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Lloyds Banking Group plc

Primary Credit Analyst:
Richard Barnes, London (44) 20-7176-7227; richard.barnes@spglobal.com

Secondary Contact:
Nigel Greenwood, London (44) 20-7176-1066; nigel.greenwood@spglobal.com

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Lloyds Banking Group plc

UGCP	a-		+	Support	+2	+	Additional factors	0

Anchor	bbb+	
Business position	Strong	+1
Capital and earnings	Adequate	0
Risk position	Adequate	0
Funding	Average	0
Liquidity	Adequate	

ALAC support	+2
GRE support	0
Group support	0
Sovereign support	0

Issuer credit rating
A+/Stable/A-1
Resolution counterparty rating
AA-/A-1+
Holding company ICR
BBB+/Stable/A-2

ICR--Issuer credit rating. UGCP--Unsupported group credit profile of the Lloyds group. The bank holding company ICR shown applies to Lloyds Banking Group plc and is one notch below the UGCP. The ICR and resolution counterparty rating apply to Lloyds Banking Group's two core operating subsidiaries: Lloyds Bank plc and Bank of Scotland plc.

Major Rating Factors

Issuer Credit Rating
BBB+/Stable/A-2

Strengths:	Weaknesses:
• Market-leading franchise in U.K. retail banking, and strong positions in U.K. corporate banking and insurance. • Cost-efficient operating model that underpins profitability, business stability, and competitiveness. • Supportive capitalization, funding, and liquidity profiles.	• Geographically concentrated in the U.K., where Brexit brings a risk of weaker economic conditions. • Our risk-adjusted capital ratio is lower than the average for U.K. peers, which partly reflects the full deduction of the investment in insurance subsidiary Scottish Widows.

Outlook

The stable outlook on Lloyds Banking Group plc (Lloyds) reflects our view that it should remain resilient to current U.K. political and economic risks arising from the uncertain Brexit outcome. Our base case expectation is that statutory profitability will improve toward management's targets, and continued dividends and share buybacks will maintain our risk-adjusted capital (RAC) ratio in the 7.5%-8.0% range over our two-year outlook horizon. We project that credit losses will gradually normalize from the current low level, but asset quality will remain sound assuming an orderly Brexit process. We also expect that Lloyds will maintain a sizable buffer of additional loss-absorbing capacity (ALAC).

The stable outlook on the operating subsidiaries mirrors that on Lloyds. It also assumes no change to our assessment of their respective importance to the wider group.

Upside scenario

A positive rating action is unlikely in the next 12-18 months while we continue to see potential downside risks to the U.K. economy and banking system from a disruptive Brexit process. Thereafter, an upgrade would depend on a stronger assessment of Lloyds' intrinsic creditworthiness, which we capture in the 'a-' unsupported group credit profile (UGCP). We see Lloyds' limited international diversification as a material, but not insurmountable, barrier to higher ratings. In combination with continued balance sheet strength and a controlled risk appetite, we could raise the ratings if we see Lloyds as a clear winner in the digital banking era in comparison with highly-rated global peers. This would likely result from disciplined execution of its strategic plan, resulting in continued market leadership and strong, predictable profitability across its business lines, to the benefit of its creditors.

An upgrade of the bank subsidiaries is less likely than for Lloyds itself. This is because, under our rating methodology, we would reduce the ALAC uplift in the issuer credit ratings (ICRs) on the subsidiaries if we improved the UGCP to 'a'.

Downside scenario

We would most likely lower the ratings if Lloyds' performance appears likely to significantly undershoot our current earnings and capital expectations. This could be triggered by a severe adverse economic scenario in the U.K., possibly linked to a disruptive Brexit outcome. We could also lower the ratings if we saw a material increase in Lloyds' risk appetite.

Rationale

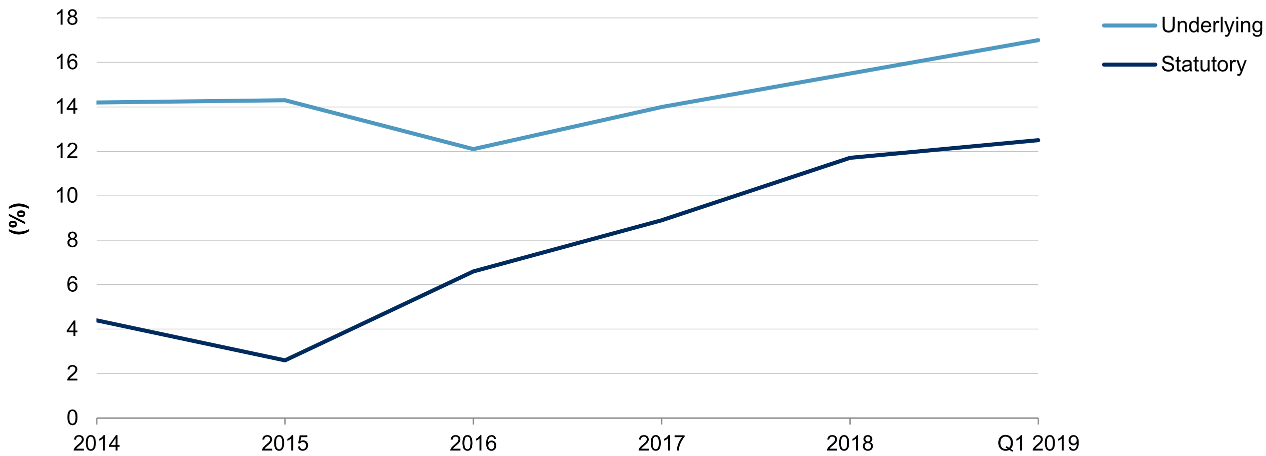
Our ratings reflect Lloyds' market-leading U.K. franchise and a business model that appears well-adjusted to the dynamic operating environment. We consider that Lloyds is well-placed to manage digital transformation, changing customer preferences, and the evolving competitive landscape.

Lloyds' strengthened balance sheet--specifically, its asset mix, funding, regulatory capitalization, and ALAC buffer--supports the ratings and we expect these attributes to remain consistent. Led by improved cost efficiency and lower nonoperating charges, its statutory profitability has also improved markedly to a level that exceeds many European peers' (see chart 1). Absent a major weakening in the U.K. economy, it appears on course for the 14%-15% statutory return on tangible equity (ROTE) that it targets in 2019.

Chart 1

Reported Post-Tax Return On Tangible Equity

Statutory returns improving toward management's 14%-15% target



Source: Lloyds. Underlying figures exclude nonoperating items including restructuring charges.

Although Lloyds and its U.K. peers have strengthened their balance sheets, we think that certain potential Brexit outcomes could lead to a more challenging operating and wholesale funding environment. This could lower customer activity, weigh on the net interest margin, and weaken asset quality beyond our current, relatively benign expectations.

Like its major domestic peers, Lloyds has operated under the U.K. ring-fencing regime since January 2019. Although ring-fencing incrementally weakens the fungibility of group resources and adds some ongoing frictional costs, we do not regard it as a materially negative factor for the group's overall creditworthiness. The long-term ICRs on Lloyds' bank subsidiaries outside the ring-fence are one notch lower than those inside because we see them as slightly less integral to the group.

Anchor: Reflects Lloyds' strong U.K. focus

The starting point for our ratings on Lloyds is the 'bbb+' anchor, which is based on our view of economic and industry risks in the group's home market. U.K.-based clients account for over 90% of Lloyds' lending.

We view the economic risk trend for the U.K., as it affects its domestic banking sector, as stable. While economic growth will remain lackluster, and may well decline in a disruptive Brexit scenario, the sector as a whole is now much more resilient to a tougher operating environment thanks to the steady strengthening of U.K. banks' balance sheets over the past decade and the reduction of pockets of risk and legacy assets at the large and diversified banks. An orderly Brexit with a transitional arrangement is still our base case. However, the risk of a disorderly Brexit has increased. If such a scenario materializes, or becomes likely, and we see a severe economic shock looming, we could make a negative revision to the U.K. economic risk score or consider that the economic risk trend had become negative.

We view the U.K. banking industry risk trend as stable. The domestic reform agenda is well advanced and banks have clarity on their future regulatory environment. We assume that past changes in regulatory structures will now continue to support market discipline, constrain risk appetites, curb adventurous management strategies, encourage a better conduct and compliance agenda, and still enable the banking industry to yield adequate profitability. We see limited downside to our industry risk assessment in our base case, though implicit in our assessment is the expectation that the industry continues on its path toward consistent statutory profitability and a return to earnings above the cost of capital.

Table 1

Lloyds Banking Group PLC Key Figures

	--Year-ended Dec. 31--				
(Mil. £)	**2018**	**2017**	**2016**	**2015**	**2014**
Adjusted assets	675,038	681,041	684,608	685,842	730,796
Customer loans (gross)	448,402	450,813	445,121	452,410	479,483
Adjusted common equity	21,953	24,173	24,633	32,226	34,299
Operating revenues	18,995	18,650	17,849	17,795	17,988
Noninterest expenses	9,500	9,552	9,291	9,293	9,569
Core earnings	6,318	5,658	4,769	4,860	5,823

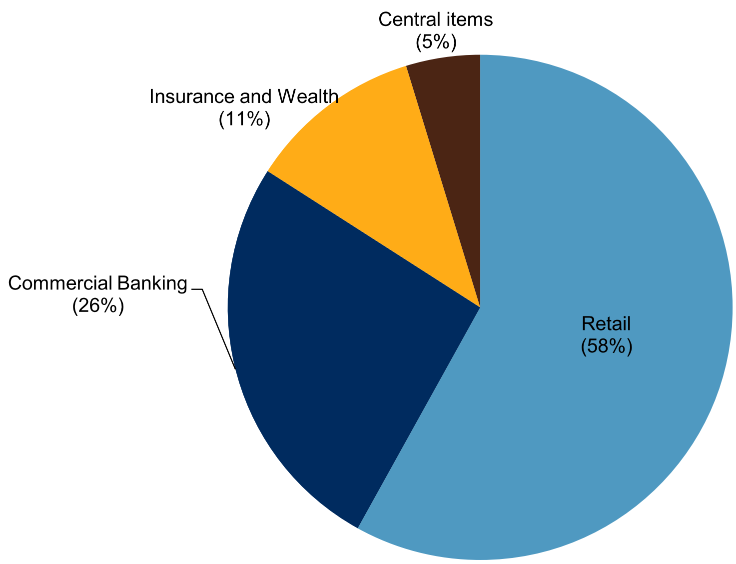
N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Business position: Leading U.K. banking franchise

We assess Lloyds' business position as strong, based on its market-leading position in U.K. retail banking and complementary activities in domestic commercial banking and insurance (see chart 2). We believe that it is pursuing a coherent strategy focused on leveraging digital technology to improve efficiency and client service. As it executes this plan, we will look for evidence that Lloyds at least maintains its franchise strength, delivers planned efficiency improvements, and further improves statutory profitability.

Chart 2

Retail-Focused Revenue Profile
Net income by division in 2018



Source: Lloyds.

Lloyds serves about 26 million U.K. retail customers, of which 15.9 million are digitally active. It operates an integrated multi-channel model under a brand portfolio that includes Lloyds, Halifax, and Bank of Scotland in retail and commercial banking and Scottish Widows in insurance. It estimates market shares of 25% for consumer credit card balances, 22% for personal current account deposits, 19% for open book residential mortgages, 17% for retail savings deposits, and 18%-19% for small and mid-market business relationships. Lloyds has a less complex profile than many peers. For example, it is not active in investment banking, but its commercial banking division offers debt capital markets, foreign exchange, and transaction banking services. We view Lloyds' relative lack of reliance on market-sensitive income as supportive of its business stability.

Lloyds is currently executing its third Group Strategic Review (GSR3), which was announced in February 2018 and runs through year-end 2020. Its ambition is to increase digitalization and automation to improve customer experience, cost efficiency, and shareholder returns. Lloyds plans to invest over £3 billion during the three-year period covered by GSR3, of which it had spent £1.2 billion by March 2019. Like peers, we consider that Lloyds faces disintermediation risks in the digital era, including from the Open Banking initiative (the U.K. implementation of the second EU Payment Services Directive). However, we see its large customer base, cost efficiency, and investment capacity as significant advantages relative to both new and incumbent competitors.

Lloyds' insurance business offers a degree of franchise differentiation from U.K. peers, and it targets further growth under GSR3. Lloyds' subsidiary Scottish Widows is a leading provider of life and pensions and investment business, and has one of the largest intermediary sales channels in the U.K. Lloyds also underwrites general insurance products through other subsidiaries. In our view, the insurance businesses have performed steadily but have yet to demonstrate sustained earnings momentum. Lloyds also has ambitions to grow its wealth business under GSR3, and plans to launch a joint venture with Schroders in the second quarter of 2019.

Lloyds has occasionally used bolt-on acquisitions to accelerate organic growth in target markets. The prime examples are MBNA's U.K. credit card portfolio and Zurich's U.K. workplace pensions and savings business. We think further transactions of this type are possible if opportunities arise and Lloyds identifies sufficient financial and strategic value.

We consider the other major providers of universal banking services in the U.K.--Barclays PLC ('bbb+' UGCP), HSBC Holdings plc ('a+'), and The Royal Bank of Scotland Group plc ('bbb+')--to be the primary peers for Lloyds, alongside Nationwide Building Society ('a-') and Santander UK Group Holdings plc ('bbb+'). Unlike Barclays and HSBC, Lloyds has minimal international operations, although it supports corporate clients' trade and investment activities outside the U.K. In other geographies, we see domestically-focused retail and commercial banks as Lloyds' closest peers, particularly those with insurance businesses. They include Credit Agricole S.A. ('a' UGCP), Credit Mutuel group ('a-'), Danske Bank A/S ('a-'), ING Bank N.V. ('a'), KBC Bank N.V. ('a'), Nordea Bank AB ('a+'), Cooperatieve Rabobank U.A. ('a'), and Wells Fargo & Co. ('a').

Table 2

Lloyds Banking Group PLC Business Position

	--Year-ended Dec. 31--				
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Total revenues from business line (currency in millions)	18,945	18,929	18,288	17,421	16,399
Commercial banking/total revenues from business line	24.6	25.6	25.8	26.3	27.1
Retail banking/total revenues from business line	59.3	57.7	59.2	64.1	66.7
Commercial & retail banking/total revenues from business line	83.9	83.3	85.0	N/A	N/A
Insurance activities/total revenues from business line	10.5	10.5	8.8	9.6	9.7
Other revenues/total revenues from business line	5.6	6.2	6.2	(1.2)	(9.2)
Return on average common equity	9.9	8.0	5.7	2.0	3.4

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Capital and earnings: Capitalization is satisfactory, while statutory profitability should strengthen further

We view Lloyds' capital and earnings as adequate because we project that its RAC ratio will operate in the 7.5%-8.0% range through year-end 2021. This positions the bank as fairly typical among large European peers, but somewhat below the other major U.K. banks that often have RAC ratios in the 9%-10% range. Its internal capital generation has increased as it has strengthened its underlying performance and reduced nonoperating charges. Since Lloyds' asset growth is modest and it has no need to strengthen regulatory capitalization, it returns the majority of earnings to shareholders, and we anticipate that this policy will continue.

Lloyds reported a 13.9% fully-loaded common equity Tier 1 (CET1) ratio at March 31, 2019. This compares well with peers and sits comfortably above the estimated end-state regulatory requirement (about 12.5%) and management's internal target (about 13.5%, revised down from 14% in May 2019 following confirmation of the domestic systemic risk buffer). Lloyds targets surplus capital generation before shareholder distributions of 1.7%-2.0% of regulatory RWAs.

Lloyds paid £2.3 billion of dividends in respect of its 2018 earnings and completed a £1 billion share buyback during the year, which equates to an 85% aggregate payout of its net profit attributable to ordinary shareholders. It enlarged the share buyback program to £1.75 billion for 2019, and we also expect dividends to increase gradually. The Bank of England's approval of the increased buyback indicates its confidence in Lloyds' capital position despite current U.K. political and economic uncertainties. We expect the buyback programs will be adjusted up and down according to Lloyds' regulatory capital position, and could be halted in the event of stress.

The substantial gap between the CET1 and RAC ratios primarily reflects the higher capital charges that we apply to Lloyds' residential mortgages and insurance subsidiaries. At year-end 2018, the mortgage book had a 10% average regulatory risk-weight under the internal rating-based approach, whereas our standard risk-weight for prime U.K. mortgages is 37% (see table 3). We also fully deduct Lloyds' investment in its insurance subsidiaries from total adjusted capital (TAC), the numerator of the RAC ratio. In contrast, in the regulatory capital metrics, part of the investment is deducted and the remainder risk-weighted at 250%. We deduct the insurance investment in full because these subsidiaries are separately regulated and their capital is not freely available to support banking risks.

Table 3

Lloyds Banking Group PLC RACF [Risk-Adjusted Capital Framework] Data

(Mil. £)	Exposure*	Basel III RWA	Average Basel III RW(%)	S&P Global RWA	Average S&P Global RW (%)
Credit risk					
Government & central banks	92,005	763	1	1,278	1
Of which regional governments and local authorities	0	0	0	0	0
Institutions and CCPs	25,648	3,263	13	4,154	16
Corporate	106,084	65,750	62	96,011	91
Retail	401,368	82,150	20	193,005	48
Of which mortgage	343,608	41,088	12	139,785	41
Securitization§	27,438	4,262	16	12,628	46
Other assets†	8,584	16,138	69	6,934	81
Total credit risk	661,127	172,325	25	314,009	47
Credit valuation adjustment					
Total credit valuation adjustment	--	702	--	0	--
Market Risk					
Equity in the banking book	3,416	5,749	172	25,259	739
Trading book market risk	--	2,085	--	3,309	--
Total market risk	--	7,834	--	28,567	--
Operational risk					
Total operational risk	--	25,505	--	29,198	--

Table 3

Lloyds Banking Group PLC RACF [Risk-Adjusted Capital Framework] Data (cont.)

(Mil. £)	Exposure	Basel III RWA	Average Basel II RW (%)	S&P Global RWA	% of S&P Global RWA
Diversification adjustments					
RWA before diversification	--	206,366	--	371,774	100
Total Diversification/ Concentration Adjustments	--	--	--	(26,420)	(7)
RWA after diversification	--	206,366	--	345,354	93

(Mil. £)	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	S&P Global RAC ratio (%)
Capital ratio				
Capital ratio before adjustments	37,539	18.2	29,197	7.9
Capital ratio after adjustments‡	37,539	18.2	29,197	8.5

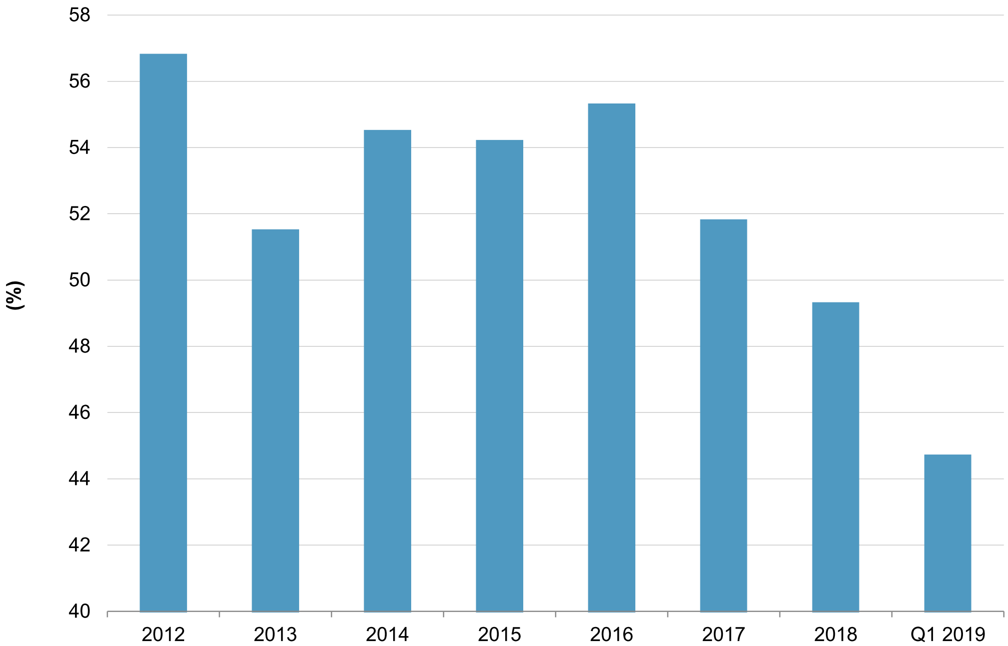
*Exposure at default. §Securitization Exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). Tier 1 capital ratio shown on a transitional basis. RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of 'Dec. 31 2018', S&P Global Ratings.

Lloyds' recent earnings illustrate healthy and strengthening profitability. It reported 13% year-on-year growth in statutory pretax profit in 2018 as underlying earnings improved by 6% and there were lower "below the line" nonoperating charges. These charges include restructuring costs, payment protection insurance (PPI) mis-selling provisions, and accounting volatility. Underlying pretax earnings grew 8% year-on-year in the first quarter of 2019 but were flat on a statutory basis. The latter reflected a provision for the estimated cost of exiting Scottish Widows' investment management contract with Standard Life Aberdeen. This was partly mitigated by a £136 million benefit (included in underlying earnings) under embedded value accounting from moving the contract to Blackrock and Schroders.

Lloyds is progressing towards its target of a cost-to-income ratio in the low 40s exiting 2020 (see chart 3). Under GSR3, it initially aimed to reduce costs below £8 billion by year-end 2020, but is now on track to deliver this target a year early. We see its efficient business model as a competitive advantage relative to peers and an important factor in its improving earnings.

Chart 3

Improving Cost Efficiency
Reported cost-to-income ratio since 2012

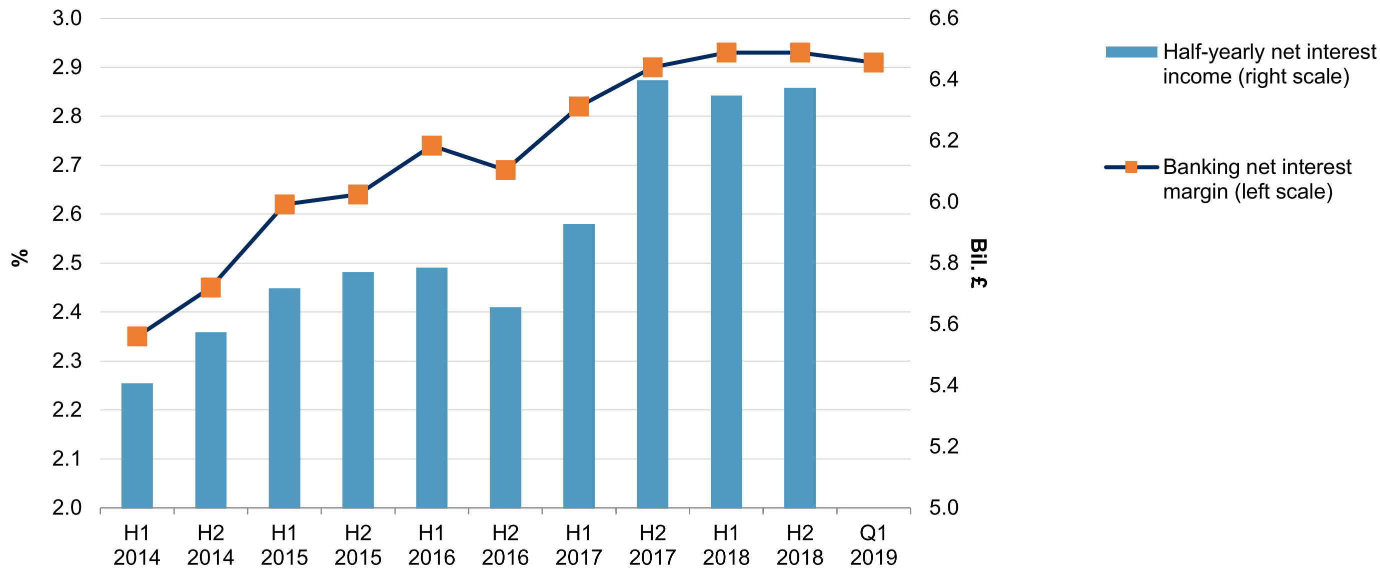


Source: Lloyds. Costs include remediation charges.

Lloyds' positive net interest margin trajectory is notable given strong asset price competition, particularly in mortgages (see chart 4). In addition to disciplined management across its brands and channels, the improvement reflects a business mix change following the June 2017 acquisition of the MBNA U.K. credit card business. Like peers, Lloyds' disclosures indicate its revenues would benefit from rising interest rates. This is mostly due to higher earnings on its structural balance sheet hedge, which had a £180 billion nominal value at year-end 2018 and an average duration of about four years. There may also be opportunities to widen margins through product repricing. We are cautious on the outlook for funding spreads as banks refinance borrowing under the Bank of England's Term Funding Scheme (TFS). However, we note that Lloyds has some high cost retail deposits that will mature soon and revert to cheaper front-book pricing.

Chart 4

Resilient Net Interest Margin



Source: Lloyds.

Key elements of our base case projections through year-end 2021 include the following factors:

- Statutory annual pretax profits rising to above £7 billion;
- Modest revenue and asset growth, constrained by competitive pricing pressures and low credit demand;
- An improving cost-to-income ratio throughout the period;
- A gradually increasing impairment charge of up to 30 basis points (bps) of average customer loans;
- Declining charges for restructuring, PPI, and other nonoperating items;
- Gradual dividend growth supplemented by further share buybacks to distribute surplus regulatory capital generation.
- Contributions to the employee pension schemes in line with the agreed recovery plan to address the actuarial funding deficit (the schemes were in surplus on an accounting basis at year-end 2018).

We consider the quality of capital to be satisfactory, with hybrids accounting for 25% of TAC at year-end 2018. We also project a comfortable earnings buffer (that is, normalized operating income divided by S&P Global Ratings' RWAs) of about 1.7% on average in 2019-2021. This suggests that Lloyds should be able to absorb an unexpected spike in credit losses within earnings.

Table 4

Lloyds Banking Group PLC Capital And Earnings

	--Year-ended Dec. 31--				
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Tier 1 capital ratio	17.8	16.6	16.1	15.2	16.5
S&P Global Ratings' RAC ratio before diversification	7.9	8.0	8.2	8.0	8.4
S&P Global Ratings' RAC ratio after diversification	8.5	8.6	8.8	9.6	10.2
Adjusted common equity/total adjusted capital	75.2	79.7	79.9	83.6	84.2
Double leverage	103.5	103.8	102.2	110.0	108.1
Net interest income/operating revenues	70.5	58.5	52.0	63.6	62.7
Fee income/operating revenues	7.7	8.5	9.5	10.2	12.5
Market-sensitive income/operating revenues	(20.4)	63.4	103.9	20.9	54.3
Noninterest expenses/operating revenues	50.0	51.2	52.1	52.2	53.2
Preprovision operating income/average assets	1.2	1.1	1.1	1.0	1.0
Core earnings/average managed assets	0.8	0.7	0.6	0.6	0.7

Tier 1 capital ratio shown on a fully loaded basis. N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Risk position: Solid profile anchored by overweight position in residential mortgages

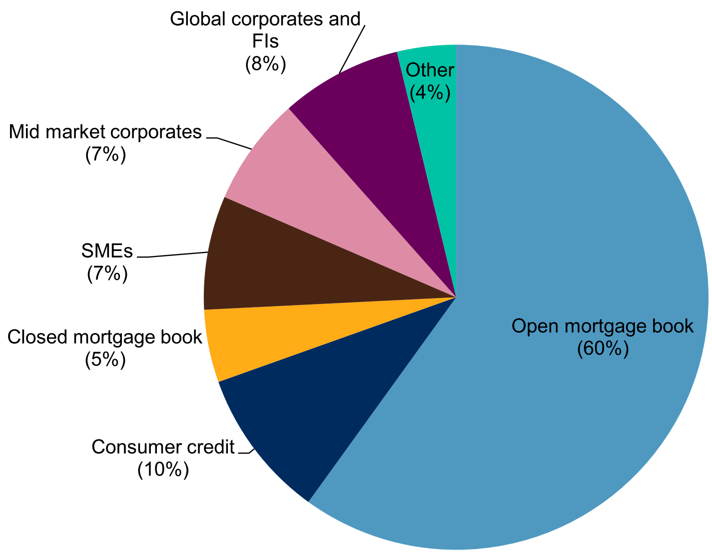
Our risk position assessment considers risks that, on a relative basis, may not be well captured by the standard assumptions in our capital and earnings analysis. For Lloyds, we assess its risk position to be adequate, reflecting the group's satisfactory asset quality and our view that it is unlikely to weaken its current contained risk appetite. It also takes account of our expectation that Lloyds' RAC ratio will remain in the lower half of the 7%-10% range. We also see Lloyds as an inherently less complex organization than many peers, aided by its operational simplification and product rationalization, limited international presence, modest capital markets activity, and integrated risk management.

Lloyds' customer loan portfolio has been broadly stable in size for an extended period as the runoff of legacy assets has offset new business growth. The portfolio is skewed toward secured residential mortgages loans, though this weighting has decreased slightly as the consumer credit book has grown (see chart 5). At year-end 2018, prime, owner-occupied loans represented 77% of outstanding mortgages, with 18% in buy-to-let and the remaining 5% in legacy specialist mortgage products that are closed to new business and running off. Its mortgage exposure to London and the south-east of England is slightly below the market average, which might prove a relative advantage in a disorderly Brexit scenario.

Chart 5

U.K. Focused Loan Portfolio With Strong Mortgage Weighting

Customer loans and advances at March 31, 2019

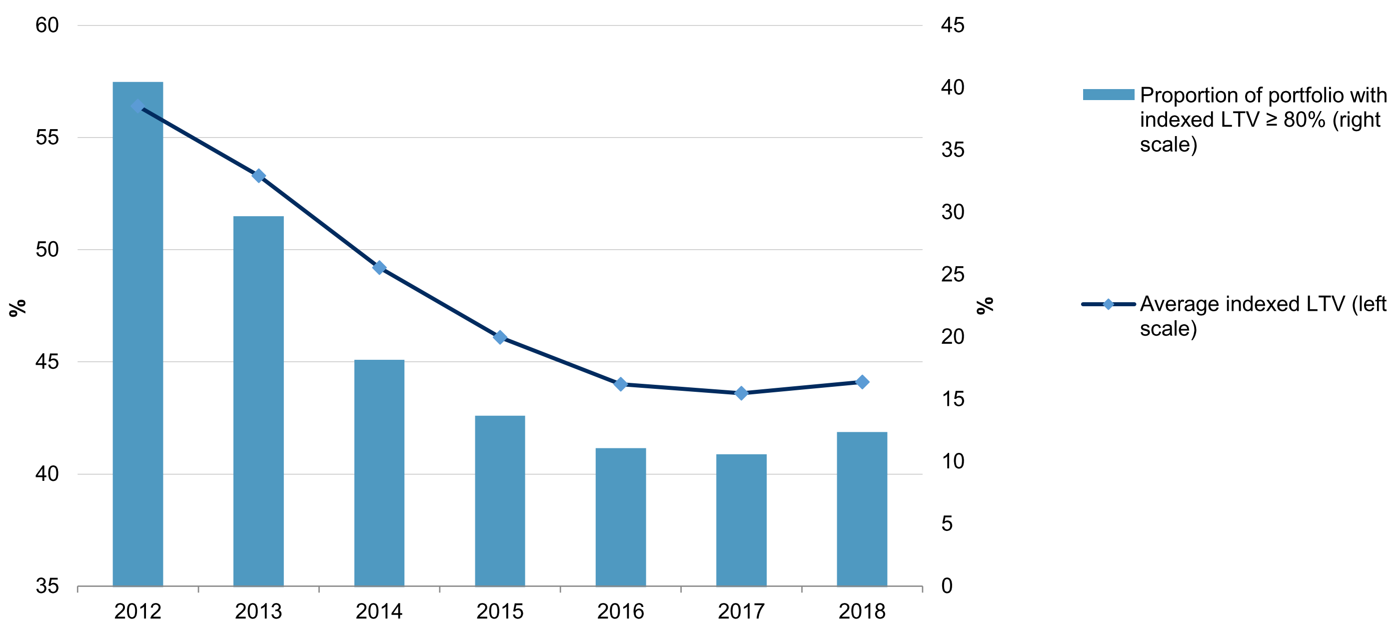


Source: Lloyds. Excludes reverse repurchase agreements.

Residential mortgages are underwritten based on the borrowers' repayment capacity, but the loan-to-value (LTV) distribution indicates collateral cover in the event of foreclosure. The LTV profile of Lloyds' mortgage book has improved steadily as U.K. house prices improved and it managed down higher risk legacy exposures (see chart 6). The most recent LTV data indicate a sizable cushion to absorb more challenging economic and housing market conditions.

Chart 6

Improved Quality Of U.K. Mortgage Book
Loan-to-value profile has strengthened since 2012



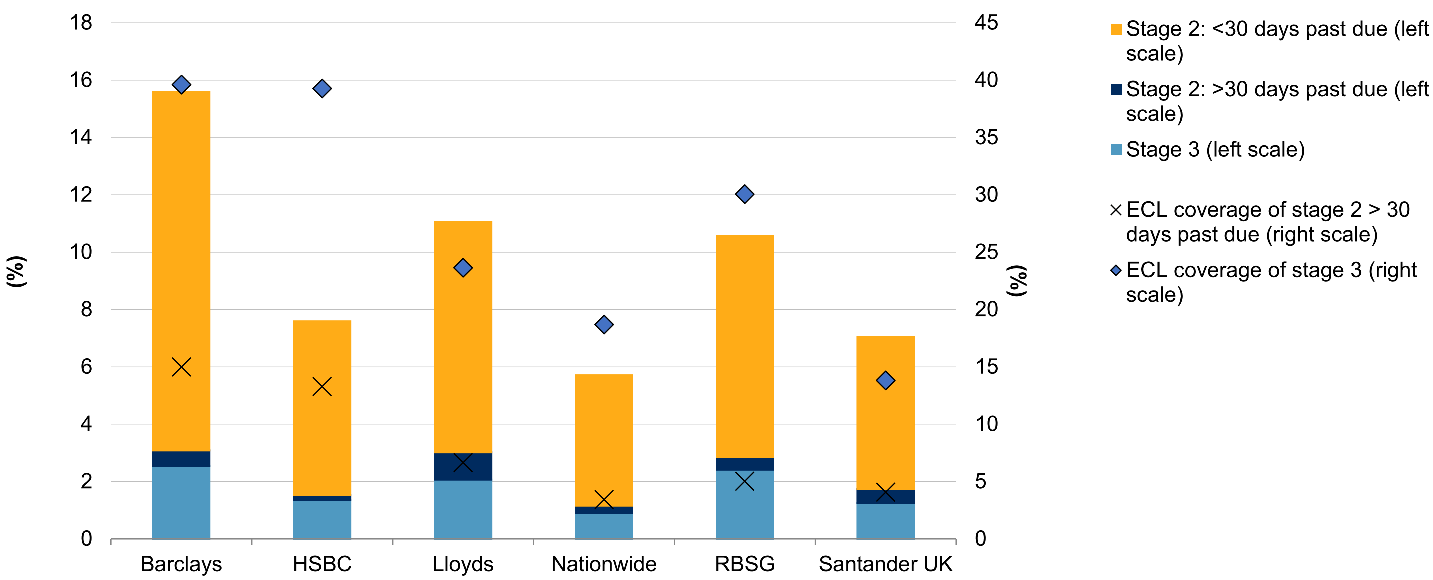
Source: Lloyds. LTV-Loan To Value.

Although mortgages dominate Lloyds' customer lending, we see its consumer credit and commercial banking portfolios as more significant sources of potential risk in a severe stress scenario. Organic growth and the MBNA transaction increased Lloyds' weighting toward consumer credit, including auto finance, and it is a market leader alongside Barclays. This portfolio currently performs well, but U.K. households are among the most leveraged in Europe and their repayment capacity would be adversely affected by a severe economic downturn. The pace of U.K. consumer credit growth has slowed in recent quarters but remains ahead of nominal GDP growth.

We view Lloyds' nonperforming assets as typical among the rated U.K. banks (see chart 7). Provisions on stage 3 assets covered 24% of drawn stage 3 balances at year-end 2018. This ratio is lower than certain peers' due to Lloyds' focus on collateralized lending.

Chart 7

Lloyds' Asset Quality Metrics Are Similar To U.K. Peers'
Customer loans by IFRS 9 classification

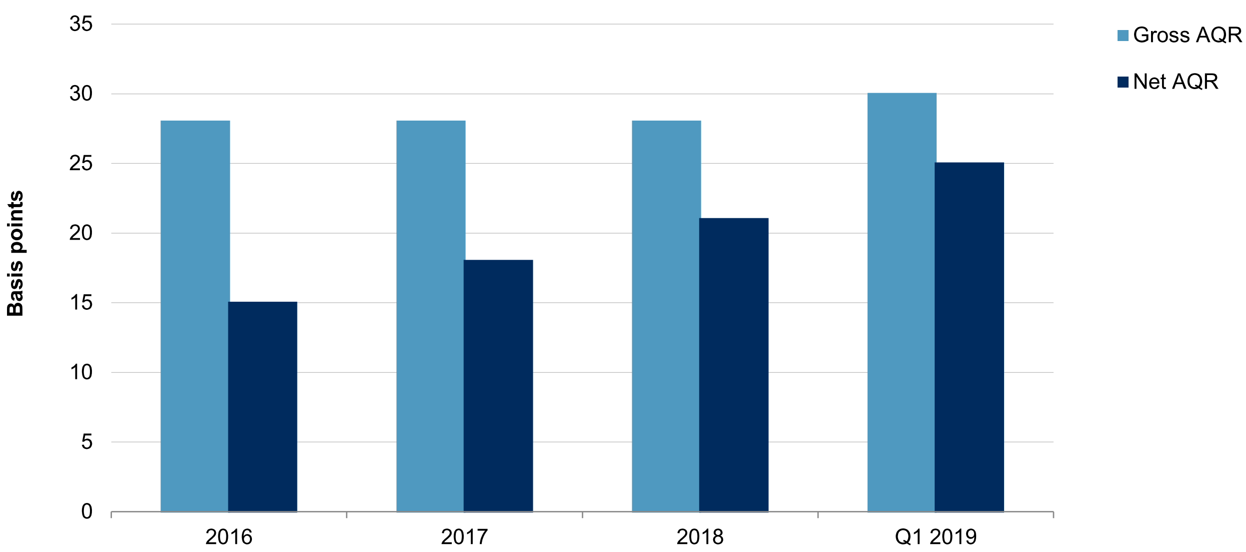


Source: Institutions' disclosures. Data based on retail and commercial loans. Figures at year-end 2018 except for Nationwide, which are at April 4, 2019.

We expect the trend in Lloyds' asset quality to mirror that for the U.K. system more broadly. Its current impairment losses are very low, and have ticked up since 2015 primarily as a result of lower provision releases and writebacks (see chart 8). Lloyds expects its net impairment charge to remain below 30 bps in 2019-2020 and average 35 bps through a credit cycle, reflecting the large proportion of its lending that is secured. Similarly, our base-case expectation is that credit losses will rise gradually in 2019-2021, partly due to recent consumer credit growth. We think a disorderly Brexit could prompt a stronger increase by triggering a moderate recession and lowering the economy's long-term growth potential.

Chart 8

Impairment Charge Increasing Due To Lower Releases And Writebacks
Gross and net asset quality ratios



Source: Lloyds. AQR: Asset quality ratio (impairment losses as a percentage of loans and advances).

The 2018 Bank of England stress test results confirmed our view that Lloyds' asset quality is solid but unexceptional relative to domestic peers (see table 5 and "Everyone Passed: Stress Tests Highlight Growing Resilience Of U.K. Banks," published on Nov. 29, 2018). Its mortgage loss rate was more than double those of other lenders due to very high assumed impairments on the closed legacy book, which is very seasoned but retains a higher risk profile than the open book. The stress test was conducted using the transitional IFRS 9 approach, and, on that basis, Lloyds' CET1 ratio fell from 14.0% at year-end 2017 to a low of 9.3%, still above its 8.5% hurdle rate. If IFRS 9 were fully applied, Lloyds' low point would have been 6.4%, which would have led to the conversion of its contingent Additional Tier 1 (AT1) securities. This is because the terms of those AT1s include a 7% trigger based on a CET1 definition that excludes the benefit of the IFRS 9 transitional approach. In the stress test results, the Bank of England noted that the capital hit from IFRS 9 was larger for Lloyds than the other banks participating in the exercise due to its retail-focused balance sheet.

Table 5

Projected Cumulative Five-Year Impairment Charge Rates On U.K. Lending In The Stress Scenario, Ranked

Ranked best to worst

Mortgage lending to individuals	Non-mortgage lending to individuals	Commercial real estate (CRE) lending	Lending to business excluding CRE
HSBC (0.7%)	Santander UK (20.6%)	HSBC (5.9%)	Standard Chartered (3.4%)
Barclays (0.9%)	HSBC (22.4%)	Nationwide (6.0%)	HSBC (8.6%)

Table 5

Projected Cumulative Five-Year Impairment Charge Rates On U.K. Lending In The Stress Scenario, Ranked (cont.)

Ranked best to worst

Mortgage lending to individuals	Non-mortgage lending to individuals	Commercial real estate (CRE) lending	Lending to business excluding CRE
RBSG (0.9%)	RBSG (22.5%)	RBSG (6.2%)	RBSG (8.7%)
Nationwide (1.1%)	Lloyds (27.0%)	Santander UK (6.2%)	Barclays (9.2%)
Santander UK (1.5%)	Nationwide (27.4%)	Barclays (6.7%)	Lloyds (9.4%)
Lloyds (3.4%)	Barclays (35.9%)	Lloyds (7.2%)	Santander UK (12.6%)

Source: Bank of England.

Like U.K. peers, Lloyds has been burdened by provisions to compensate customers for legacy mis-selling, notably from PPI. In light of this experience, it has overhauled its products and practices with the aim of mitigating the risk of future conduct problems. For example, branch staff are no longer incentivized according to product sales. PPI compensation has been extremely expensive for Lloyds, and its £100 million charge in the first quarter of 2019 raised its aggregate provisioning to £19.5 billion. There is an August 2019 deadline for PPI complaints and further provisions may be required as it draws closer, but any such amounts should be manageable. There is close regulatory scrutiny of banks' business conduct in the U.K., and we therefore assume further charges (for compensation, fines, or remediation) in our projections, but at a far lower level than for PPI.

The diversification benefit in our RAC ratio calculation reflects the spread of Lloyds' activities by business line and risk type. Although it has a high geographic concentration in its domestic market, the U.K. is a large economy and Lloyds' exposures are reasonably diversified regionally and sectorally.

Table 6

Lloyds Banking Group PLC Risk Position

	--Year-ended Dec. 31--				
(%)	2018	2017	2016	2015	2014
Growth in customer loans	(0.5)	1.3	(1.6)	(5.6)	(5.0)
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	(7.3)	(6.2)	(17.0)	(17.7)
Total managed assets/adjusted common equity (x)	36.3	33.6	33.2	25.0	24.9
New loan loss provisions/average customer loans	0.2	0.2	0.2	0.1	0.2
Net charge-offs/average customer loans	0.2	0.2	0.3	0.7	1.2
Gross nonperforming assets/customer loans + other real estate owned	2.6	2.4	2.8	3.4	4.7
Loan loss reserves/gross nonperforming assets	36.6	20.4	19.4	19.8	28.4

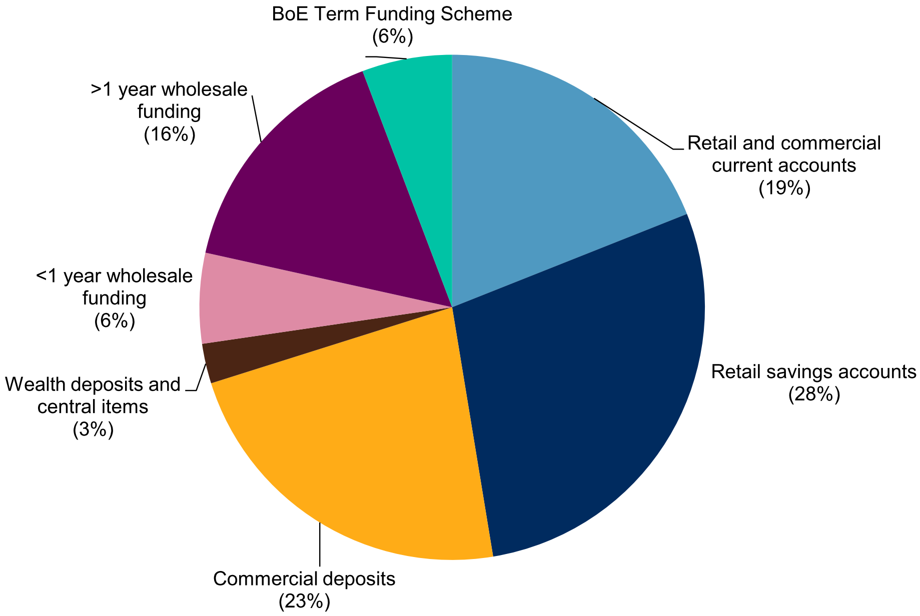
N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Funding and liquidity: A strong deposit franchise and satisfactory ratios

We regard Lloyds' funding as average compared with U.K. peers, and its liquidity position, which we compare globally, as adequate. Its metrics are underpinned by its strong deposit franchise and diversified term funding base by market and currency (see chart 9).

Chart 9

Deposit Franchise Anchors Funding Base
Funding sources at year-end 2018



Source: Lloyds. Excludes equity and repurchase agreements. BoE-Bank of England.

Lloyds reported a 106% loan-to-deposit ratio at March 31, 2019, which is around the median for the top 20 U.K. banks. Our stable funding ratio was 107% at end-2018 and we expect it will remain above 100%. Lloyds' £123 billion total wholesale borrowing at year-end 2018 has been on an increasing trend due to ALAC issuance, but its wholesale funding usage is still over 75% lower than in 2008. The reported proportion of wholesale borrowing due within one year was steady at 27%, and primarily funded the liquid asset portfolio. With likely modest growth in customer loan balances requiring little additional funding, we expect that Lloyds will focus on optimizing the quality and cost of its deposit base and its diversity across retail and commercial banking.

While Lloyds' leading market position confers pricing power in the deposit market and its liability base is well-diversified, the bank's funding metrics are insufficiently strong to merit a higher funding assessment relative to U.K. peers. We also take account of Lloyds' borrowings from the Bank of England, which totaled £27 billion at March 31, 2019. We see this as opportunistic and anticipate that it will be able to comfortably refinance these borrowings, mostly through deposit growth and secured wholesale funding.

Lloyds' ratio of broad liquid assets to short-term wholesale funding has been consistently healthy at over 1.5x for many years, and we expect this metric to remain robust. It disclosed a consolidated 130% regulatory liquidity coverage ratio at year-end 2018. We note that Lloyds' mortgage loan book in particular also offers substantial secured access to the

Bank of England discount window in case of need.

Table 7

Lloyds Banking Group PLC Funding And Liquidity					
	--Year-ended Dec. 31--				
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Core deposits/funding base	70.9	70.6	71.0	70.7	72.0
Customer loans (net)/customer deposits	106.7	108.0	107.2	107.4	105.8
Long-term funding ratio	91.1	86.9	85.6	85.2	85.3
Stable funding ratio	107.3	103.9	103.9	103.5	102.4
Short-term wholesale funding/funding base	9.6	14.1	15.5	15.9	15.8
Broad liquid assets/short-term wholesale funding (x)	2.2	1.6	1.5	1.5	1.5
Net broad liquid assets/short-term customer deposits	16.1	12.2	11.8	11.3	10.8
Short-term wholesale funding/total wholesale funding	31.7	46.4	51.6	52.5	54.3
Narrow liquid assets/3-month wholesale funding (x)	3.0	2.1	2.0	2.0	1.8

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Support: Large ALAC buffer

In our view, Lloyds has high systemic importance in the U.K., mainly reflecting its material market share in retail deposits. Since 2015, we have regarded the prospect of extraordinary government support for U.K. banks as uncertain, in view of the clear intent of the authorities to avoid taxpayer bailouts of failing banks, and the well-advanced and effective resolution framework. As a result, systemically important banks in the U.K. are not eligible for any uplift for possible future U.K. government support. However, we view the U.K. resolution regime as effective under our ALAC criteria because, among other factors, we believe it contains a well-defined bail-in process under which authorities would permit nonviable, systemically important banks to continue critical functions as a going concern following a bail-in of eligible liabilities.

We apply the standard 8% threshold for two notches of ALAC uplift. By year-end 2018, Lloyds' significant issuance of bail-in instruments, mainly holding company senior unsecured debt, had taken its ALAC ratio to 10.3%. As such, the GCP includes a two-notch uplift in respect of ALAC support. Lloyds' regulatory bail-in cushion--the minimum requirement for own funds and eligible liabilities (MREL)--was 31.5% on a transitional basis at March 31, 2019. It plans to issue about £5 billion of MREL issuance per year on average to meet the end-state regulatory requirement applicable from 2022, which is likely to be close to 30% (including regulatory capital buffers).

Table 8

Summary ALAC Calculation At Dec. 31, 2018			
		(Mil. £)	**% of S&P Global Ratings RWA**
A	Adjusted common equity	21,953	
B	Hybrids in TAC	7,244	
C (A+B)	TAC	29,197	7.9
D	TAC in excess of our 7% threshold	3,173	0.9
E	ALAC-eligible instruments	34,991	9.4
	Of which NOHC senior	20,435	
	Of which minimal equity content hybrids	13,866	

Table 8

Summary ALAC Calculation At Dec. 31, 2018 (cont.)

		(Mil. £)	% of S&P Global Ratings RWA
	Of which other	690	
F (=D+E)	ALAC buffer	38,163	10.3
	S&P Global Ratings RWAs	371,774	

Source: S&P Global Ratings database. ALAC--Additional loss-absorbing capacity. RWAs--Risk-weighted assets. TAC--Total adjusted capital. NOHC--Nonoperating holding company.

Additional rating factors:

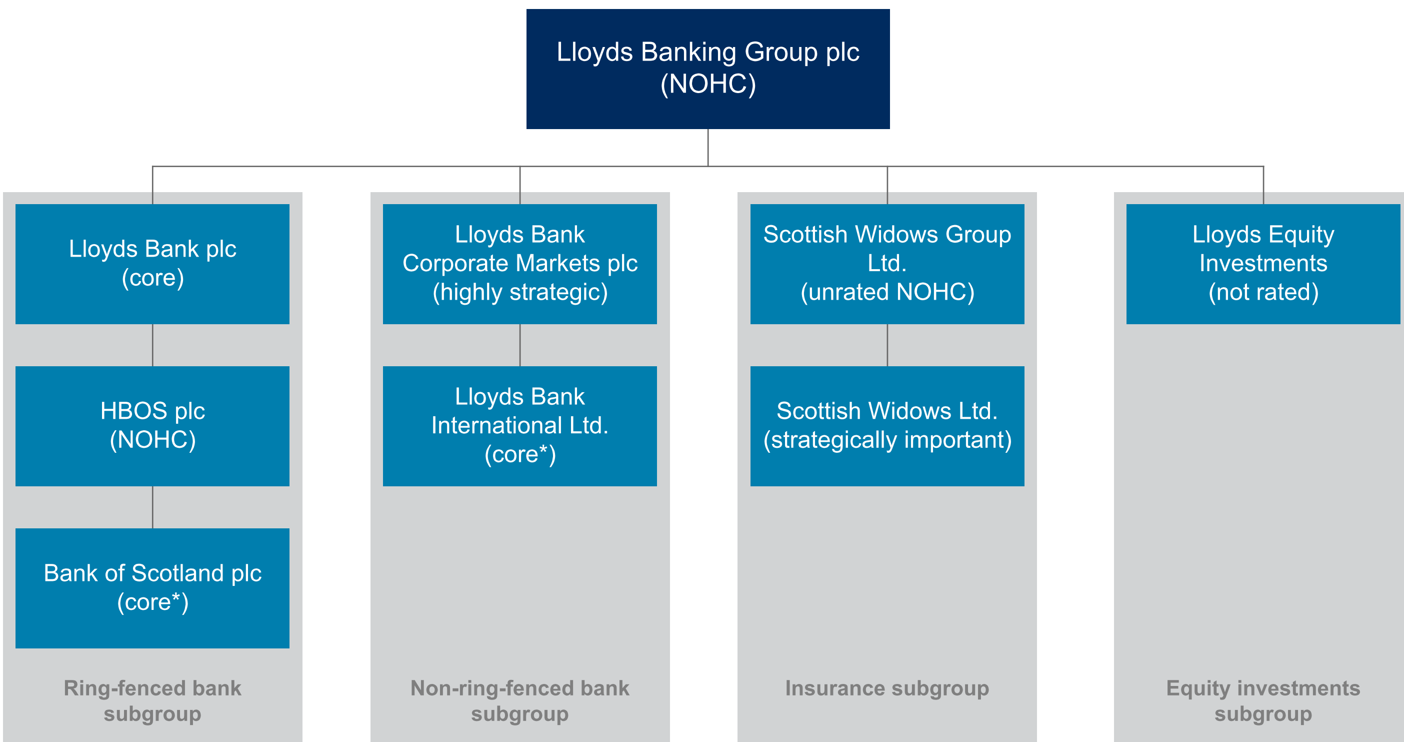
No other factors affect the ratings.

Group structure, rated subsidiaries, and hybrid issue ratings

Lloyds is the nonoperating holding company (NOHC) of the group that it heads, and the operating subsidiaries are organized in separate subgroups (see chart 10).

Chart 10

Highly Simplified Overview Of Lloyds' Legal Entity Structure



Source: Lloyds, S&P Global Ratings.

Information in parentheses shows our group status classification. *These subsidiaries are core to their respective subgroups. NOHC--Nonoperating holding company.

We see the ring-fenced subgroup as core to Lloyds, and expect that regulators would intervene at the point of nonviability, bailing in junior liabilities and, if necessary, NOHC liabilities, to ensure that senior obligations are honored. Our ratings on these entities are therefore in line with the 'a+' ALAC-supported GCP.

We consider it highly likely that the non-ring-fenced subgroup would also be supported through a bail-in led resolution. However, this subgroup's highly strategic status reflects our view that the non-ring-fenced operations are somewhat riskier and less integral than those of the core ring-fenced businesses. As a result, our ratings on the non-ring-fenced entities are one notch below those on the core subsidiaries.

We view Scottish Widows as strategically important because we view the group's insurance businesses as less integral than the core banking activities. That said, we acknowledge that Scottish Widows' importance to Lloyds could increase if the group realizes its ambitions in the areas of retirement planning and corporate pensions solutions under GSR3. As is typical for the insurance subsidiaries of other European groups, we assume that Scottish Widows would not benefit from a resolution action on the parent, meaning that any ratings uplift potential is measured in reference to the 'a-' UGCP of Lloyds. The 'A' long-term ICR on Scottish Widows is in line with the company's 'a' stand-alone credit profile and currently reflects no group-related uplift.

Lloyds' equity investments business has operated since 1981 and focuses on U.K. mid-market private equity transactions. It has performed consistently and makes a small but useful revenue contribution.

Ahead of Brexit, the ring-fenced, non-ring-fenced, and insurance subgroups have each established new EU27-based subsidiaries to maintain customer service.

We do not include notches for ALAC support in the ratings on U.K. NOHCs because we consider it unlikely that their senior obligations would continue to receive full and timely payment in a resolution scenario. As a result of this, and our view that the claims of the creditors of NOHCs are structurally subordinated to those of operating company creditors, we rate both Lloyds and HBOS three notches below the GCP, leading to a long-term ICR one notch below the 'a-' UGCP.

We notch down the AT1, legacy Tier 1, and Tier 2 hybrid capital instruments from the 'a-' UGCP, depending on each instrument's features. Notably, for AT1 instruments issued by Lloyds, this includes:

- One notch because the notes are contractually subordinated;
- Two notches because the notes have Tier 1 regulatory capital status;
- One notch because we consider the notes have a contractual write-down clause;
- One notch because the notes are issued (or guaranteed) by a NOHC.
- For contingent issues, one notch because we expect that Lloyds will maintain its CET1 ratio slightly less than 700 bps above the 7% trigger. This view is consistent with Lloyds' 13.5% target CET1 ratio.

Resolution counterparty ratings (RCRs)

We set the RCRs on Lloyds Bank, Bank of Scotland, and Lloyds Bank Corporate Markets one notch above our long-term ICRs on these entities, reflecting the typical approach under our framework when the ICR ranges from 'BBB-' to 'A+'. The RCRs also reflect our jurisdiction assessment for the U.K. We do not assign an RCR to Lloyds Bank International Ltd.

An RCR is a forward-looking opinion of the relative default risk of certain senior liabilities that may be protected from default through an effective bail-in resolution process for the issuing financial institutions. RCRs apply to issuers in jurisdictions where we assess the resolution regime to be effective and we consider the issuer likely to be subject to a resolution that entails a bail-in if it reaches nonviability.

Related Criteria

- Criteria - Financial Institutions - General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria | Financial Institutions | Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria | Financial Institutions | Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- U.K. Banks: Looking At The Facts Rather Than Received Wisdom, March 4, 2019
- Countdown To Brexit: Rating Implications Of A No-Deal Brexit, Feb. 6, 2019
- The 2019 Outlook For U.K. Banks Hinges On Brexit, Jan. 10, 2019
- Everyone Passed: Stress Tests Highlight Growing Resilience Of U.K. Banks, Nov. 29, 2018
- Banking Industry Country Risk Assessment: United Kingdom, Nov. 5, 2018
- Our Credit Loss Estimates For U.K. Banks: 2018-2020, June 7, 2018
- Lloyds Banking Entities Upgraded On Strengthened Bail-In Buffer And Improving Profitability; Outlook Stable, May 8, 2018

- Lloyds Bank Corporate Markets plc And Lloyds Bank International Ltd. Assigned 'A-/A-2' Ratings; Outlook Positive, April 24, 2018

Ratings Detail (As Of June 21, 2019)*	
Lloyds Banking Group PLC	
Issuer Credit Rating	BBB+/Stable/A-2
Junior Subordinated	BB-
Preference Stock	BB
Senior Unsecured	BBB+
Short-Term Debt	A-2
Subordinated	BBB-
Issuer Credit Ratings History	
15-Nov-2017	BBB+/Stable/A-2
07-Jul-2016	BBB+/Negative/A-2
09-Jun-2015	BBB+/Stable/A-2
03-Feb-2015	BBB/Positive/A-2
Sovereign Rating	
United Kingdom	AA/Negative/A-1+
Related Entities	
Bank of Scotland Capital Funding L.P.	
Preferred Stock	BB+
Bank of Scotland PLC	
Issuer Credit Rating	A+/Stable/A-1
Resolution Counterparty Rating	AA-/--/A-1+
Junior Subordinated	BB+
Junior Subordinated	BBB-
Senior Secured	AAA/Stable
Senior Unsecured	A+
Subordinated	BBB
HBOS PLC	
Issuer Credit Rating	BBB+/Stable/A-2
Junior Subordinated	BB+
Senior Unsecured	BBB+
Short-Term Debt	A-2
Subordinated	BBB
Subordinated	BBB-
LBG Capital No. 1 PLC	
Junior Subordinated	BB+
Subordinated	BBB-
LBG Capital No. 2 PLC	
Junior Subordinated	BB+
Subordinated	BB+
Lloyds Bank Corporate Markets PLC	
Issuer Credit Rating	A/Stable/A-1

Ratings Detail (As Of June 21, 2019)*(cont.)	
Resolution Counterparty Rating	A+/--/A-1
Commercial Paper	A-1
Lloyds Bank International Ltd.	
Issuer Credit Rating	A/Stable/A-1
Lloyds Bank PLC	
Issuer Credit Rating	A+/Stable/A-1
Resolution Counterparty Rating	AA-/--/A-1+
Commercial Paper	A-1
Junior Subordinated	BB+
Junior Subordinated	BBB-
Senior Unsecured	A+
Short-Term Debt	A-1
Subordinated	BBB

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.