

ISSUER IN-DEPTH

18 February 2019

 Rate this Research

RATINGS

Lloyds Banking Group plc

Baseline Credit Assessment (BCA)	a3
Senior unsecured	A3 Stable

Lloyds Bank plc

Baseline Credit Assessment (BCA)	A3
Adjusted BCA	A3
Deposits	Aa3 Stable/Prime-1
Senior unsecured	Aa3 Stable

Lloyds Bank Corporate Markets plc

Baseline Credit Assessment (BCA)	baa3
Adjusted BCA	baa1
Deposits	A1 Stable/Prime-1
Issuer rating	A1 Stable

Lloyds Bank International Limited

Baseline Credit Assessment (BCA)	baa2
Adjusted BCA	baa1
Deposits	Baa1 Stable/Prime-2
Issuer rating	Baa1 Stable

Scottish Widows Limited

Insurance Financial Strength Rating (IFSR)	A2
Subordinate	Baa1(hyb)
Outlook	Stable

Source: Moody's Investors Service

Lloyds Banking Group plc

Solvency and diversification in insurance remain key strengths despite change in structure

Summary

In 2018, [Lloyds Banking Group plc](#) (LBG) altered its structure to comply with the UK's ring-fencing legislation, which requires large banks to separate their retail and SME operations, and deposit taking in the European Economic Area (EEA) from their other activities, including the riskier capital markets and trading business. As part of the change, LBG designated [Lloyds Bank plc](#) as the "ring-fenced" entity housing its retail, SME and corporate banking operations. It also assumed direct ownership of insurer [Scottish Widows Limited](#), previously a subsidiary of Lloyds Bank. The changes had little impact on the creditworthiness of LBG and Lloyds Bank, leading us to affirm the deposit and senior unsecured ratings of both entities. Scottish Widows' ratings were unaffected.

- » **LBG's reorganisation was less complex than that of most UK peers.** The Lloyds Banking Group is predominantly focused on retail and corporate banking, and the required structural changes were therefore relatively minor. The group created a small separate legal entity, [Lloyds Bank Corporate Markets plc](#) (LBCM), to manage its limited capital markets and trading operations, and it transferred its offshore subsidiary, [Lloyds Bank International Limited](#) (LBIL), to LBCM from Lloyds Bank. LBG also became parent to Scottish Widows, previously part of Lloyds Bank. Aside from Santander UK, the other large UK banks faced more complex restructurings to address ring-fencing requirements, reflecting their greater exposure to capital markets and non-EEA businesses.
- » **Lloyds Bank's standalone rating was affirmed at higher level than LBCM and LBIL.** In January 2019, we affirmed Lloyds Bank's a3 baseline credit assessment (BCA), a measure of its standalone credit strength. Lloyds Bank's BCA remains above the BCAs of LBCM and LBIL, which we set for the first time in April 2018 at baa3 and baa2 respectively. The lower BCAs reflects their limited operating histories and their high single-name and sector concentrations. LBCM has also higher market and operational risk, in line with its business model. The adjusted BCAs of LBCM and LBIL, which include support from LBG, are baa1, one notch below the adjusted BCA of Lloyds Bank.
- » **Excess holding company debt may not absorb losses of the operating companies.** As is the case for the other large UK banking groups, we believe that excess loss absorbing liabilities issued by the holding company and not downstreamed as such may not be available to absorb losses of its operating companies. Under the new corporate structure, this results in higher loss-given-failure for Lloyds Bank's deposits and senior debt, although the existing government support assumptions were sufficient to offset the increase.

LBG's reorganisation was less complex than that of most UK peers

In the UK, large banking groups with retail and small business deposits of more than £25 billion were required to "ring fence" their retail operations from other activities, including their riskier capital markets and trading, by 1 January 2019. The legislation applied to the five largest UK banks: HSBC, Barclays, Lloyds, RBS, and Santander UK, each of which opted for a different compliance strategy. Nationwide Building Society, a large mutually owned UK lender, was exempt. This is because separate legislation is in place restricting mutually-owned banks, known in the UK as building societies, to a narrower range of permitted activities than ring-fenced banks.

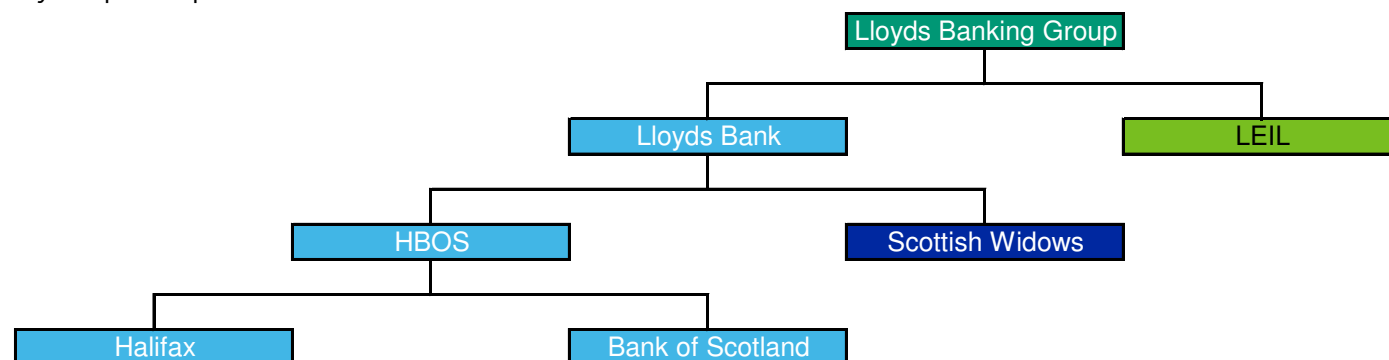
At the same time, UK domiciled banks serving European customers from the UK have had to restructure their businesses to mitigate against the potential loss of revenues from these customers based in the European Economic Area (EEA) after the UK leaves the European Union (EU) and the EEA at the end of March 2019. As in their approach to ring-fencing, each international banking group based in the UK has opted for a different strategy to manage the loss of passporting rights.

Prior to ring-fencing, Lloyds had a relatively simple structure, in line with its position as a large UK-focused retail and corporate bank. The holding company, Lloyds Banking Group plc (LBG), was the sole owner of Lloyds Bank, which was in turn the only shareholder in the group's other retail banks ([Halifax Limited](#) and [Bank of Scotland plc](#), via sub-holding [HBOS plc](#)), and in the insurer Scottish Widows. Lloyds Bank also owned all the group's overseas businesses via subsidiaries that it directly and indirectly controlled. Aside from Lloyds Bank, LBG owned private equity house Lloyds Equity Investments Limited (LEIL) (see Exhibit 1).

Exhibit 1

From a relatively simple structure...

Lloyds simplified corporate structure 2017



Source: Moody's Investors Service

In order to comply with the UK's ring-fencing legislation, Lloyds left its core retail and corporate banking activities within Lloyds Bank and its UK banking subsidiaries, and aggregated its relatively limited capital markets, trading activities, and non-EEA business into Lloyds Bank Corporate Markets plc (LBCM), a newly-created entity reporting to LBG. At the same time, LBG took direct ownership of Scottish Widows, formerly part of Lloyds Bank, and retained ownership of LEIL (see Exhibit 2).

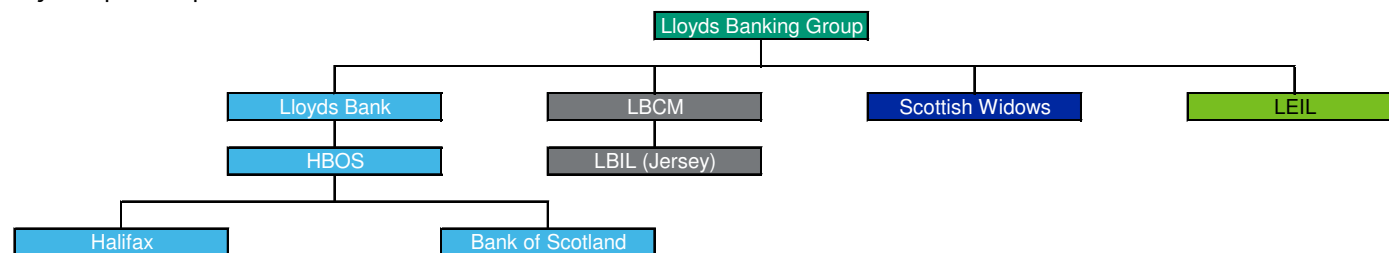
LBCM took ownership of Lloyds Bank's Jersey-based offshore lender, Lloyds Bank International Limited (LBIL). At the same time, branches of Lloyds Bank in the US, Asia, and Gibraltar were transferred to LBCM. The group is separately transferring its EU businesses into subsidiaries and branches in Germany, the Netherlands and Luxembourg that will be controlled by Lloyds Bank, LBCM, and Scottish Widows. Housing its EU businesses within Germany and Luxembourg-based subsidiaries and branches will allow Lloyds to continue operating in the EU/EEA after the UK leaves the EU.

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Exhibit 2

...to a more complex one

Lloyds simplified corporate structure 2018



Source: Moody's Investors Service

The changes have made Lloyds' structure more complex. However, Lloyds Bank still dominates the group with around three-quarters of total assets, followed by Scottish Widows with around 18%. LBCM (less than 10%, including LBIL) and LEIL (less than 1%) are less significant.

The other UK banking groups took different approaches to ring-fencing and passporting, reflecting their different business profiles.

Barclays Plc

[Barclays Bank PLC](#) is the group's non-ring-fenced bank, controlling its trading, investment banking, large corporate, payments, wealth management and international consumer and cards activities, representing around three quarters of [Barclays Plc](#)'s group risk-weighted assets (RWAs). The remaining one quarter of the group's RWAs are housed within the recently-created [Barclays Bank UK PLC](#), the ring-fenced bank focused on UK consumer and business banking.

Barclays is mitigating the potential loss of "passporting" rights by transferring corporate, investment and private banking activities with EEA customers, and the Barclaycard business in Germany, to its existing Irish bank, Barclays Bank Ireland, a wholly-owned subsidiary of Barclays Bank PLC.

HSBC Holdings plc

[HSBC Holdings plc](#) (the group holding company) transferred its UK retail, small and medium-sized commercial, and private banking activities, representing around one third of RWAs, to HSBC Bank UK plc, which it designated as its ring-fenced bank. These were previously part of [HSBC Bank plc](#), which became the group's non-ring-fenced bank, representing around two thirds of RWAs and housing its wholesale banking and capital markets activities. Both HSBC Bank plc and HSBC Bank UK plc operate under a new UK intermediate holding company set-up in 2018.

HSBC Holdings plc is mitigating the potential loss of "passporting" rights by transferring certain capital markets activities conducted with European clients to its French subsidiary, [HSBC France](#).

The Royal Bank of Scotland Group plc

[The Royal Bank of Scotland Group plc](#) went through a complex group restructuring as part of its ring-fencing implementation. Most of its retail and commercial banking operations were organised within a ring-fenced sub-group, representing around 80% of RWAs, under a new intermediate holding company, NatWest Holdings Limited, which controls [National Westminster Bank PLC](#), the retail and commercial bank domiciled in England; [The Royal Bank of Scotland plc](#) domiciled in Scotland, [Ulster Bank Limited](#) in Northern Ireland, [Ulster Bank Ireland DAC](#) in the Republic of Ireland and wealth manager Coutts & Company. The group's capital markets and trading activities are housed in [NatWest Markets Plc](#) in the UK, and [Natwest Markets N.V.](#) in the EU, representing around 15% of RWAs.

The bank's activities serving the Crown Dependencies and funds clients have come under another intermediate holding company, RBS International. The group is also setting up additional branches and subsidiaries in the EU to conduct some activities in the bloc.

Santander UK Group Holdings plc

The impact of ring-fencing and loss of passporting was more limited for [Santander UK Group Holdings plc](#) than for any other UK bank. [Santander UK plc](#) has become the Santander UK Group's main ring-fenced bank in the UK, while [Abbey National Treasury Services plc](#) (ANTS), originally set up as a capital management and funding issuance vehicle, has transferred most of its business to either Santander

UK or to the London branch of its parent, [Banco Santander S.A. \(Spain\)](#). As at 31 December 2018, ANTS retained £0.3 billion customer loans of consolidated group customer loans of £200 billion.

LBG benefits from diversification in insurance and strong profile of Lloyds Bank

LBG: diversification in insurance and strong solvency metrics

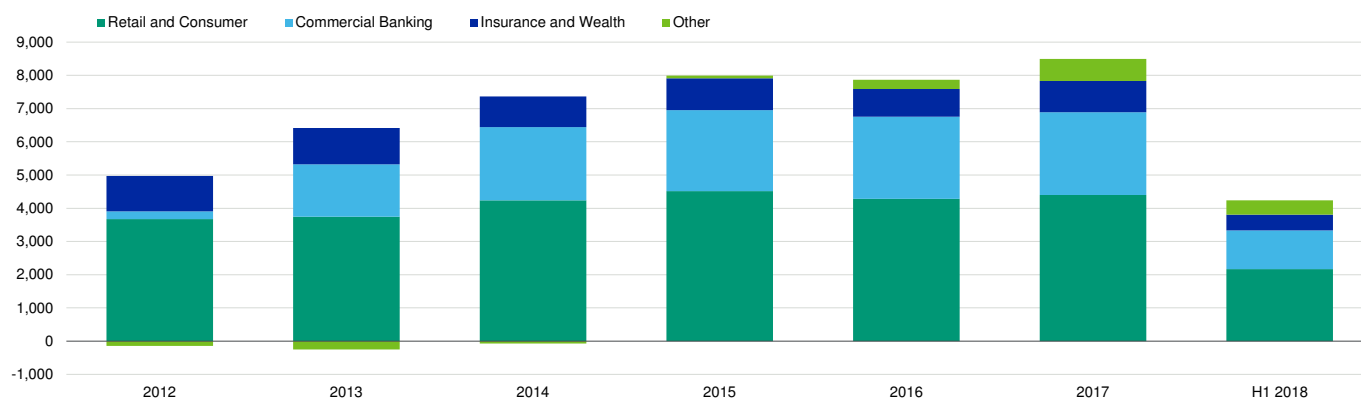
LBG has low asset risk and stable core earnings. The group is also strongly capitalised; however, LBG's capital is more susceptible to deterioration under stressed conditions than most of peers due to the group's exposure to unsecured consumer loans and buy-to-let mortgages.

A key strength of LBG is its diversification into insurance via Scottish Widows, a material source of earnings. Over the last four and a half years, the insurance division (which includes wealth management from 2017) has accounted for 11% of group annual underlying profits on average.

Exhibit 3

Scottish Widows provides a substantial earnings stream to LBG

LBG's underlying profits composition



2012 and 2013 figures include earnings from former banking subsidiary TSB. Prior to 2017, the Insurance and Wealth division only included insurance.

Source: LBG's financial reports

If required, LBG could also upstream some excess capital from Scottish Widows, subject to the approval of the insurer's board and of the supervisor. Alternatively, LBG may be able to boost its capital in a time of stress by selling the insurance business outright. In December 2017, Scottish Widows reported total consolidated equity of £4.8 billion, or around 2.3% of LBG's consolidated risk-weighted assets.

These considerations result in a notional baseline credit assessment (BCA) of a3.

LBCM and LBIL: limited operating histories and high concentrations

Compared with Lloyds Bank, LBCM and LBIL have limited operating histories and high borrower and industry concentrations¹; LBCM has is also subject to high operational risk, given its small size and its role as a capital markets and trading unit. These challenges are partially offset by some mitigating factors: we expect LBCM to have sound capitalisation, reflecting regulatory requirements as well as the need to win the confidence of capital markets counterparties. LBCM will also benefit from stable funding from LBG, offsetting its partial reliance on confidence sensitive wholesale funding, and will likely hold mostly liquid assets.

On balance, these results in a BCA of baa3 for LBCM, three notches below LBG's a3 notional BCA. LBIL's BCA is a more moderate two notches below LBG's, reflecting the entity's relatively low exposure to market risk, and its more stable business profile.

Regulation constrains ring-fenced entities from providing support to non ring-fenced entities that might lead to higher risks for the ring-fenced entity's depositors and bondholders. However, we believe that LBCM and LBIL are highly interconnected with the rest of the group, mostly due to having shared clients. Furthermore, the small size of LBCM and LBIL limit the potential amount of capital or liquidity that Lloyds Bank would need to provide to the non-ring-fenced entities in case of need. We therefore believe there is a very

high probability that LBCM and LBIL would receive support from the group if required, resulting in an adjusted BCA of baa1 for both banks.

Lloyds Bank: solvency mildly deteriorated following transfer of Scottish Widows

Lloyds Bank has strong solvency metrics. However, the loss of profitability and capital stemming from the transfer of Scottish Widows outweighs the modest reduction in risk resulting from the transfer of capital markets activities to LBCM. We therefore see Lloyds Bank's a3 BCA as less resilient to a potential downturn in the operating environment than LBG.

Despite the moderate deterioration, we affirmed the a3 BCA of Lloyds Bank after the transfer of the capital markets and trading activities to LBCM, and the transfer of Scottish Widows to LBG.

Scottish Widows: strong profile, unaffected by the group's structural changes

The transfer of Scottish Widows from Lloyds Bank to LBG did not change the insurer's business profile, structure, or financials, and we maintained our forecasts for the business.

The ratings of Scottish Widows were therefore not affected by the structural changes of LBG. Our A2 Insurance Financial Strength Rating (IFSR) for Scottish Widows is based on the consolidated insurance group's good market position in the UK life market, supported by its relatively large scale, low product risk, and good business diversification.

The credit profile of the entities within the Lloyds group remains strong

Before the recent structural changes, we derived the standalone BCA of Lloyds Bank using the consolidated financials of the group, as group assets outside Lloyds Bank were immaterial. This was in line with our approach to other relatively simple UK banking group structures, where the operating company accounts for the vast majority of the group.

Following Lloyds' structural changes, we:

- » Assigned an a3 notional and adjusted BCA to LBG, based upon LBG's consolidated financials. This is in line with the a3 that we previously assigned to Lloyds Bank, using LBG's financials.
- » Assigned new BCAs of baa3 to LBCM, and baa2 to LBIL, reflecting the two entities' limited operating histories and high sectoral concentrations. The adjusted BCAs of LBCM and LBIL, which incorporate support from LBG, were assigned at baa1, one notch below the notional and adjusted BCA of LBG and Lloyds Bank.
- » Affirmed the a3 BCA and adjusted BCA of Lloyds Bank, using the bank's consolidated financials; the loss of profitability and potential capital support stemming from the transfer of Scottish Widows to LBG outweighs the modest reduction in risk resulting from the transfer of capital markets activities to LBCM, but not sufficiently to alter the BCA.
- » Took no action on Scottish Widows' ratings, as the change in ownership had no impact on the insurer's business profile, financials, or forecasts.

Exhibit 4

LBCM and LBIL have weaker BCAs than LBG

Comparison of BCA factors for the four banking rated entities of the Lloyds Banking Group

	LBG	Lloyds Bank	LBCM	LBIL
Asset Risk	baa1	baa1	baa1	baa1
Capital	aa2	a1	aa3	a3
Profitability	baa3	baa3	baa3	baa2
Combined Solvency Score	a3	a3	a3	baa1
Funding Structure	baa1	a3	b3	ba3
Liquid Resources	a3	baa2	aa2	aa2
Combined Liquidity Score	baa1	baa1	baa3	baa2
Financial Profile	a3	a3	baa1	baa1
Business Diversification	0	0	0	0
Opacity and Complexity	0	0	-1	0
Corporate Behaviour	0	0	0	0
Total Qualitative Adjustments	0	0	-1	0
Scorecard Calculated BCA range	a2-baa1	a2-baa1	baa1-baa3	a3-baa2
Assigned BCA	a3	a3	baa3	baa2
Affiliate Support notching	0	0	2	1
Adjusted BCA	a3	a3	baa1	baa1

Source: Moody's Investors Service

Excess holding company debt may not absorb losses of the operating companies

When Lloyds Bank was LBG's only material subsidiary, we assumed that all unsecured liabilities issued by LBG, including those not downstreamed to Lloyds Bank, would absorb the losses of the operating company. We therefore applied a single advanced Loss Given Failure (LGF) analysis to LBG and Lloyds Bank. This indicated extremely low loss-given-failure for Lloyds Bank's deposits and senior opco debt, resulting in three notches of uplift. It also indicated moderate loss-given-failure for LBG's senior holdco debt, which received no uplift.

Under the new group structure, excess loss-absorbing capital issued by the holding company can be used to support LBCM, LBIL, and Scottish Widows as well as Lloyds Bank. Accordingly, we believe that unsecured liabilities issued by the holding company and not downstreamed to Lloyds Bank cannot be assumed a priori to absorb Lloyds Bank's losses at failure.

Taking into account our expectation that part of LBG's debt will be downstreamed to LBCM, and that the holding company will retain some excess capital, we believe that loss-given-failure for Lloyds Bank's deposit and senior debt has risen as a result of the structural changes. However, our existing government support assumptions were sufficient to offset the higher loss-given-failure.

Exhibit 5

Only Lloyds Bank's deposit and senior debt rating benefit from government support uplift

Ratings summary for the four banking rated entities of the Lloyds Banking Group

	LBG	Lloyds Bank	LBCM	LBIL
BCA	a3	a3	baa3	baa2
Adjusted BCA	a3	a3	baa1	baa1
Deposit and senior debt LGF notching	0	2	3	0
Government support	0	1	0	0
Long-term deposit and issuer rating	A3	Aa3	A1	Baa1

LBG is not a chartered bank, and it does not have deposits or deposit ratings.

Source: Moody's Investors Service

Moody's related publications

- » [UK ring-fencing reforms will increase risk for bank bondholders](#), 13 October 2014
- » [New rules credit positive for ring-fenced bank and holdco creditors](#), 16 October 2015
- » [Impact on Financial Institutions' 'Passports' following the UK's exit from the EU](#), 19 September 2016
- » [UK ring-fencing will impact affected banks' credit fundamentals](#), 26 September 2016
- » [Large banks' ring-fencing preparations are well advanced](#), 23 January 2018
- » [Ring-fenced banks have stronger credit profiles](#), 25 June 2018
- » [The Royal Bank of Scotland Group plc: Ring-fenced entities have stronger credit profiles](#), 2 May 2018

Latest Credit Opinions

- » [Lloyds Banking Group plc: Update following affirmation of senior and subordinated debt ratings](#), 8 February 2019
- » [Lloyds Bank plc: Update following affirmation of deposit and senior debt ratings](#), 8 February 2019
- » [Lloyds Bank Corporate Markets plc: Update to credit analysis](#), 6 December 2018
- » [Lloyds Bank International Limited: New Issuer - Good capitalisation, high probability of support from Lloyds Banking Group](#), 6 December 2018
- » [Scottish Widows Limited: Update to credit analysis](#), 16 October 2018

Peer Group

- » [Barclays Plc](#)
- » [Barclays Bank PLC](#)
- » [Barclays Bank UK PLC](#)
- » [HSBC Holdings plc](#)
- » [HSBC Bank plc](#)
- » [HSBC France](#)
- » [The Royal Bank of Scotland Group plc](#)
- » [National Westminster Bank PLC](#)
- » [NatWest Markets Plc](#)
- » [Santander UK plc](#)

Endnotes

- ¹ LBIL has a long operating history; however, it has been operating in its current form only post-ring-fencing.

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