that it received until the 29 August 2019 deadline for UK consumers to claim compensation, PPI-related charges could remain volatile until at least the end of 2020.

Governance is highly relevant for LBG, as it is to all banks. Corporate governance weaknesses can lead to a deterioration in a company's credit quality, while governance strengths can benefit its credit profile. Governance risks are largely internal rather than externally driven, and for LBG we do not have any particular governance concern. Nonetheless, corporate governance remains a key credit consideration and requires ongoing monitoring.

Support and structural considerations

Loss Given Failure (LGF) analysis

LBG is subject to the UK implementation of the European Union's Bank Recovery and Resolution Directive, which we consider an operational resolution regime.

Our analysis assumes residual tangible common equity of 3% and post-failure losses of 8% of tangible banking assets, in line with our standard assumptions.

Our advanced LGF analysis indicates that LBG's senior unsecured debt is likely to face moderate loss-given-failure because of the loss absorption provided by the subordinated debt issued by LBG and by its subsidiaries, and the volume of LBG's senior debt itself. This does not result in any uplift from the bank's BCA.

Junior securities issued by LBG are likely to face a high level of loss-given-failure, given the small volume of debt and limited protection from more subordinated instruments and residual equity. We also incorporate additional notching for junior subordinated and preference share instruments, reflecting the coupon features.

Government support considerations

Given LBG's systemic importance to the UK economy, reflecting its large national market share of residential mortgages, we incorporate a moderate probability of government support for deposits and senior unsecured operating company debt. However, the moderate probability of support does not result in any uplift because of the ratings proximity to the UK's sovereign debt rating.

For other junior securities, and for the senior debt of the holding company, we believe that the probability of potential government support is low, and these ratings thus do not include any related uplift.

About Moody's Bank scorecard

Our scorecard is designed to capture, express and explain in summary form our Rating Committee's judgement. When read in conjunction with our research, a fulsome presentation of our judgement is expressed. As a result, the output of our scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating methodology and scorecard factors

Exhibit 9

Lloyds Banking Group plc

Macro Factors		
Weighted Macro Profile	**Strong +**	**100%**

Factor	Historic Ratio	Initial Score	Expected Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	2.2%	a2	←→	a3	Quality of assets	
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel III - fully loaded)	20.9%	aa1	↓	aa2	Expected trend	
Profitability						
Net Income / Tangible Assets	0.7%	baa2	←→	baa2	Return on assets	
Combined Solvency Score		a1		a2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	17.0%	a3	↓	baa1	Expected trend	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	25.9%	a3	↓	baa1	Expected trend	
Combined Liquidity Score		a3		baa1		
Financial Profile				a3		
Qualitative Adjustments				Adjustment		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint				Aa2		
BCA Scorecard-indicated Outcome - Range				a2 - baa1		
Assigned BCA				a3		
Affiliate Support notching				0		
Adjusted BCA				a3		

Balance Sheet is not applicable.

Debt Class	De Jure waterfall		De Facto waterfall		Notching		LGF Notching Guidance vs. Adjusted BCA	Assigned LGF notching	Additional Notching	Preliminary Rating Assessment
	Instrument volume + subordination	Sub-ordination	Instrument volume + subordination	Sub-ordination	De Jure	De Facto				
Senior unsecured holding company debt	-	-	-	-	-	-	-	0	0	a3
Dated subordinated holding company debt	-	-	-	-	-	-	-	-1	0	baa1
Holding company non-cumulative preference shares	-	-	-	-	-	-	-	-1	-2	baa3

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency Rating	Foreign Currency Rating
Senior unsecured holding company debt	0	0	a3	0	A3	A3
Dated subordinated holding company debt	-1	0	baa1	0	(P)Baa1	Baa1
Holding company non-cumulative preference shares	-1	-2	baa3	0	Baa3 (hyb)	Baa3 (hyb)

[1]Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.
Source: Moody's Investors Service

Ratings

Exhibit 10

Category	Moody's Rating
LLOYDS BANKING GROUP PLC	
Outlook	Negative
Baseline Credit Assessment	a3
Adjusted Baseline Credit Assessment	a3
Senior Unsecured	A3
Subordinate	Baa1
Bkd Jr Subordinate -Dom Curr	Baa2 (hyb)
Pref. Stock Non-cumulative	Baa3 (hyb)
Preference Shelf	(P)Baa3
Other Short Term -Dom Curr	(P)P-2
LLOYDS BANK PLC	
Outlook	Negative
Counterparty Risk Rating	Aa2/P-1
Bank Deposits	Aa3/P-1
Baseline Credit Assessment	a3
Adjusted Baseline Credit Assessment	a3
Counterparty Risk Assessment	Aa2(cr)/P-1(cr)
Senior Unsecured	Aa3
Subordinate	Baa1
Jr Subordinate	Baa2 (hyb)
Pref. Stock	Baa3 (hyb)
Commercial Paper	P-1
Other Short Term -Dom Curr	(P)P-1
LLOYDS BANK CORPORATE MARKETS PLC	
Outlook	Stable
Counterparty Risk Rating	A1/P-1
Bank Deposits	A1/P-1
Baseline Credit Assessment	baa3
Adjusted Baseline Credit Assessment	baa1
Counterparty Risk Assessment	A1(cr)/P-1(cr)
Issuer Rating	A1
Senior Unsecured	A1
Commercial Paper	P-1

Other Short Term	(P)P-1
BANK OF SCOTLAND PLC	
Outlook	Negative
Counterparty Risk Rating	Aa2/P-1
Bank Deposits	Aa3/P-1
Baseline Credit Assessment	a3
Adjusted Baseline Credit Assessment	a3
Counterparty Risk Assessment	Aa2(cr)/P-1(cr)
Issuer Rating	Aa3
Bkd Senior Unsecured	Aa3
Jr Subordinate	Baa2 (hyb)
Pref. Stock Non-cumulative -Dom Curr	Baa3 (hyb)
SCOTTISH WIDOWS LIMITED	
Outlook	Stable
Insurance Financial Strength	A2
Subordinate -Dom Curr	Baa1 (hyb)
HBOS PLC	
Outlook	Negative
Counterparty Risk Rating	Aa2/P-1
Counterparty Risk Assessment	Aa2(cr)/P-1(cr)
Issuer Rating	Aa3
Subordinate	Baa1
Jr Subordinate -Dom Curr	Baa2 (hyb)
ST Issuer Rating	P-1
HBOS CAPITAL FUNDING NO. 1 LP	
BACKED Pref. Stock Non-cumulative	Baa3 (hyb)
HBOS CAPITAL FUNDING NO. 2 LP	
BACKED Pref. Stock Non-cumulative	Baa3 (hyb)
HALIFAX LTD	
Bkd Subordinate -Dom Curr	Baa1
Bkd Jr Subordinate -Dom Curr	Baa3 (hyb)
HBOS STERLING FINANCE (JERSEY) LP	
BACKED Pref. Stock Non-cumulative -Dom Curr	Baa3 (hyb)
BANK OF SCOTLAND CAPITAL FUNDING L.P.	
BACKED Pref. Stock Non-cumulative -Dom Curr	Baa3 (hyb)

Source: Moody's Investors Service

Endnotes

1 The bank's ratings shown in this report are the deposit rating, senior unsecured debt/issuer rating, and the BCA and Adjusted BCA, respectively.

2 Our calculation for Stage 3 loans includes those classified by LBG as Stage 3 among the group's portfolio of purchased or originated credit-impaired assets.

3 For our macroeconomic forecasts, see Global Macro Outlook: 2020-21, 14 November 2019. Our forecasts compare with real GDP growth of 1.8% in 2017, 1.4% in 2018, and with our expectation of a 1.2% real GDP growth in 2019.

4 For the six largest UK lenders, buy-to-let mortgages represented the following percentages of total residential mortgages as of the end of their latest fiscal years: Barclays 15%, Lloyds 18%, Nationwide 17%, RBS 8%, Santander UK 6%; data not available for HSBC.

5 For the other banks that participated in the Bank of England stress test, retail unsecured lending represented the following percentages of total losses in a stress: Barclays 66%, HSBC 27%, Nationwide 35%, RBS 29%, Santander UK 35% and Standard Chartered 0%.

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