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Lloyds Banking Group PLC

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Lloyds Banking Group PLC

Group SACP	a-	
Anchor	bbb+	
Business Position	Strong	+1
Capital and Earnings	Adequate	0
Risk Position	Adequate	0
Funding	Average	0
Liquidity	Adequate	

+

Support	+2
ALAC Support	+2
GRE Support	0
Group Support	0
Sovereign Support	0

+

Additional Factors	0

Issuer Credit Rating
A+/Negative/A-1
Resolution Counterparty Rating
--/--/--
Holding Company ICR
BBB+/Negative/A-2

Group SACP—The stand-alone credit profile of the Lloyds group. The holding company issuer credit rating (ICR) shown applies to Lloyds Banking Group PLC, and is one notch below the UGCP. The ICR and the resolution counterparty rating apply to Lloyds Banking Group PLC's two core bank operating subsidiaries: Lloyds Bank PLC and Bank of Scotland PLC.

Major Rating Factors

Issuer Credit Rating
BBB+/Negative/A-2

Strengths:

- Market-leading franchise in U.K. retail banking, and strong positions in U.K. corporate banking and insurance.
- Cost-efficient operating model that supports strong pre-provision profitability, business stability, and competitiveness.
- Supportive funding and liquidity profiles anchored by strong deposit franchise.

Weaknesses:

- Geographically concentrated in the U.K., which is now in recession owing to the impact of COVID-19.
- Our risk-adjusted capital (RAC) ratio is lower than the average for U.K. peers, which partly reflects the deduction of Lloyds' material investment in its insurance business.

Outlook

The negative outlook on Lloyds Banking Group reflects potential earnings pressures arising from the economic and market impact of the COVID-19 pandemic.

Downside scenario

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.

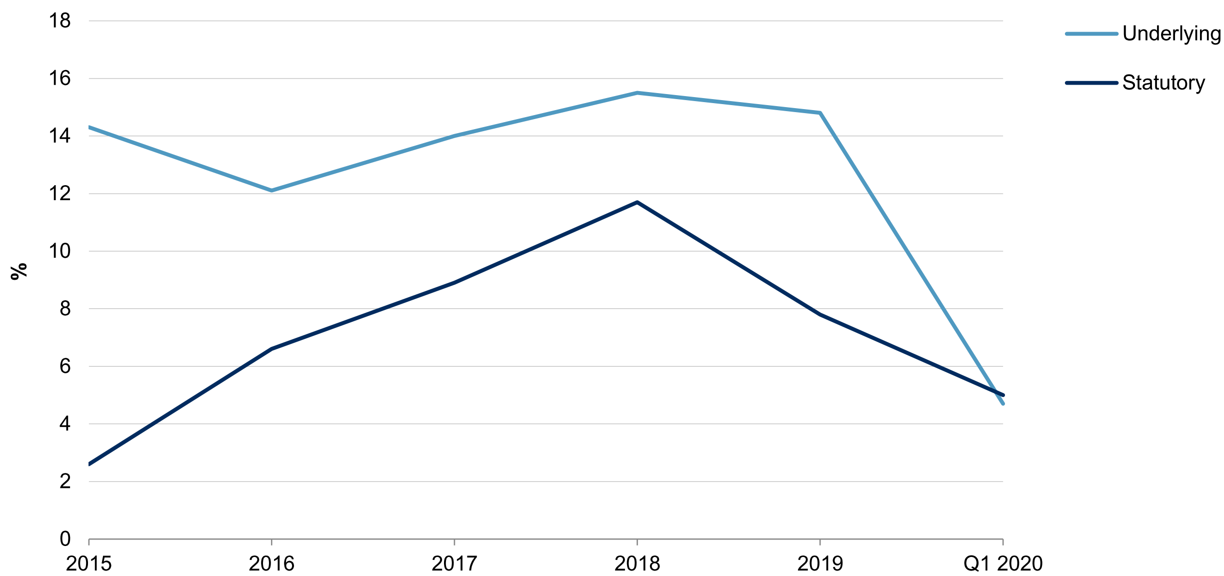
Rationale

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

Lloyds' balance sheet--specifically, its asset mix, funding, capitalization, and additional loss-absorbing capacity (ALAC) buffer--supports the ratings and we expect these attributes to remain consistent. Its market-leading cost efficiency underpins strong underlying profitability (see chart 1). Its statutory profitability improved steadily in 2015-2018, but suffered a setback in 2019 due to a resurgence in payment protection insurance (PPI) provisions. We don't anticipate any more PPI provisions, however, in 2020, high credit provisions as a consequence of the COVID-19 pandemic, and the negative impact of the lower rate environment, will weigh on earnings.

Chart 1

Lloyds Banking Group PLC--High Loan Loss Provisions Held Back Returns In Q12020
Post-tax returns on tangible equity



Source: S&P Global Ratings, Lloyds.

Like its major domestic peers, Lloyds has operated under the U.K. ring-fencing regime since January 2019. Although this 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 ICR on Lloyds' non-ring-fenced subsidiary Lloyds Bank Corporate Markets plc is one notch lower than those on ring-fenced entities because we see it as slightly less integral to the group.

Anchor: Reflects Lloyds' strong domestic 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 negative. This principally reflects the possibility we see, in light of the evolving impact of COVID-19, that domestic loan losses in 2020 could rise to around 100bp of outstanding balances. This loan loss rate would be around five times the level of each of the previous six years, and would challenge the current economic risk assessment, allied with our existing view of the U.K.'s relatively high household leverage. We would also factor in the likely pace and strength of the economic recovery that we assume will occur in 2021.

The industry risk trend is stable. The banking system is being supported during the current COVID-19 crisis by the firm actions of the Bank of England, and government measures. Moreover, the banking system entered this period with a robust balance sheet profile, confirmed by the results of the latest Bank of England stress tests in both December 2019 and May 2020. However, pre-provision earnings will be further squeezed by the even lower rate environment than we had previously assumed, as well as reduced economic activity. The weaker profitability outlook for the industry may offset our growing views of the robustness of the system's balance sheet profile and its institutional strengths.

All else being equal, a lowering of the economic risk score, as implied by the negative economic risk trend, would result in a bank anchor of 'bbb' compared to the current 'bbb+'.

Table 1

Lloyds Banking Group PLC--Key Figures

	--Year-ended Dec. 31--				
(Mil. £)	**2019**	**2018**	**2017**	**2016**	**2015**
Adjusted assets	690,906	675,038	681,041	684,608	685,842
Customer loans (gross)	444,205	448,402	450,813	445,121	452,410
Adjusted common equity	25,016	25,341	24,173	24,633	32,226
Operating revenues	18,264	18,995	18,650	17,849	17,795
Noninterest expenses	9,304	9,500	9,552	9,291	9,293
Core earnings	4,778	5,885	5,243	4,769	4,860

Source: S&P Global Ratings Database.

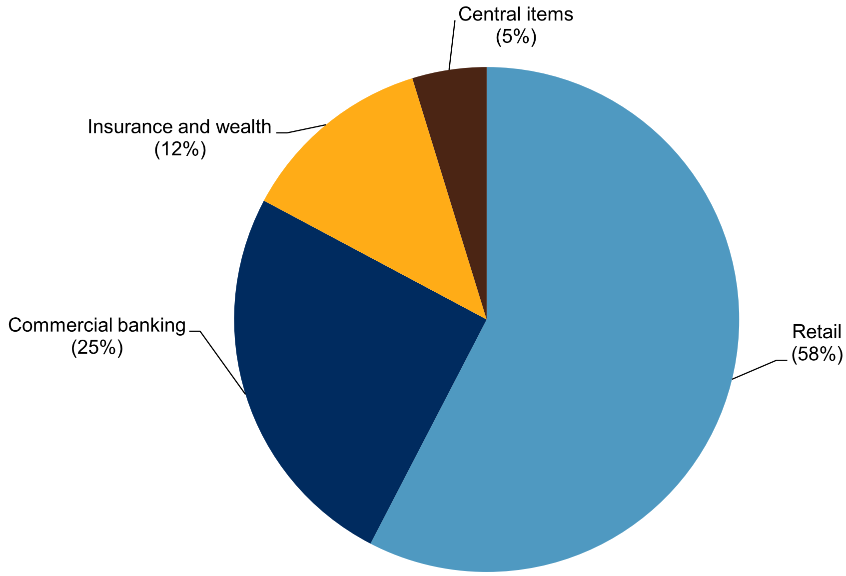
Business position: Leading U.K. financial services franchise

Our favorable view of Lloyds' business position is based on its market-leading position in U.K. retail banking and complementary activities in domestic commercial banking and insurance (see chart 2). This profile represents a powerful franchise that generates stable and relatively predictable revenues. Lloyds has a strong domestic focus and the absence of meaningful international diversification is a constraining factor in our assessment in the context of our current view of the U.K. banking system. We believe that Lloyds is pursuing a coherent strategy focused on leveraging digital technology to improve efficiency and client service. The stable senior management team has set consistent priorities for the group and executed them well, in our view.

Chart 2

Lloyds Banking Group PLC--Retail-Focused Revenue Profile

Reported net income by division in 2019



Source: S&P Global Ratings, Lloyds.

Lloyds serves over 26 million U.K. retail customers, of which almost 17 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 reports market shares of 24% for consumer credit card balances, 22% for personal current account deposits, 19% for open book mortgages, 16% for retail savings deposits, and 18%-19% for small and mid-market business relationships.

Net interest income contributes the majority of revenues since Lloyds is primarily a lending and deposit-taking institution. It has a less complex profile than many peers and we view its limited reliance on market-sensitive income as supportive of its business stability. It is not active in investment banking, but its commercial banking division offers debt capital markets, foreign exchange, and transaction banking services to corporate customers.

Lloyds is currently executing its third Group Strategic Review (GSR3), which was announced in early 2018 and runs until year-end 2020. Its ambition is to increase digitalization and automation to improve customer experience, cost efficiency, and shareholder returns. Lloyds has invested over £2 billion during the GSR3 period so far. 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. 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. It also underwrites general insurance products through other subsidiaries. We see growing financial and operational linkages between the banking and insurance businesses. For example, Lloyds' single customer view initiative enables clients to manage banking and insurance products together on Lloyds' digital platform. Nevertheless, we believe the insurance business is less integral to Lloyds than the banking activities.

Lloyds has also increased its presence in the wealth market, launching a joint venture with Schroders, called Schroders Personal Wealth, which has ambitions to become a top three U.K. wealth manager by the end of 2023.

Lloyds has occasionally used bolt-on acquisitions to accelerate organic growth in target markets. The most recent example was its 2019 acquisition of Tesco Personal Finance's small U.K. prime residential mortgage portfolio. We think further transactions 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+' group SACP), 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' group SACP), 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'). The majority of the U.K. and international peer group, like Lloyds, are on a negative outlook.

In the context of the potential lowering of Lloyds' group SACP, as implied by the negative outlook, potential mortgage-biased peers with a 'bbb+' SACP include Bendigo & Adelaide Bank, Caixabank, and De Volksbank. In each case, their ratings outlook is stable.

Table 2

Lloyds Banking Group PLC--Business Position

	--Year-ended Dec. 31--				
	2019	**2018**	**2017**	**2016**	**2015**
Total revenues from business line (currency in millions)	18,634	18,945	18,929	18,288	17,421
Commercial banking/total revenues from business line	23.3	24.6	25.6	25.8	26.3
Retail banking/total revenues from business line	58.1	59.3	57.7	59.2	64.1
Commercial & retail banking/total revenues from business line	81.4	83.9	83.3	85.0	N.A.
Insurance activities/total revenues from business line	11.4	10.5	10.5	8.8	9.6
Other revenues/total revenues from business line	7.2	5.6	6.2	6.2	(1.2)
Return on average common equity	5.8	8.9	7.0	5.7	2.0

Source: S&P Global Ratings Database. N.A.--Not available.

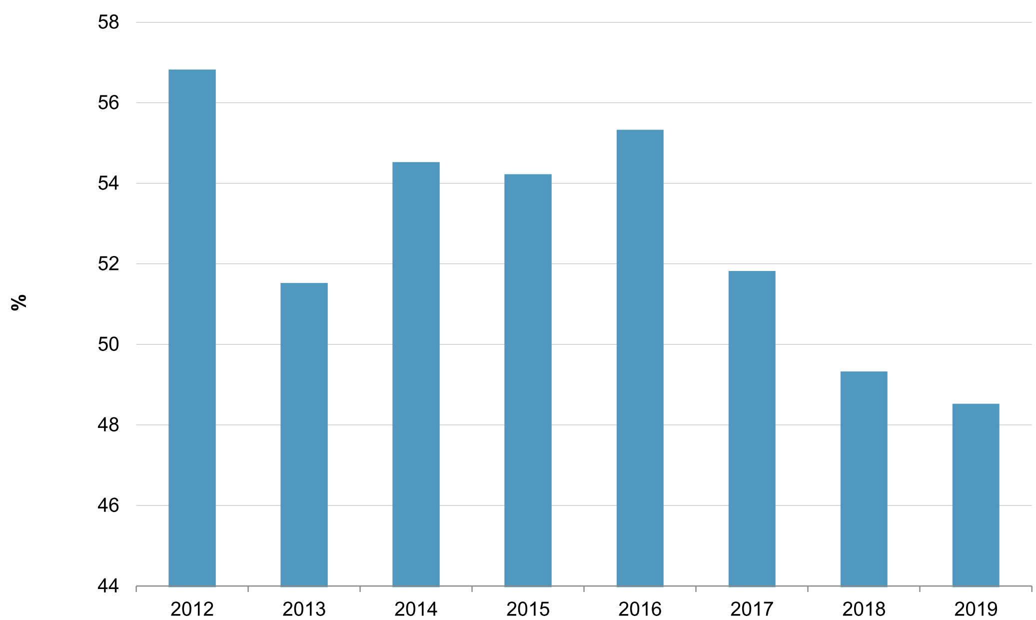
Capital and earnings: Our view of Lloyds' capitalization should be able to withstand the strain arising from the COVID-19 pandemic

We project that Lloyds' RAC ratio will operate in the 7.75%-8.25% range through year-end 2022. This positions the bank as fairly typical among large European peers, but somewhat below the other major U.K. banks. In 2020, we expect higher credit losses and lower revenue generation as a consequence of the COVID-19 pandemic, notwithstanding lower conduct charges than prior years, will hamper its normally strong internal capital generation.

Prior to COVID-19, we considered that Lloyds was progressing toward its previous target cost-to-income ratio in the low 40s exiting 2020 (see chart 3). We see its efficient business model as a competitive advantage relative to peers and an important contributor to its strong internal capital generation.

Chart 3

Lloyds Banking Group PLC--Cost Efficiency Had Been Improving
Reported cost-to-income ratio

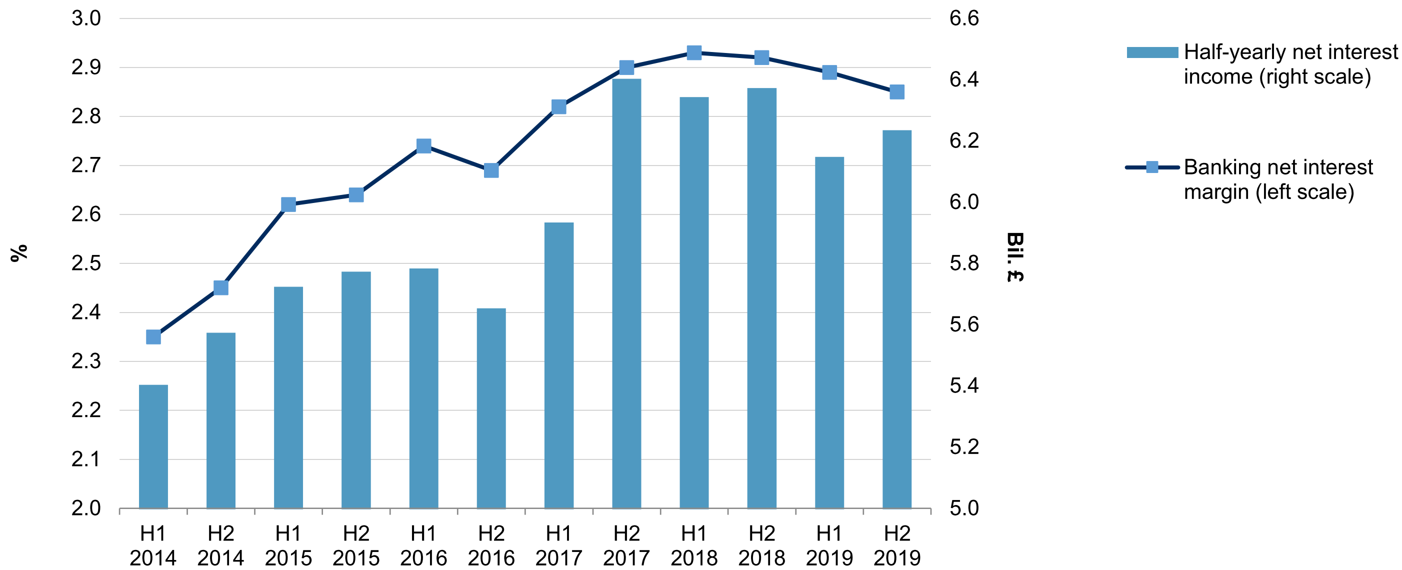


Source: S&P Global Ratings, Lloyds. Costs include remediation charges and exclude nonoperating items such as payment protection insurance provisions.

Similarly, Lloyds' net interest margin (NIM) had been demonstrating resilience despite strong asset price competition in the U.K., particularly in mortgages (see chart 4). In addition to disciplined management across its brands and channels, its margin benefited from a business mix change following the 2017 acquisition of MBNA's U.K. credit card business. The reported NIM fell by 6 basis points (bps) in the first quarter of 2020 and Lloyds has stated that the impact of the Bank of England base rate cuts in March could reduce the NIM by 30-40 bps in the second quarter.

Chart 4

Lloyds Banking Group PLC--Resilient Net Interest Margin, Prior To 2020



Source: S&P Global Ratings.

Lloyds reported a 14.2% common equity Tier 1 (CET1) ratio at March 31, 2020. This compares well with peers and sits comfortably above the management's previous internal target of about 12.5% plus a 100bp buffer. In March 2020, the Bank of England reduced the U.K. countercyclical buffer to 0% from 1% (and it had been planning to increase this to 2% in December 2020), which gives Lloyds an additional headroom over its regulatory requirements.

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. The residential mortgage book has 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.

Lloyds normally distributes the majority of its earnings to shareholders through dividends and share buybacks. However, it suspended its £1.75 billion buyback program for 2019 in September 2019, when the scale of its PPI provision requirement was confirmed. About £600 million of the program was unused at that point. In late March 2020, in common with other U.K. banking groups at the behest of the U.K. regulator, Lloyds cancelled its final dividend in respect of 2019 earnings. Furthermore, it will not be paying quarterly dividends in 2020.

Key elements of our base-case RAC projection through year-end 2022 include the following factors:

- We assume a slight growth in loan balances in 2020 and 2021, before rising by around 3% in 2022.
- A loan loss rate of around 100 basis points (bps) in 2020, which would be similar to S&P Global Ratings' published credit loss estimates for the U.K. In 2021, we assume the loss rate will fall by around one-third and then revert to closer to recent norms in 2022.
- We include a modest estimate of further potential litigation and customer redress charges, as we do for other U.K. banking groups.
- We think that statutory pre-tax profit could fall by well over one-half in 2020, from £4.4 billion in 2019, before recovering to around 2019 levels in 2021 and accelerating in 2022.
- We expect a typical level of shareholder distributions to resume in 2021, as we do for other U.K. banking groups.
- We note that on a pro forma basis, if we increased our economic risk weights in the U.K., as indicated by our negative BICRA economic risk trends, the pro forma impact on our RAC ratio is around 120 bps.

We consider the quality of capital to be satisfactory, with hybrids accounting for 21% of TAC at year-end 2019. We also project a comfortable earnings buffer (that is, normalized operating income divided by S&P Global Ratings' RWAs) of about 1.3% on average in 2020-2022. This indicates that Lloyds should be able to absorb the expected spike in credit losses within earnings.

Indicative of the weak near-term outlook, Lloyds reported a low underlying RoTE of 4.7% in the first quarter of 2020 as adjusted profit before tax fell to just £74 million. The reported expected credit loss charge was £1.43 billion, or a 130 bps loss rate, compared to 25 bps in the same period of 2019, mainly due to Lloyds' revised economic assumptions.

Table 3

Lloyds Banking Group PLC--Capital And Earnings

	--Year-ended Dec. 31--				
(%)	**2019**	**2018**	**2017**	**2016**	**2015**
Tier 1 capital ratio	16.5	17.8	16.6	16.1	15.2
S&P Global Ratings’ RAC ratio before diversification	8.7	8.8	8.0	8.2	8.0
S&P Global Ratings’ RAC ratio after diversification	9.3	9.4	8.6	8.8	9.6
Adjusted common equity/total adjusted capital	78.7	77.7	79.7	79.9	83.6
Double leverage	104.5	103.5	103.8	102.2	110.0
Net interest income/operating revenues	55.7	70.5	58.5	52.0	63.6
Fee income/operating revenues	7.7	7.7	8.5	9.5	10.2
Market-sensitive income/operating revenues	100.1	(20.4)	63.4	103.9	20.9
Noninterest expenses/operating revenues	50.9	50.0	51.2	52.1	52.2
Preprovision operating income/average assets	1.1	1.2	1.1	1.1	1.0
Core earnings/average managed assets	0.6	0.7	0.6	0.6	0.6

Source: S&P Global Ratings Database.

Table 4

Lloyds Banking Group PLC--Risk-Adjusted Capital Framework Data

(Mil. £)	Exposure*	Basel III RWA	Average Basel III RW(%)	S&P Global Ratings RWA	Average S&P Global Ratings RW (%)
Credit risk					
Government & central banks	132,183.6	600.0	0.5	2,484.7	1.9
Of which regional governments and local authorities	0.0	0.0	0.0	0.0	0.0
Institutions and CCPs	25,068.6	2,650.0	10.6	4,348.1	17.3
Corporate	97,368.6	56,262.5	57.8	85,633.1	87.9
Retail	401,069.2	86,445.6	21.6	190,988.8	47.6
Of which mortgage	342,193.9	44,200.0	12.9	137,051.2	40.1
Securitization§	28,986.9	5,075.0	17.5	10,524.6	36.3
Other assets†	10,226.0	7,475.0	73.1	9,776.9	95.6
Total credit risk	694,903.0	158,508.1	22.8	303,756.1	43.7
Credit valuation adjustment					
Total credit valuation adjustment	--	584.0	--	2,220.8	--
Market Risk					
Equity in the banking book	3,797.0	6,809.0	179.3	28,072.8	739.3
Trading book market risk	--	1,790.0	--	2,840.8	--
Total market risk	--	8,599.0	--	30,913.6	--
Operational risk					
Total operational risk	--	25,482.0	--	27,919.8	--
	Exposure	**Basel III RWA**	**Average Basel II RW (%)**	**S&P Global Ratings RWA**	**% of S&P Global Ratings RWA**
Diversification adjustments					
RWA before diversification	--	203,441.1	--	364,810.3	100.0
Total Diversification/ Concentration Adjustments	--	--	--	(22,513.6)	(6.2)
RWA after diversification	--	203,441.1	--	342,296.8	93.8
		Tier 1 capital	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		33,625.0	16.5	31,805.0	8.7
Capital ratio after adjustments‡		33,625.0	16.5	31,805.0	9.3

*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). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of 'Dec. 31 2019', S&P Global Ratings.

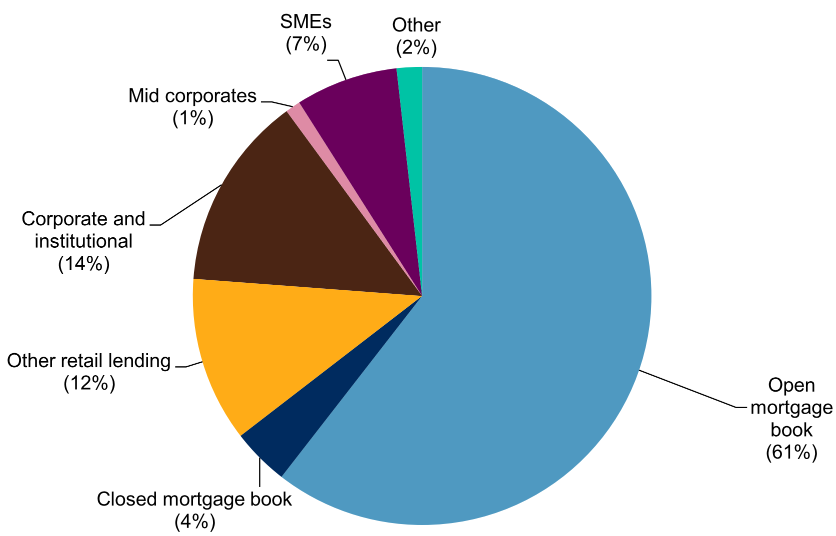
Risk position: Solid profile anchored by overweight position in residential mortgages

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 view its risk position to be adequate, reflecting the group's satisfactory asset quality track record and its contained risk appetite. 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 moderate new business growth. However, it does proactively manage new business according to its view of market conditions. The loan portfolio is skewed toward secured residential mortgages (see chart 5). At Dec. 31, 2019, prime, owner-occupied loans represented 79% of outstanding mortgages, with 17% in buy-to-let (in line with the industry average) and the remainder in legacy specialist mortgage products that are closed to new business and running off.

Chart 5

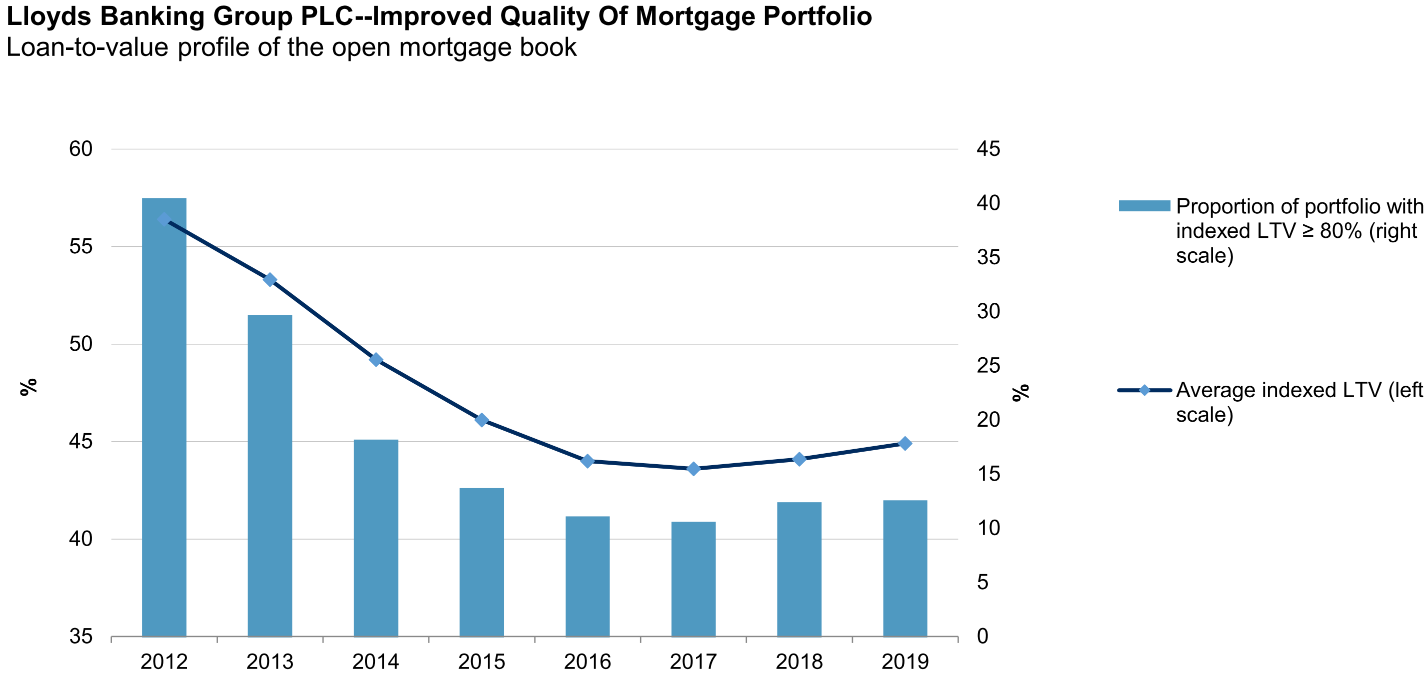
Lloyds Banking Group PLC--U.K. Focused Loan Portfolio With Strong Mortgage Weighting
Customer loans and advances at March 31, 2020



Source: S&P Global Ratings, Lloyds. Excludes reverse repurchase agreements. SMEs--small and medium-sized enterprises.

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. Moreover, Lloyds states that the proportion of the mortgage book originated in the 2006-2008 period--when underwriting standards were weaker than subsequently--has reduced to 19% of the total mortgage book at March 31, 2020 and that 92% of this segment has an LTV less than or equal to 80%, similar to the total book.

Chart 6



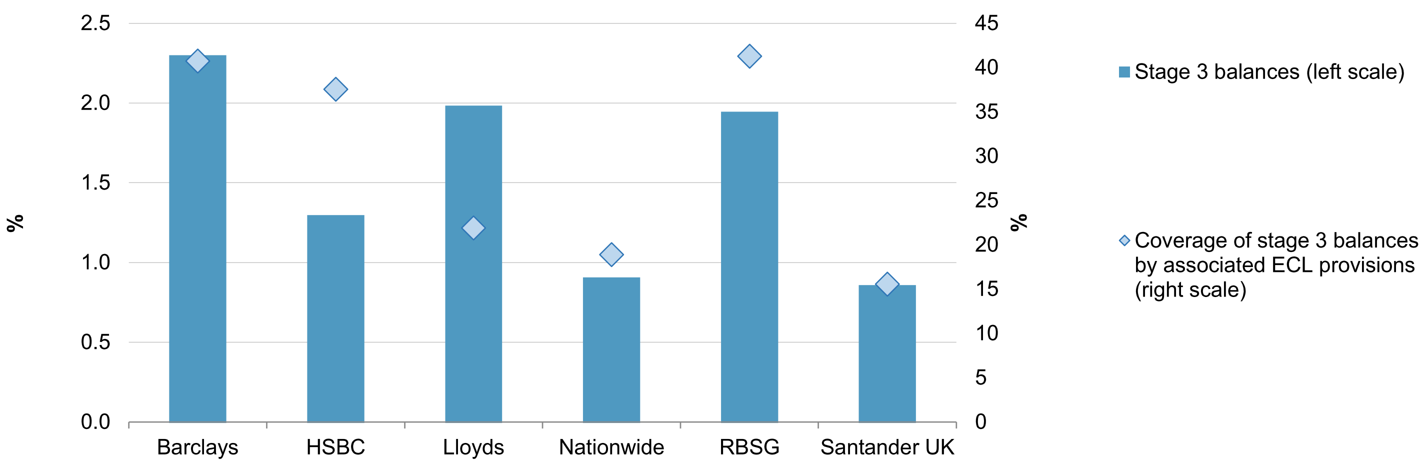
Source: S&P Global Ratings, Lloyds. LTV--Loan To Value.

Although mortgages dominate Lloyds' customer lending, we see its consumer credit and commercial banking portfolios as more significant sources of risk in the current recessionary environment, as reflected in our assumed loan loss rates. In consumer credit, it is the joint market leader in credit cards, and is also active in unsecured personal loans and car finance.

We view Lloyds' current nonperforming assets as typical among the rated U.K. banks (see chart 7). Provisions on stage 3 assets covered a reported 23% of drawn stage 3 balances at year-end 2019. This ratio is lower than certain peers' due to Lloyds' focus on collateralized lending and differing write-off policies across peers. In the first quarter of 2020, reported Stage 3 loans remained unchanged at 1.8% of loans, although provision coverage increased to 25%.

Chart 7

Lloyds Banking Group PLC--Asset Quality Metrics Are Similar To U.K. Peers'
U.K. lenders' IFRS 9 stage 3 disclosures



Source: Institutions' disclosures. Data based on retail and commercial loans and after excluding reverse repos. Figures as at December 2019 except for Nationwide, which are as at April 4, 2020. ECL: Expected Credit Loss.

In the current environment Stage 2 loans can provide a better insight into asset quality. Lloyds did not disclose Stage 2 loans at March 31, 2020, but we assume they have increased from year-end, like U.K. peers. At Dec. 31, 2019, a reported 7.7% of Lloyds' loans (excluding reverse repos) were classified as Stage 2, of which only a modest proportion were more than 30 days overdue. This measure was below Santander UK (4.3%), but similar to HSBC and RBS (7.7% and 8.2% respectively) and a bit below Barclays (11.1%). We currently expect the trend in Lloyds' asset quality to mirror that for the U.K. system more broadly.

As the largest U.K. retail bank, PPI remediation has been extraordinarily expensive for Lloyds, costing £21.9 billion in aggregate provisions between 2011 and 2019. We don't anticipate any further PPI provisions. Lloyds has materially overhauled its product design and sales practices in recent years to mitigate the risk of future conduct issues. There remains close regulatory scrutiny of banks' business conduct in the U.K., and we assume some further remediation charges in our earnings projections, but at a far lower level than for PPI.

The 6% 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 5

Lloyds Banking Group PLC--Risk Position					
	--Year-ended Dec. 31--				
(%)	**2019**	**2018**	**2017**	**2016**	**2015**
Growth in customer loans	(0.9)	(0.5)	1.3	(1.6)	(5.6)

Table 5

Lloyds Banking Group PLC--Risk Position (cont.)

	--Year-ended Dec. 31--				
(%)	**2019**	**2018**	**2017**	**2016**	**2015**
Total diversification adjustment/S&P Global Ratings' RWA before diversification	(6.2)	(6.8)	(7.3)	(6.2)	(17.0)
Total managed assets/adjusted common equity (x)	33.3	31.5	33.6	33.2	25.0
New loan loss provisions/average customer loans	0.3	0.2	0.2	0.2	0.1
Net charge-offs/average customer loans	0.3	0.2	0.2	0.3	0.7
Gross nonperforming assets/customer loans + other real estate owned	3.0	3.2	2.4	2.8	3.4
Loan loss reserves/gross nonperforming assets	29.5	29.7	20.4	19.4	19.8

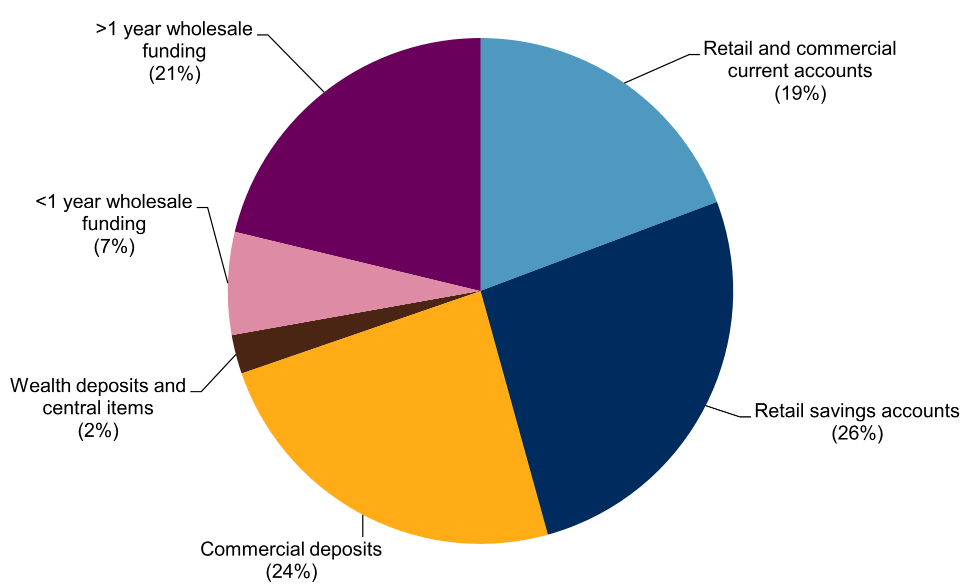
Source: S&P Global Ratings Database.

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 8).

Chart 8

Lloyds Banking Group PLC--Deposit Franchise Anchors Funding Base
Funding sources at March 31, 2020



Source: S&P Global Ratings, Lloyds. Excludes equity and repurchase agreements.

Lloyds reported a 103% loan-to-deposit ratio at March 31, 2020; the median for the top 25 U.K. banks by revenues is around 111%. Our stable funding ratio was 102% at end-2019 and we expect it will remain above 100%. Lloyds' wholesale markets funding stood at £126 billion on March 31, 2020 and the proportion of wholesale borrowing due within one year was 31%, and primarily funded the liquid asset portfolio.

While Lloyds' leading market position confers potential 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.

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. 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 6

Lloyds Banking Group PLC--Funding And Liquidity					
	--Year-ended Dec. 31--				
(%)	**2019**	**2018**	**2017**	**2016**	**2015**
Core deposits/funding base	70.2	70.9	70.6	71.0	70.7
Customer loans (net)/customer deposits	106.9	106.7	108.0	107.2	107.4
Long-term funding ratio	89.9	91.1	86.9	85.6	85.2
Stable funding ratio	102.4	107.3	103.9	103.9	103.5
Short-term wholesale funding/funding base	10.8	9.6	14.1	15.5	15.9
Broad liquid assets/short-term wholesale funding (x)	1.9	2.2	1.6	1.5	1.5
Net broad liquid assets/short-term customer deposits	13.5	16.1	12.2	11.8	11.3
Short-term wholesale funding/total wholesale funding	35.0	31.7	46.4	51.6	52.5
Narrow liquid assets/3-month wholesale funding (x)	2.8	3.0	2.1	2.0	2.0

Source: S&P Global Ratings Database.

Environmental, Social And Governance:

Avoiding new instances of conduct failure is a prominent consideration for Lloyds' management and strategy. The U.K. industrywide PPI misselling episode illustrates the significant financial and reputational damage that can arise when banks fail to treat customers fairly. As the largest U.K. retail bank, Lloyds was by far the most affected by PPI provisions. We see ongoing customer remediation charges as largely unavoidable in U.K. financial services, particularly for a large retail player such as Lloyds. However, any sums should be significantly smaller than for PPI. We believe that U.K banks, including Lloyds, have substantially strengthened their compliance and conduct frameworks, and 2019 was the last year when banks had to create provisions for PPI claims. This is why we consider that this episode, generated by commercial practices in place more than a decade ago, is largely over and do not affect our forward-looking view of the bank's credit quality.

Lloyds is also increasing its attention on environmental sustainability. This includes supporting customers in transitioning to low-carbon solutions and increasing resilience to climate change. It is also working to reduce its own carbon footprint and manage the effect of environmental risks on its asset quality. Lloyds is working towards the Bank of England's biennial exploratory scenario in relation to the physical and transition risks of climate change, which we assume will help banks better manage the potential for stranded assets. The regulator has recently agreed to delay this work beyond its planned 2021 publication in light of the greater burden that COVID-19 has placed on both regulators and banks.

We see Lloyds' governance standards as consistent with domestic norms. The ring-fenced bank, non-ring-fenced bank, and insurance subgroups each have stronger governance arrangements than typically found in subsidiaries, including independent board members.

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. We regard 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 2019, Lloyds' significant issuance of bail-in instruments, mainly holding company senior unsecured debt, had taken its ALAC ratio to 11.2% (see table 7). As such, the group credit profile (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 34.5% on a transitional basis at March 31, 2020. 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 7

Lloyds Banking Group PLC--Summary ALAC Calculation At Dec. 31, 2019

		(Mil. £)	% of S&P Global Ratings RWA
A	Adjusted common equity	25,016	
B	Hybrids in TAC	6,789	
C (A+B)	TAC	31,805	8.7
D	TAC in excess of our 7% threshold	6,268	1.7
E	ALAC-eligible instruments	34,845	9.6
	Of which NOHC senior	23,036	
	Of which minimal equity content hybrids	4,227	
	Of which other	7,582	
F (=D+E)	ALAC buffer	40,784	11.2
	S&P Global Ratings RWAs	364,810	

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

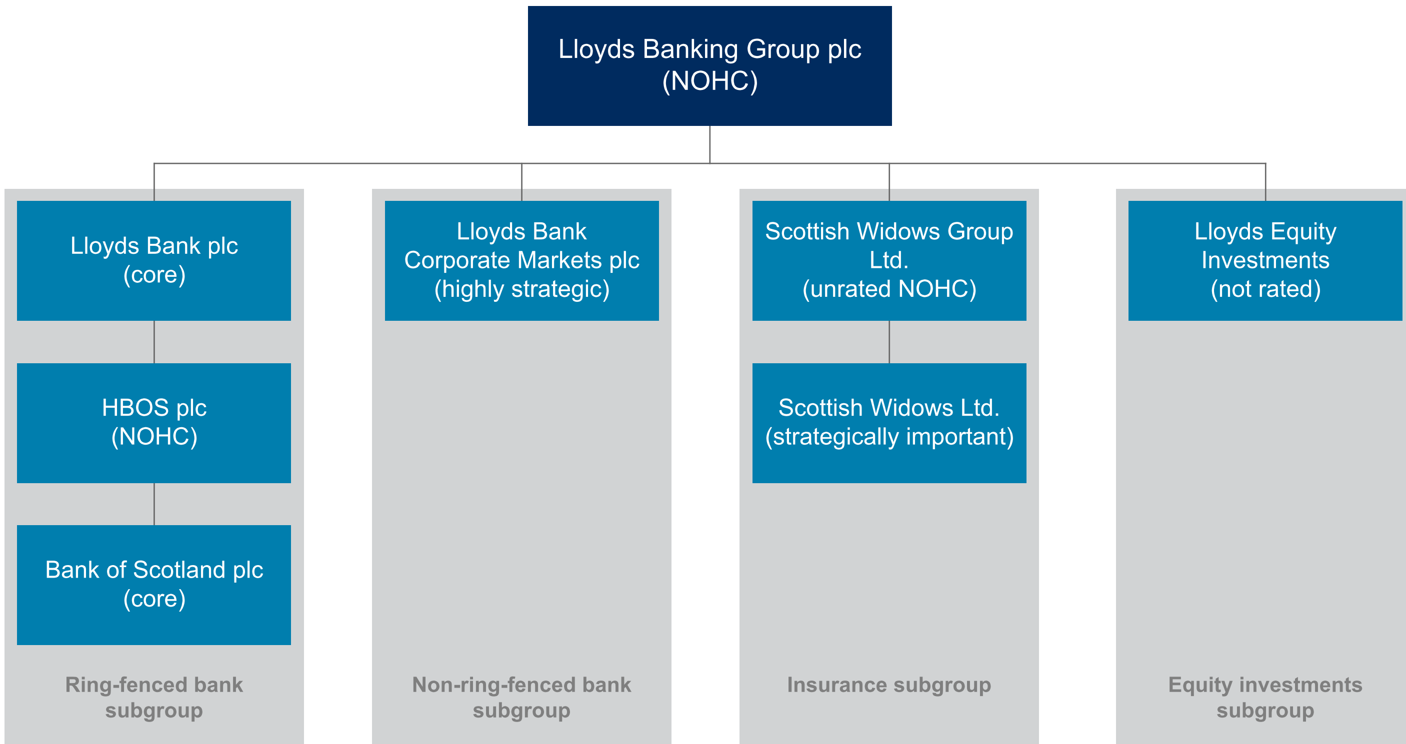
Additional rating factors:None

No other factors affect the ratings.

Group structure, rated subsidiaries, and hybrid issue ratings

Lloyds Banking Group PLC is the nonoperating holding company (NOHC) of the group that it heads, and the operating subsidiaries are organized in separate subgroups (see chart 9).

Highly Simplified Overview Of Lloyds' Legal Entity Structure



Source: Lloyds, S&P Global Ratings.
Information in parentheses shows our group status classification.

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 less diversified and less integral than those of the core ring-fenced entities.

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, 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-' group SACP of

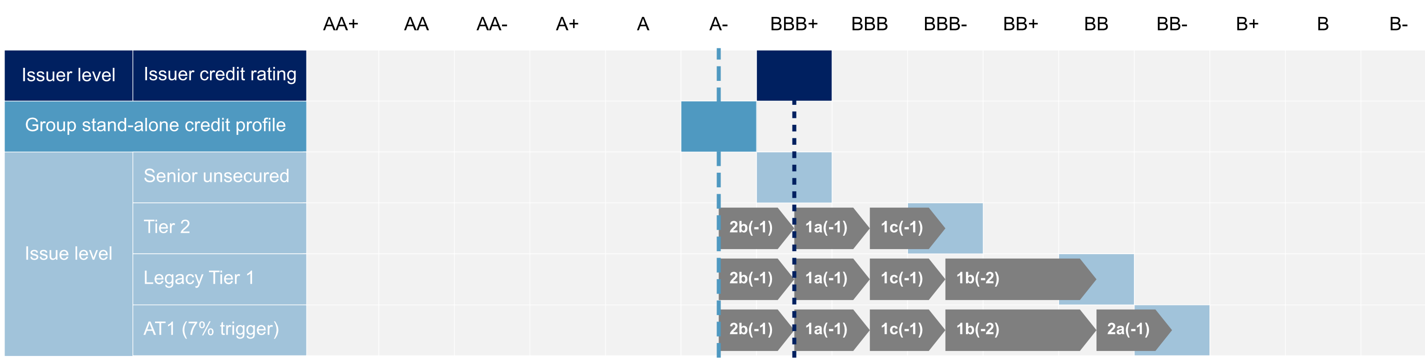
Lloyds. The 'A' long-term ICR on Scottish Widows is in line with the company's 'a' stand-alone credit profile and currently reflects no group-related uplift.

Lloyds' equity investments business (Lloyds Development Capital; LDC) has operated since 1981 and focuses on U.K. mid-market private equity transactions. LDC has typically performed well and makes a small but useful revenue contribution. In the first quarter of 2020, Lloyds stated that market conditions affected valuations and therefore reported a write-down of around £100 million.

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-' group SACP.

We rate hybrid debt instruments according to their respective features (see charts 10 and 11).

Lloyds Banking Group plc: NOHC Notching

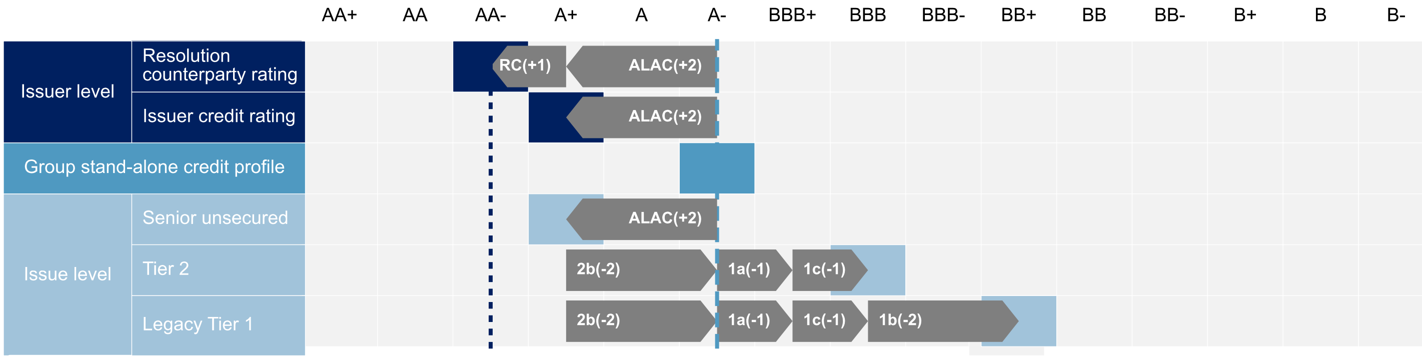


Key to notching

-----	Group stand-alone credit profile
------	Issuer credit rating
1a	Contractual subordination
1b	Discretionary or mandatory nonpayment clause and whether the regulator classifies it as regulatory capital
1c	Mandatory contingent capital clause or equivalent
2a	Mandatory going-concern, regulatory capital-based trigger (either statutory or contractual)
2b	Other nonpayment or default risk not captured already

Note: The number-letter labels in the table above are in reference to the notching steps we apply to hybrid capital instruments, as detailed in table 3 of our “Hybrid Capital: Methodology And Assumptions” criteria, published on July 1, 2019.
The nonoperating holding company (NOHC) issuer credit rating and senior unsecured debt ratings are notched from the group stand-alone credit profile (SACP) under our criteria. Since ALAC notching does not benefit NOHCs, for simplicity the diagram above is stylized to show the positioning of these ratings with reference to the group SACP.
AT1--Additional Tier 1.

Lloyds Bank plc: Notching



Key to notching

- Group stand-alone credit profile
- Issuer credit rating

RC	Resolution counterpartyliabilities (senior secured debt)
ALAC	Additional loss-absorbing capacity buffer
1a	Contractual subordination
1b	Discretionary or mandatory nonpayment clause and whether the regulator classifies it as regulatory capital
1c	Mandatory contingent capital clause or equivalent
2b	Other nonpayment or default risk not captured already

Note: The number-letter labels in the table above are in reference to the notching steps we apply to hybrid capital instruments, as detailed in table 3 of our “Hybrid Capital: Methodology And Assumptions” criteria, published on July 1, 2019.

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.

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

- Group Rating Methodology, July 1, 2019
- Hybrid Capital: Methodology And Assumptions, July 1, 2019
- Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- Risk-Adjusted Capital Framework Methodology, July 20, 2017
- Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Guarantee Criteria, Oct. 21, 2016
- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Commercial Paper I: Banks, March 23, 2004

Related Research

- Lloyds Bank Corporate Markets PLC, June 5, 2020
- Scottish Widows Ltd. Outlook Revised To Negative; 'A/A-1' Ratings Affirmed, May 22, 2020
- COVID-19 Effects Might Quadruple U.K. Bank Credit Losses In 2020, May 4, 2020
- Lloyds Banking Group Outlook Revised To Negative On Economic Impact Of COVID-19; Ratings Affirmed, April 23, 2020
- Outlooks Revised On Six U.K. Banks On Deepening COVID-19 Downside Risks, 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

Ratings Detail (As Of June 5, 2020)*	
Lloyds Banking Group PLC	
Issuer Credit Rating	BBB+/Negative/A-2
Junior Subordinated	BB-
Preference Stock	BB
Senior Unsecured	BBB+
Short-Term Debt	A-2
Subordinated	BBB-

Ratings Detail (As Of June 5, 2020)*(cont.)	
Issuer Credit Ratings History	
23-Apr-2020	BBB+/Negative/A-2
15-Nov-2017	BBB+/Stable/A-2
07-Jul-2016	BBB+/Negative/A-2
09-Jun-2015	BBB+/Stable/A-2
Sovereign Rating	
United Kingdom	AA/Stable/A-1+
Related Entities	
Bank of Scotland Capital Funding L.P.	
Preferred Stock	BB+
Bank of Scotland PLC	
Issuer Credit Rating	A+/Negative/A-1
Resolution Counterparty Rating	AA-/--/A-1+
Junior Subordinated	BB+
Junior Subordinated	BBB-
Senior Secured	AAA/Stable
Subordinated	BBB
HBOS PLC	
Issuer Credit Rating	BBB+/Negative/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/Negative/A-1
Resolution Counterparty Rating	A+/--/A-1
Commercial Paper	A-1
Senior Unsecured	A
Short-Term Debt	A-1
Lloyds Bank Corporate Markets PLC (New York Branch)	
Commercial Paper	A-1
Lloyds Bank PLC	
Issuer Credit Rating	A+/Negative/A-1
Resolution Counterparty Rating	AA-/--/A-1+
Commercial Paper	A-1
Junior Subordinated	BB+

Ratings Detail (As Of June 5, 2020)*(cont.)	
Junior Subordinated	BBB-
Senior Unsecured	A+
Short-Term Debt	A-1
Subordinated	BBB
Scottish Widows Ltd.	
Financial Strength Rating	
Local Currency	A/Negative/--
Issuer Credit Rating	
Local Currency	A/Negative/A-1
Junior 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.