S&P Global
Ratings

RatingsDirect®

Research Update:

Lloyds Banking Entities Upgraded On Strengthened Bail-In Buffer And Improving Profitability; Outlook Stable

Primary Credit Analyst:
Giles Edwards, London (44) 20-7176-7014; giles.edwards@spglobal.com

Secondary Contacts:
Nigel J Greenwood, London (44) 20-7176-1066; nigel.greenwood@spglobal.com
Richard Barnes, London (44) 20-7176-7227; richard.barnes@spglobal.com

Table Of Contents

Research Update:

Lloyds Banking Entities Upgraded On Strengthened Bail-In Buffer And Improving Profitability; Outlook Stable

Overview

- Lloyds Banking Group PLC (Lloyds) has made rapid progress in recent months in building its bail-in buffer, which serves to protect senior creditors of its bank operating companies should Lloyds fail.
- In addition, Lloyds continues to make good progress in further building its strong statutory profitability, improving its comparability with highly rated peers in the U.K. and the rest of Europe.
- We are raising our long-term issuer credit ratings on Lloyds' bank operating companies by one notch, to 'A+' for the ringfenced subsidiaries and to 'A' for the nonringfenced subsidiaries.
- The stable outlook on our ratings on Lloyds and its bank operating subsidiaries reflects our view that the group is likely to be resilient, increasingly profitable, and that its bail-in buffers will continue to rise through end-2019.

Rating Action

On May 8, 2018, S&P Global Ratings raised its long-term issuer credit ratings on Lloyds Banking Group PLC's (Lloyds') ringfenced bank operating subsidiaries Lloyds Bank PLC and Bank of Scotland PLC to 'A+' from 'A'. We affirmed the 'A-1' short-term issuer credit ratings.

At the same time, we raised to 'A/A-1' from 'A-/A-2' our long- and short-term issuer credit ratings on Lloyds Bank Corporate Markets PLC and Lloyds Bank International Ltd.

We affirmed our 'BBB+' long-term and 'A-2' short-term issuer credit ratings on Lloyds.

The outlook on all these entities is stable.

Rationale

Our upgrades reflect Lloyds' progress in building up its bail-in buffer to better protect the senior creditors of its bank operating companies should Lloyds fail and undergo a bail-in-led resolution process. The upgrades also reflect our view that Lloyds now compares well to highly rated European peers. It already had a solid balance sheet and an extensive client franchise, but its improving statutory profitability now exceeds that of many large European banks. We have affirmed our ratings on Lloyds and the banking group's hybrid instruments because these ratings depend on our view of Lloyds' intrinsic creditworthiness, reflected in the unchanged 'a-' unsupported group credit profile (GCP).

Since 2015, we have regarded the prospect of extraordinary government support for U.K. banks as uncertain. This is in view of the authorities' clear intent to avoid taxpayer bailouts of failing banks, and what we view as a well-advanced and effective resolution framework. As a result, our ratings on systemically important U.K. banks are not eligible for any uplift for possible future U.K. government support, but our ratings on their operating companies can benefit from uplift where we see a substantial buffer of additional loss-absorbing capacity (ALAC).

At end-2016, Lloyds' ALAC ratio was 5.4%, meriting one notch of uplift. Significant issuance of bail-in instruments, mainly holding company senior unsecured debt, had taken this ratio to 7.2% by end-2017. Lloyds has continued to issue apace in 2018, and on a pro forma basis had an ALAC ratio of about 8.5% at end-April. We expect this ratio to move higher still through end-2019 as Lloyds anticipates building its regulatory bail-in buffer--minimum requirement for eligible liabilities--from a reported 27.4% at March 2018 toward a ratio of closer to 30% in the coming years. As such, the Lloyds (supported) GCP now merits a second notch of ALAC support.

We consider that Lloyds' earnings through 2017 and the first quarter of 2018 are evidence of its solid and strengthening underlying profitability. The group reported a first-quarter underlying profit before tax of £2.0 billion, up 6% on the same period in 2017. This equated to a 15.4% underlying return on tangible equity (ROTE), just over management's 14.0%-15.0% target range from 2019. The improvement was more evident in the statutory (that is, unadjusted) figures: the £1.6 billion profit before tax was up 23% and the 12.3% ROTE was much closer to management's target range than previously. The cost-to-income ratio was a reported 47.8%, compared with a future target ratio in the low 40s exiting 2020 (both figures include remediation costs).

Following Lloyds' management's third Group Strategic Review, it is seeking primarily to further enhance profitability in 2018-2020 rather than to grow the bank. While the group has the resources to fund substantial asset growth, particularly to help grow its commercial banking franchise (where it remains slightly underweight versus peer Royal Bank of Scotland), we anticipate that Lloyds will remain disciplined from a risk-appetite perspective. Indeed, amid current lackluster demand for credit in the U.K., we anticipate modest asset growth in the coming years. Group profitability will therefore depend on initiatives to grow non-interest income and investment in digital transformation that will further improve the group's already market-leading efficiency.

Looking ahead, we consider that Lloyds' increased resilience, and that of the broader U.K. banking sector, has strengthened its ability to deal with the uncertain--and potentially turbulent--run-up to the U.K.'s March 2019 exit from the EU (Brexit). Key elements of our 2018-2020 projection for Lloyds include:

- Weak organic revenue growth of barely 2% per year, constrained by modest net interest margin (NIM) pressure after 2018 and continued weak activity levels that hold back growth in noninterest income;
- An improving cost-to-income ratio throughout the period;
- An impairment charge of about 30 basis points (bps) of average customer loans in 2018 and about 35 bps in 2019/2020. This is consistent with the slightly rising trend that we anticipate for U.K. asset classes generally;
- Further payment protection insurance and/or other customer redress, fair value unwind, and other "below the line" charges of £1.2 billion on average in each of the three years;
- Statutory net income of about £13 billion across the three-year period;
- S&P Global Ratings risk-weighted assets growth of barely 1% per year; and
- A dividend rate of at least 50%, with the possibility of buybacks or other exceptional distributions if the group generates substantial excess capital (on a regulatory basis).

These factors are consistent with trends reported by Lloyds for the first quarter but also reflect:

- Our degree of extra caution on the outlook for NIM and asset quality in light of possibly sustained wider wholesale funding spreads and a slower-than-previously anticipated economic backdrop; and
- Some caution about the scope for further material "below the line" items, even if the pattern of a substantial reduction seems well-set.

Lloyds is the ultimate and nonoperating holding company (NOHC) of the group that it heads. It operates through two principal ringfenced banking subsidiaries: Lloyds Bank PLC and its subsidiary Bank of Scotland PLC, which it holds via HBOS PLC, an intermediate NOHC. Following the expected transfer of assets in late May 2018, Lloyds will also operate through two nonringfenced banking subsidiaries--Lloyds Bank Corporate Markets PLC and Lloyds Bank International Ltd. We expect that if the group failed due to insolvency, the Bank of England would bail-in junior liabilities and, if necessary, Lloyds' senior liabilities, to ensure the continued servicing of the senior liabilities of all these operating subsidiaries. By contrast, we do not include notches for ALAC support in the ratings on Lloyds (nor on other U.K. NOHCs) because we do not believe that their senior obligations would continue to receive full and timely payment in a resolution scenario.

On April 19, 2018, we published new criteria for assigning resolution counterparty ratings (RCRs) to certain financial institutions. We consider that there is an effective resolution regime in the U.K., and that an RCR may be relevant to some rated Lloyds entities under these criteria. In coming weeks, we will complete our analysis of the U.K. resolution regime, the associated liability categories that are protected from default risk by structural or operational features of a given resolution framework, and the rated banking group entities to which we may assign RCRs under our new criteria.

Outlook

Lloyds Banking Group PLC

The stable outlook on our ratings on Lloyds reflects our view that Lloyds is relatively resilient to the uncertainties and potential turbulence arising from Brexit negotiations in the period to March 2019. We expect that Lloyds' statutory profitability will further improve through end-2019, that it will maintain an S&P Global Ratings RAC ratio of 7.8%-8.3% (it was 8.0% at end-2017), and that total credit growth will be lower than the U.K. industry with no significant step-up in risk appetite. We also expect that Lloyds will continue to build its ALAC buffer through end-2019, further improving the group's resolvability, to the likely benefit of senior operating company creditors.

Downside scenario

We would most likely lower the ratings on Lloyds and its banking subsidiaries if we consider that Lloyds' risk appetite has substantially increased, or if its performance appears likely to significantly undershoot our current expectations, for example due to a significant weakening of asset quality. This would likely be consistent with a severe adverse economic scenario in the U.K., possibly linked to a disorderly outcome to the U.K.'s EU exit, which would in time significantly raise insolvency and unemployment rates, and so retail and corporate defaults.

Upside scenario

We consider a positive rating action to be unlikely in the coming 12-24 months. This partly reflects residual uncertainties related to Brexit, reflected in our still-negative outlook on our 'AA' long-term sovereign rating on the U.K. Furthermore, with no further ratings uplift possible under our ALAC criteria, and it being highly unlikely that we would improve our group status assessment for the group's nonringfenced banking subsidiaries, any upgrade would rely on the group's intrinsic creditworthiness (the unsupported group credit profile [UGCP]) strengthening. Aside from Lloyds maintaining balance sheet strength and a disciplined risk appetite, this would likely only follow a sustained, predictable, above-market performance across retail and commercial banking and insurance--and not only in the coming 24 months. This could follow, not only from Lloyds making exceptional progress in growing its commercial banking franchise and improving synergies with its insurance business, but also successfully navigating the era of digital transformation and associated changed competitive dynamics.

Lloyds Bank PLC, Bank of Scotland PLC, Lloyds Bank Corporate Markets PLC, and Lloyds Bank International Ltd.

The stable outlook on Lloyds' bank operating companies reflects that on Lloyds. It also assumes that our view of their group status, as per our group rating methodology, does not change.

An upgrade of the bank operating companies is less likely than for Lloyds itself because even if we raised the UGCP to 'a', we would then have to remove one notch of ALAC uplift from the 'a+' GCP, leading to a neutral outcome for the operating company issuer credit ratings.

Ratings Score Snapshot

Issuer Credit Rating (opco*)	A+/Stable/A-1
Issuer Credit Rating (holdco)	BBB+/Stable/A-2
Unsupported GCP	a-
Anchor	bbb+
Business Position	Strong (+1)
Capital and Earnings	Adequate (0)
Risk Position	Adequate (0)
Funding and Liquidity	Average Adequate (0)
Support	(+2)
ALAC Support	(+2)
GRE Support	(0)
Group Support	(0)
Sovereign Support	(0)
Additional Factors	(0)

*Reflects the issuer credit ratings for core operating companies Lloyds Bank PLC and Bank of Scotland PLC.

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: 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

- The Resolution Story For Europe's Banks: The Clock Is Ticking, April 25, 2018
- Lloyds Bank Corporate Markets PLC And Lloyds Bank International Ltd. Assigned 'A-/A-2' Ratings; Outlook Positive, April 24, 2018
- Largest U.K. Banking Groups Boast Higher Statutory Pre-Tax Profits But Returns Disappoint, March 8, 2018
- Cheap Central Bank Funding Has Stimulated, Not Hooked, U.K. Banks, March 1, 2018
- U.K. Banks: What's On The Cards For 2018, Jan. 9, 2018
- Everyone Passed: Stress Test Results Reflect Strengthening U.K. Bank Balance Sheets, Nov. 29, 2017
- Outlooks On Lloyds Banking Group Entities Revised On Reducing Economic Risks And Improving Bail-In Buffer, Nov. 15, 2017

Ratings List

Upgraded

	To	From

Lloyds Bank Corporate Markets PLC		
Lloyds Bank International Ltd.		
Counterparty Credit Rating	A/Stable/A-1	A-/Positive/A-2
Lloyds Bank PLC		
Bank of Scotland PLC		
Counterparty Credit Rating	A+/Stable/A-1	A/Positive/A-1
Certificate Of Deposit		
Local Currency	A+	A
Senior Unsecured	A+	A
Lloyds Bank PLC		
Senior Unsecured	A+	A
Senior Unsecured	A+p	Ap

Ratings Affirmed

HBOS PLC	
Lloyds Banking Group PLC	
Counterparty Credit Rating	BBB+/Stable/A-2
Lloyds Bank PLC	
Subordinated	BBB
Junior Subordinated	BB+
Junior Subordinated	BBB-
Commercial Paper	A-1
Bank of Scotland Capital Funding L.P.	
Preferred Stock	BB+
Bank of Scotland PLC	
Subordinated	BBB
Junior Subordinated	BB+
Junior Subordinated	BBB-
HBOS Capital Funding L.P.	
Preferred Stock	BB
HBOS Capital Funding No. 1 L.P.	
Preference Stock	BB
HBOS PLC	
Subordinated	BBB-
Junior Subordinated	BB+
Halifax Group Sterling Finance (Jersey) L.P.	
Preferred Stock	BB
LBG Capital No. 1 PLC	
Subordinated	BBB-

Junior Subordinated	BB+
LBG Capital No. 2 PLC	
Subordinated	BBB
Lloyds Bank Capital 2 L.P.	
Preferred Stock	BB+
Lloyds Banking Group PLC	
Senior Unsecured	BBB+
Subordinated	BBB-
Junior Subordinated	BB+
Junior Subordinated	BB-
Preference Stock	BB

Additional Contact:
Financial Institutions Ratings Europe; FIG_Europe@spglobal.com

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.