Research Update:

Lloyds Banking Group Outlook Revised To Negative On Economic Impact Of COVID-19; Ratings Affirmed

April 23, 2020

Overview

- Despite governments' and central banks' measures to contain the COVID-19 pandemic, global economies face an unprecedented challenge and there are substantial downside risks.
- We are therefore revising our outlook on Lloyds Banking Group plc (Lloyds) and related entities to negative from stable.
- We are affirming our issuer and issue ratings because Lloyds' robust balance sheet and prudent risk management are significant mitigants to the adverse operating environment.
- The negative outlook reflects potential earnings pressures arising from the economic and market impact of the COVID-19 pandemic.

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Rating Action

On April 23, 2020, S&P Global Ratings revised its outlook on Lloyds Banking Group plc (Lloyds) and related entities to negative from stable. The related entities include Lloyds Bank PLC, Bank of Scotland PLC, and Lloyds Bank Corporate Markets PLC.

At the same time, we affirmed our issuer and issue ratings on Lloyds, its related entities, and their respective debt instruments.

Rationale

The revision of the outlook to negative from stable reflects our view that economic and market stress triggered by the COVID-19 pandemic may reduce Lloyds' profitability and capital metrics in the coming quarters.

In addition to the human cost, the pandemic has caused large parts of global economic activity to grind to a halt. With isolation strategies still very much in force, our economists expect a sharp economic contraction in the second quarter of 2020, followed by a rebound starting in the third quarter. However, they are now more cautious on the strength of recovery through end-2020 and into 2021, envisaging global GDP growth falling 2.4% in 2020 with a rebound to 5.9% in 2021; in the U.K. they assume a 6.5% decline in GDP in 2020 before a rebound to 6.0% in 2021. Even under this base case, the effects of COVID-19 will be evident for long after the crisis subsides.

We have affirmed the ratings because we think that Lloyds' credit strengths are significant mitigants to the adverse operating environment. In particular, its ability to internally generate capital compares well to U.K. and international peers. This capability is aided by its recent decision to cancel its final dividend in respect of 2019 earnings and not to pay a quarterly dividend during the course of 2020. Moreover, like U.K. peers, Lloyds' funding, and liquidity metrics were robust at the onset of the pandemic.

Nevertheless, Lloyds is a significant lending bank--the largest domestic lender in the U.K.--and its lending portfolio includes sizable exposures to market segments that may be particularly impacted by the current lockdown, including corporate sectors that rely on discretionary spending, and the largest credit card book. In our view, its earnings capacity will now face further pressure from a material increase in IFRS9 credit impairments and margin compression from recent interest rate cuts. We expect its regulatory capital position will remain strong, helped by the aforementioned dividend policy restraint. However, its regulatory capital ratios are likely to be moderately diluted by increased risk-weighted assets arising from market volatility and drawdowns of committed facilities, as well as regulatory methodology changes implemented in January.

We currently assume that Lloyds will remain above our 7% risk adjusted capital (RAC) threshold for its ratings. We calculate this metric to be 8.7% at Dec. 31, 2019 and note that a lowering of our U.K. economic risk assessment, as implied by our negative trend, could reduce this metric by around 120 basis points. However, in this troubled economic scenario we assume that Lloyds' board will apply a more conservative approach to shareholder distributions than historically.

Compared to the reports we published during 2019, we have refreshed our Dec. 31, 2018 calculation of Lloyds Banking Group's RAC ratio to 8.8% from 7.9%. The around 90 basis points increase is due to our previously making a too-conservative adjustment for Lloyds' investment in its insurance subsidiary, Scottish Widows Group, based on the historical cost. We have now amended our adjustment to take account of reserves accumulated since the acquisition in 2000. As a result, we now deduct £6.2 billion from total adjusted capital (TAC) in 2018, the numerator of our RAC ratio, compared to the £9.6 billion deduction we previously made. The effect of this deduction was largely unchanged in our 2019 RAC calculation. The updated RAC ratio calculation does not alter our view of Lloyds' capital and earnings, which remain credit neutral.

The ratings on Lloyds' wholly owned insurance subsidiary, Scottish Widows Ltd. (A/Stable/A-1), are not affected by this rating action. While we consider Scottish Widows to be a strategically important subsidiary of Lloyds, which would ordinarily cap the ratings below that of the main operating bank, in this case the stand-alone credit profile (SACP) of Scottish Widows is already 'a'.

Outlook

The negative outlook on Lloyds Banking Group reflects potential earnings pressures arising from the economic and market impact of the COVID-19 pandemic. If we saw clear signs that the U.K. systemwide domestic loan loss rate was going to exceed 100 basis points in 2020, and not be offset by the prospect of a quick economic recovery, we would likely lower the anchor, our starting point for rating U.K. banks, to 'bbb' from 'bbb+'. In turn, we would therefore expect to lower our ratings on Lloyds, including its rated banking subsidiaries, and hybrid ratings, by one notch. In this economic scenario, we assume that management adjusts its 2021 shareholder distributions such that the RAC ratio remains above our 7% threshold.

Upside scenario

A revision of the outlook to stable would require either an improvement in our view of U.K. economic risk, or strong evidence that Lloyds was outperforming domestic and international peers in terms of pre-provision earnings, asset quality and capital conservation.

Ratings Score Snapshot

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	To	From
Issuer Credit Rating	A+/Negative/A-1	A+/Stable/A-1
Resolution Counterparty Rating	AA-/--/A-1+	A-/--/A-1+
Lloyds Bank Corporate Markets PLC		
Issuer Credit Rating	A/Negative/A-1	A/Stable/A-1
Resolution Counterparty Rating	A+/--/A-1	A+/--/A-1
Group SACP	a-	a-
Anchor	bbb+	bbb+
Business Position	Strong (+1)	Strong (+1)
Capital and Earnings	Adequate (0)	Adequate (0)
Risk Position	Adequate (0)	Adequate (0)
Funding and Liquidity	Avge and Adequate (0)	Avge and Adequate (0)
Support	+2	+2
ALAC Support	+2	+2
GRE Support	0	0
Group Support	0	0
Sovereign Support	0	0
Additional Factors	0	0

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- 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

- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banks: Rating 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

- Outlooks Revised On Six U.K. Banks On Deepening COVID-19 Downside Risks, April 23, 2020
- How COVID-19 Risks Prompted European Bank Rating Actions, April 23, 2020
- Europe’s AT1 Market Faces The COVID-19 Test: Bend, Not Break, April 22, 2020
- COVID-19 Deals A Larger, Longer Hit To Global GDP, April 16, 2020
- Industry Report Card: U.K. Banks' Strong Balance Sheets Should See Them Through Another Difficult Stretch, March 12, 2020
- U.K. Banks Ease, Rather Than Roar Into The 2020s, Jan. 7, 2020
- U.K. Banks' Latest Stress Tests Confirm Balance Sheet Resilience, Dec. 17, 2019
- United Kingdom Outlook Revised To Stable; 'AA/A-1+' Ratings Affirmed, Dec. 17, 2019
- Banking Industry Country Risk Assessment: United Kingdom, Dec. 5, 2019
- Lloyds Banking Group plc, Dec. 3, 2019