Lloyds Banking Group PLC (Holding Company)
Lloyds Bank PLC (Lead Bank)

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# Lloyds Banking Group PLC (Holding Company)

Lloyds Bank PLC (Lead Bank)

## Footnote

In the above snapshot, the 'SACP' reflects the unsupported group credit profile of the Lloyds group. The bank holding company rating shown applies to Lloyds Banking Group PLC. The issuer credit rating applies to its two core operating subsidiaries: Lloyds Bank PLC and Bank of Scotland PLC.

## Major Rating Factors

<table>
<thead>
<tr>
<th>Strengths:</th>
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</tr>
</thead>
</table>
| • Leading franchise in U.K. retail banking and strong positions in U.K. commercial and corporate banking, and insurance.  
• Efficient operating model should support business stability and good relative profitability in the coming years  
• Supportive capitalization, funding and liquidity profiles. | • Expected weaker economic conditions following U.K. vote to exit the EU.  
• Still rebuilding statutory profitability, although the drag on earnings from nonrecurring items is declining. |
Outlook: Negative

The negative outlook reflects the negative trend we see for economic risk in the U.K. and our view that Lloyds' creditworthiness could weaken if its operating environment weakens. Nevertheless, our ratings reflect our view that Lloyds' statutory profitability will further improve through end-2019; that it will maintain an S&P Global Ratings risk-adjusted capital (RAC) ratio of 7.8%-8.3%; that loan growth will likely be lower than the U.K. industry average, with no significant step-up in risk appetite; and it will build its buffer of additional loss-absorbing capacity (ALAC) to at least 7% by 2019.

We could lower the ratings on Lloyds or its subsidiaries if we revised down the unsupported group credit profile (UGCP), which is currently 'a-'. This would most likely follow a weakening in our economic risk assessment for the U.K. While far less likely, we could also revise down the UGCP if, for example, Lloyds' risk appetite increased substantially such that its future asset quality or exposure to conduct risk were affected.

We would most likely revise the outlook to stable if we considered that risks to the U.K. economy were reducing. Similarly, if we consider it highly likely that Lloyds will build its ALAC buffer sustainably beyond 8% in the near-to-medium term, we could revise to stable our outlook on core operating subsidiaries Lloyds Bank PLC and Bank of Scotland PLC.

We consider it likely that Lloyds's ring-fencing plans will have no ratings impact for the rated entities. Lloyds Bank and Bank of Scotland are set to be within the ringfence.

Rationale

Overall, we continue to regard Lloyds as a banking group with a market-leading franchise in the U.K. and a business model that appears well-adjusted to its operating environment, including tougher regulatory demands. The balance sheet—specifically capitalization, the funding profile, and asset quality—has improved significantly in recent years and is likely to remain supportive. Furthermore, since mid-May 2017, Lloyds no longer has any U.K. government ownership. While Lloyds' statutory profitability still remains, for now, below potential, it is improving and appears well placed to deliver management's stated 2019 target of a 13.5%-15.0% return on tangible equity (ROTE), absent a major weakening in asset quality. This would improve relativities versus higher-rated peers—most of whom are national champions in good banking markets, with strong balance sheets, producing strong, reliable shareholder returns. Lloyds shares currently trade at about 1.0x book value—above most U.K. majors, but well behind highly profitable major banks in countries like Australia and Sweden.

After years of restructuring and deleveraging from 2009-2014, Lloyds' management is seeking to enhance profitability and grow lending, like asset and consumer finance, where the group is underweight and segment growth is addressable within its current risk appetite. While this is a generally positive development, we continue to monitor any development in Lloyds' risk appetite, the quality of new lending, and whether, as we expect, Lloyds' statutory earnings improve as below-the-line items such as charges for payment protection insurance (PPI) reduce substantially.

While our base case remains relatively benign, we continue to see significant downside risk from a disorderly Brexit, which could be marked by an unsupportive operating and wholesale funding environment in the U.K. This could act as a drag on the otherwise solid net interest margin, lead to lower activity levels notably in new lending and, in time,
weaken moderately the bank's asset quality beyond our current, quite benign expectations.

Like most major U.K. peers, Lloyds will need to split its U.K. business into ringfenced and non-ringfenced operations by 2019. However, given its heavy focus on retail and commercial banking, we expect that this exercise will be relatively more simple and less expensive for Lloyds than for some of its peers. Lloyds' two main rated U.K. operating companies, Lloyds Bank and Bank of Scotland (BOS), will both be inside the ringfence. At this time, we do not see any ringfencing-related rating implications for these entities or for Lloyds.

**Anchor: Reflects strong U.K. focus**

The starting point for our ratings on Lloyds and its affiliates is the 'bbb+' anchor, which is based on our view of economic and industry risk in its domestic U.K. market. The U.K.-based clients comprise over 90% of Lloyds' loan book exposures.

After the Brexit vote in June 2016, we assigned a negative trend for U.K. banking sector economic risk, indicating a one-in-three possibility that we could revise down our view of economic risk over the following 24 months. We maintain this view; the negative trend reflects the elevated level of economic uncertainty arising from the U.K.'s exit from the EU. We could consider lowering the economic risk score if we saw a significantly increased risk of a disorderly Brexit resulting in asset-price corrections becoming more likely, with expected credit losses jumping to levels well above the long-term average of 69 basis points (bps), and closer to levels seen during the global financial crisis; or significant outflows of foreign capital or substantially greater-than-expected declines in foreign direct investment (FDI) inflows into the U.K. On the other hand, if we assess that uncertainty has declined and the extent of economic deterioration (if any) is likely to be contained, with manageable expected credit losses, we could revise the economic risk trend to stable.

We view the industry risk trend as stable. The domestic reform agenda is well advanced and banks are now clearer about the future regulatory environment. The ring-fencing of retail and SME deposits from January 2019 may create operational risk in implementation, but we believe that banks are well placed to manage this risk and will meet the 2019 deadline. We assume that changes in regulatory structures will support market discipline, constrain risk appetites, and, over time, yield adequate profitability. Banking regulation and supervision have substantially improved since the financial crisis: we have seen an extensive reorganization of the regulatory infrastructure to better co-ordinate bank supervision with macro-prudential risks, as well as a clear move away from the previous light-touch regulatory philosophy. The U.K. has also made less use of transitional periods to introduce higher capital requirements and greater use of Pillar 2 capital requirements to run ahead of expected changes in capital rules. We saw that the capital and debt market volatility that followed the Brexit vote did not materially affect banks' access to, and cost of, wholesale funding. Our base-case scenario is that banks will continue to be able to access such funding over time. We see limited downside sensitivities to our industry risk assessment, though implicit in our assessment is our expectation that the industry will demonstrate sustainable profitability and a return to earnings above the cost of capital.

**Table 1**

<table>
<thead>
<tr>
<th>Lloyds Banking Group PLC Key Figures</th>
</tr>
</thead>
<tbody>
<tr>
<td>--Year-ended Dec. 31--</td>
</tr>
<tr>
<td>(Mil. £)</td>
</tr>
<tr>
<td>Adjusted assets</td>
</tr>
<tr>
<td>684,608</td>
</tr>
</tbody>
</table>
Table 1

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</thead>
<tbody>
<tr>
<td>Customer loans (gross)</td>
<td>445,121</td>
<td>452,410</td>
<td>479,483</td>
<td>504,468</td>
<td>527,388</td>
</tr>
<tr>
<td>Adjusted common equity</td>
<td>32,274</td>
<td>32,226</td>
<td>34,299</td>
<td>31,184</td>
<td>31,367</td>
</tr>
<tr>
<td>Operating revenues</td>
<td>17,849</td>
<td>17,795</td>
<td>17,988</td>
<td>17,514</td>
<td>17,802</td>
</tr>
<tr>
<td>Noninterest expenses</td>
<td>9,291</td>
<td>9,293</td>
<td>9,569</td>
<td>9,851</td>
<td>10,228</td>
</tr>
<tr>
<td>Core earnings</td>
<td>4,769</td>
<td>4,860</td>
<td>5,823</td>
<td>2,759</td>
<td>980</td>
</tr>
</tbody>
</table>

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

Business position: The leading U.K. banking franchise

We assess Lloyds' business position as strong, based on the group's position as the largest mortgage and retail savings provider in the U.K., and its good revenue diversity across a wide range of banking business lines. Lloyds' U.K. insurance franchise also adds to our view of its revenue diversity and offers a degree of franchise differentiation versus U.K. peers. Moreover, we believe that having now delivered the multi-year restructuring, Lloyds' management is pursuing a coherent strategy focused on the group's strong U.K. financial services franchise. While we see reason for caution in consumer finance growth in the current environment, management's earnings growth strategy is generally one of reducing costs, including via reengineering processes and infrastructure, and optimizing capital usage, rather than seeking growth in higher yielding (and more risky) assets.

We consider the other major providers of universal banking services in the U.K.--Barclays Bank PLC, HSBC Bank PLC, and Royal Bank of Scotland PLC (RBS)--to be the primary peers for Lloyds, alongside Nationwide Building Society and Santander U.K. PLC. Unlike Barclays and HSBC, Lloyds now has minimal non-U.K. operations, although it remains willing to support trade and investment flows into and out of the U.K. for corporate clients. Outside the U.K., we see other retail and commercial banking-focused groups as Lloyds' closest peers, particularly those that have insurance businesses. These peers include Credit Agricole, ING, Rabobank, KBC, Danske Bank, Nordea, and Wells Fargo.

Lloyds states that it serves over 25 million active customers across its franchises in the U.K. and had 2,100 branches at end-2016, making it the largest U.K. domestic bank. Lloyds' structure comprises retail, consumer finance, commercial banking, and insurance divisions. It operates through three major bank brands: Lloyds, Halifax, and Bank of Scotland (BOS). Lloyds estimates market shares of 25% for personal current accounts (PCA), 21% for mortgages, 21% for retail deposits, and about 18% for commercial banking. Unlike major U.K. peers, Lloyds does not have an investment banking business, though it is active within debt capital markets, foreign exchange, and transaction banking via its commercial banking division.

We view Lloyds' relative lack of reliance on market-sensitive income as supportive of its business stability. Unlike other U.K. banks, Lloyds remains committed to the bancassurance business model. It is a major provider of life and pensions and investment business via Scottish Widows Ltd., and has one of the largest intermediary sales channels in the industry. Lloyds also underwrites general insurance products through other subsidiaries. Taken together, Lloyds' insurance division represented about 9% of group revenues in 2016--a figure that we do not expect to change materially in the medium term despite its investment in the business.
Lloyds' management team has carried out significant changes to the bank since 2011, resulting in a far stronger balance sheet and improved efficiency. We view 2015 as the first year that Lloyds showed forward momentum, having completed a six-year turnaround since 2008. Statutory profitability has improved steadily in the past three years and appears set to continue to do so, assuming no sharp reversal in asset quality. The U.K. government fully exited its stake in Lloyds in May 2017.

Looking forward, we consider Lloyds to have a straightforward business and operating model that is consistent with, and should be able to yield solid returns amid, the tougher regulatory environment under Basel III and even under a finalization of remaining initiatives such as the fundamental review of the trading book. While Lloyds has signaled further branch closures, we see this as indicative only of ongoing optimization of delivery channels and efficiency, amid a low growth environment and the rapid shift of U.K. banking customers towards digital channels. Although Lloyds is likely to set up a non-ringfenced bank by 2019, this requires relatively little change for the group, as only a small subset of the group's banking assets and liabilities are affected. We expect management to pursue a disciplined strategy that allows for relatively cautious and selective asset growth, almost entirely within the U.K. We continue to look for compelling evidence that Lloyds can translate its strong franchises into consistently strong statutory profitability—something that is difficult to achieve in the current operating environment.

Table 2

<table>
<thead>
<tr>
<th>Lloyds Banking Group PLC Business Position</th>
<th>--Year-ended Dec. 31--</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenues from business line (currency in millions)</td>
<td>18,288</td>
</tr>
<tr>
<td>Commercial banking/total revenues from business line</td>
<td>25.8</td>
</tr>
<tr>
<td>Retail banking/total revenues from business line</td>
<td>59.2</td>
</tr>
<tr>
<td>Insurance/total revenues from business line</td>
<td>8.8</td>
</tr>
<tr>
<td>Other revenues/total revenues from business line</td>
<td>6.2</td>
</tr>
<tr>
<td>Return on equity</td>
<td>5.7</td>
</tr>
</tbody>
</table>

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

Capital and earnings: Capitalization satisfactory, statutory profitability to strengthen further

We view Lloyds' capital and earnings as adequate because we project that its S&P Global Ratings RAC ratio will be in the 7.8%-8.3% range through to year-end 2019. Our confidence in Lloyds' internal capital generation capability has increased, though we continue to project some below the line costs that will likely continue to hold statutory earnings a little below potential. We project very modest asset growth through end-2019, even allowing for the recent MBNA acquisition in June 2017, and acknowledge that Lloyds already comfortably meets current regulatory capital expectations, meaning that it has no need to substantially grow core capitalization.

According to our RAC measure, Lloyds held capitalization firm through 2016, finishing the year at 8.2% (from 8.0% at end-2015). This positions the bank as fairly typical among large European peers, but it remains somewhat lower than the other major U.K. banks which now often have RAC ratios in the 9-10% range (see chart 1). Lloyds’ Basel III fully-loaded common equity Tier 1 ratio tells a slightly different story, however: at 14.3% at March 2017 (after dividend accrual and an assumed 0.8% hit from the now-completed MBNA deal), it remains solidly positioned in comparison to
other major European banks. The gap between the two metrics, which is larger for Lloyds than many of its U.K. peers, primarily reflects the substantially higher capital requirements that we apply to Lloyds' residential mortgage book and for the investment in its insurance business when compared with the regulatory measure.

Lloyds continues to guide to a CET1 ratio of about 13.0%, allowing for regulatory requirements and pillar 2 guidance plus a management buffer. This is set bearing in mind Lloyds' expected pillar 1 requirement, capital conservation and systemic risk buffers, and pillar 2A requirement totaling about 12.1% on a fully loaded basis. Lloyds will also have to meet a countercyclical buffer of 0.5% for its U.K. entities by June 2018, possibly rising to 1.0% by November 2018.

While the reported CET1 ratio might drift upward at various quarter ends in the coming years, we do not currently expect any ratio above 14.0% to be sustained for long. This expectation informs our unchanged notching approach for the group's additional Tier 1 instruments.

Chart 1

We consider that Lloyds' earnings through 2016 and the first quarter of 2017 showed solid and strengthening underlying profitability. However, it continues to face two long-term challenges:

• to grow revenues in a low growth, low activity environment, and
• to very substantially close the gap between underlying and statutory earnings.

For the first quarter, the group reported underlying profit before tax of £2.1 billion, up 1% on the same period in 2016. This equated to a 15.1% underlying return on tangible equity, at the top end of management's 13.5%-15.0% target range. Management improved guidance for the full-year 2017 net interest margin (NIM, expected to be close to 2.8%) and slightly improved their loan loss rate guidance to be less than 25bps (both figures exclude any MBNA impact). With 2017 capital generation now guided to be at the top end of management's 1.7%-2.0% (of regulatory RWAs) range, underlying profitability now appears well on track, assuming no hike in impairments.

Statutory pretax profit rose to £1.3 billion (from £0.7 billion the year before) due to lower "below the line" charges. This included £350 million extra provisioning for PPI and £0.2 billion for other conduct charges. The bottom line was a statutory return on tangible equity of only 8.8%, well above previous outcomes but still some way below the 13.5%-15% target for 2019. In light of the difficult revenue growth environment, management is focused on making further investment to improve the group's best-in-class efficiency (by U.K. standards). It now targets a 45% cost-to-income ratio exiting 2019, versus a current 47%.

Key elements of our 2017-2019 projection include the following factors.

• The completion of the MBNA acquisition in June 2017;
• Weak organic revenue growth of barely 2% per year, constrained by limited improvement in NIM after 2017 and continued weak activity levels that hold back 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 2017 and about 45 bps in 2018/2019. This is consistent with the slightly rising trend that we anticipate for U.K. asset classes generally, though we acknowledge that asset quality trends currently remain favorable;
• Further PPI and/or other customer redress charges of £1 billion on average in each of the three years;
• Other "below the line" expenses, such as for liability management, restructuring, asset sales, and the fair value unwind of under £1.0 billion in 2017, reducing a little thereafter;
• Statutory net income of about £12 billion across the three-year period;
• Dividend or other shareholder returns of more than 50% of reporting earnings; and
• S&P Global Ratings risk-weighted assets (RWA) growth of barely 1% per year through 2019.

These factors are consistent with trends reported by Lloyds for the first quarter of 2017, but also reflect:

• A 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-previous anticipated economic backdrop; and
• Some caution on the scope for further material "below the line" items, even if the pattern of a substantial reduction seems well-set.

Notwithstanding some additional Tier 1 (AT1) issuance, we consider the quality of capital to be satisfactory, with hybrids accounting for a moderate 15% of total adjusted capital (TAC). Similarly, we project an earnings buffer (that is, normalized operating income divided by S&P Global Ratings RWAs) of about 1.3x in 2017-2019. Superior to those of many major peers in the U.K. and elsewhere in Europe, this ratio suggests that Lloyds should be able to comfortably absorb any unexpected spike in credit losses within earnings, even if we then allow for further material nonrecurring expenses.
### Table 3

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

<table>
<thead>
<tr>
<th>(Mil. £)</th>
<th>Exposure*</th>
<th>Basel II RWA</th>
<th>Average Basel II RW (%)</th>
<th>Standard &amp; Poor's RWA</th>
<th>Average Standard &amp; Poor's RW (%)</th>
</tr>
</thead>
</table>

#### Credit risk

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</thead>
<tbody>
<tr>
<td>Government and central banks</td>
<td>101,348</td>
<td>1,507</td>
<td>1</td>
<td>3,301</td>
<td>3</td>
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<tr>
<td>Institutions</td>
<td>12,373</td>
<td>2,990</td>
<td>24</td>
<td>2,908</td>
<td>24</td>
</tr>
<tr>
<td>Corporate</td>
<td>119,527</td>
<td>72,736</td>
<td>61</td>
<td>103,391</td>
<td>87</td>
</tr>
<tr>
<td>Retail</td>
<td>394,815</td>
<td>70,674</td>
<td>18</td>
<td>187,453</td>
<td>47</td>
</tr>
<tr>
<td>Of which mortgage</td>
<td>349,977</td>
<td>45,905</td>
<td>13</td>
<td>147,694</td>
<td>42</td>
</tr>
<tr>
<td>Securitization§</td>
<td>27,583</td>
<td>4,081</td>
<td>15</td>
<td>11,163</td>
<td>40</td>
</tr>
<tr>
<td>Other assets</td>
<td>9,509</td>
<td>6,437</td>
<td>68</td>
<td>10,429</td>
<td>131</td>
</tr>
<tr>
<td>Total credit risk</td>
<td>665,155</td>
<td>158,426</td>
<td>24</td>
<td>320,645</td>
<td>48</td>
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#### Market risk

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</thead>
<tbody>
<tr>
<td>Equity in the banking book†</td>
<td>3,559</td>
<td>7,713</td>
<td>217</td>
<td>23,947</td>
<td>673</td>
</tr>
<tr>
<td>Trading book market risk</td>
<td>--</td>
<td>3,150</td>
<td>--</td>
<td>4,656</td>
<td>--</td>
</tr>
<tr>
<td>Total market risk</td>
<td>--</td>
<td>10,863</td>
<td>--</td>
<td>28,603</td>
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#### Insurance risk

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<tbody>
<tr>
<td>Total insurance risk</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>95,513</td>
</tr>
</tbody>
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#### Operational risk

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</thead>
<tbody>
<tr>
<td>Total operational risk</td>
<td>--</td>
<td>25,288</td>
<td>--</td>
<td>26,293</td>
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</table>

#### Diversification adjustments

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</tr>
</thead>
<tbody>
<tr>
<td>RWA before diversification</td>
<td>215,502</td>
<td>471,053</td>
<td>100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Diversification/Concentration Adjustments</td>
<td>--</td>
<td>(76,682)</td>
<td>(16)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>RWA after diversification</td>
<td>215,502</td>
<td>394,371</td>
<td>84</td>
<td></td>
<td></td>
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</tbody>
</table>

#### Capital ratio

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</thead>
<tbody>
<tr>
<td>Capital ratio before adjustments</td>
<td>36,581</td>
<td>17.0</td>
<td>38,458</td>
<td>8.2</td>
<td></td>
</tr>
<tr>
<td>Capital ratio after adjustments§</td>
<td>36,581</td>
<td>17.0</td>
<td>38,458</td>
<td>9.8</td>
<td></td>
</tr>
</tbody>
</table>

The RAC ratio after diversification does not reflect the criteria correction published on July 11, 2017. We assess that the impact of the correction on the ratio is not material to the rating. *Exposure at default. §Securitisation Exposure includes the securitisation tranches deducted from capital in the regulatory framework. †Exposure and Standard & Poor's 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, 2016, Standard & Poor's.

### Table 4

#### Lloyds Banking Group PLC Capital And Earnings

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<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>Tier 1 capital ratio</td>
<td>16.1</td>
<td>15.2</td>
<td>16.5</td>
<td>14.5</td>
<td>13.8</td>
</tr>
<tr>
<td>S&amp;P RAC ratio before diversification</td>
<td>8.2</td>
<td>8.0</td>
<td>8.4</td>
<td>6.2</td>
<td>5.8</td>
</tr>
</tbody>
</table>
Table 4

Lloyds Banking Group PLC Capital And Earnings (cont.)

<table>
<thead>
<tr>
<th>(%)</th>
<th>2016</th>
<th>2015</th>
<th>2014</th>
<th>2013</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P RAC ratio after diversification</td>
<td>9.8</td>
<td>9.6</td>
<td>10.2</td>
<td>7.5</td>
<td>7.1</td>
</tr>
<tr>
<td>Adjusted common equity/total adjusted capital</td>
<td>83.9</td>
<td>83.6</td>
<td>84.2</td>
<td>97.3</td>
<td>91.4</td>
</tr>
<tr>
<td>Double leverage</td>
<td>108.1</td>
<td>110.0</td>
<td>108.1</td>
<td>108.5</td>
<td>107.2</td>
</tr>
<tr>
<td>Net interest income/operating revenues</td>
<td>52.0</td>
<td>63.6</td>
<td>62.7</td>
<td>41.9</td>
<td>51.0</td>
</tr>
<tr>
<td>Fee income/operating revenues</td>
<td>9.5</td>
<td>10.2</td>
<td>12.5</td>
<td>15.6</td>
<td>18.5</td>
</tr>
<tr>
<td>Noninterest expenses/operating revenues</td>
<td>52.1</td>
<td>52.2</td>
<td>53.2</td>
<td>56.2</td>
<td>57.5</td>
</tr>
<tr>
<td>Preprovision operating income/average assets</td>
<td>1.1</td>
<td>1.0</td>
<td>1.0</td>
<td>0.9</td>
<td>0.8</td>
</tr>
<tr>
<td>Core earnings/average managed assets</td>
<td>0.6</td>
<td>0.6</td>
<td>0.7</td>
<td>0.3</td>
<td>0.1</td>
</tr>
</tbody>
</table>

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

Risk Position: Improved profile that we expect to be sustained

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 now-satisfactory asset quality and provisioning, and our view that its current risk appetite will prove enduring. We still see scope for some limited additional charges for PPI, but see Lloyds as less exposed to other potential litigation and conduct charges than some peers. While it is a large bank, we see it as an inherently less complex organization than some of its other large U.K. peers, aided by the simplification program that management pursued in recent years, limited international presence, and modest capital markets activity, and more limited ring-fencing-related adjustments to its business structure.

Since 2008, Lloyds has risen up from a state of demonstrably weaker asset quality and loss record than its peers, which stemmed from its 2008 HBOS acquisition and the unsupportive U.K. economic environment. We now see its asset quality in areas such as residential mortgages, credit cards, asset finance, and commercial lending as being rather typical among U.K. banks. For example, the group’s impaired assets (1.8% on a gross basis at end-March 2017) continue to reduce (see chart 2) and have moved comfortably below the long-term U.K. industry norm of major banks (which we calculate to be in the 2%-3% range since the late 1980s, incorporating two major economic downturns). Lloyds has given market guidance of an impairment charge of up to 25 bps for 2017 (excluding MBNA), having reported 15bps for 2016 (net of writebacks). Our U.K. systemwide credit loss estimate (including run-off and weakly performing banks) assumes a U.K. loan loss rate of about 28 bps in 2017 (up from 21 bps in 2015), and about 38 bps in 2018.
Mortgages continue to account for a relatively high 66% of the gross customer loan book, excluding repurchase agreements (see chart 3). U.K. mortgages account for more than 95% of this. Lloyds reported a loss rate of 3 bps in its U.K. mortgage book in 2016, a level that is typical among the major U.K. banks. As of Dec. 31, 2016, Lloyds stated that 0.7% of the book was in negative equity and that a further 10.3% had an indexed loan-to-value (LTV) ratio of between 80%-100%. We see these statistics as being fairly typical among U.K. mortgage lenders, noting that as for peers' they have improved steadily in recent years (see chart 4). LTV ratios were higher and arrears performance weaker in Lloyds' buy-to-let and specialist books—the latter is now closed to new business.
Chart 3

Lloyds Banking Group - Reported Gross Loans And Advances To Customers, By Division

(Bil £)

Sources: company accounts, S&P Global Ratings forecast. Divisional split post-2013 is not comparable with that beforehand. "TSB" and Run-off are exit portfolios. Excludes reverse repos.

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As a whole, Lloyds also stated that 1.8% of mortgage accounts (excluding repossessions) were more than 90 days in arrears at end-2016 (see chart 5). In our view, the higher arrears ratio than key peers reflects factors such as some residual, legacy weaker quality specialist lending from the HBOS acquisition, and delayed litigation in 2016 while changes were made to legal processes. Although generally performing well, we still view its U.K. mortgage book as a latent risk in the event of a sharp deterioration of the U.K. economy and rise in unemployment levels, or, less likely, an unexpected sharp rise in interest rates.
Lloyds' unsecured consumer lending accounts for about 7% of its gross customer loan book. This comprises overdrafts, unsecured personal loans, asset finance, and credit cards. We continue to expect asset quality trends in this book to remain fairly supportive. Nevertheless, at around 10% growth per year, a rate that is well ahead of nominal GDP growth, it has been the fastest growing segment of private borrowing in the U.K. While mindful of the high historical level of write-offs in U.K. consumer credit (about 340 bps over the past 20 years) versus mortgages (less than 10 bps), and Lloyds' ambition to grow this portfolio, we view positively Lloyds' stated intent to maintain its existing risk appetite.

The 16% RAC diversification benefit demonstrates the spread of Lloyds' activities by business line and risk type. Notably, Lloyds is the only U.K. bank with substantial insurance risk exposure (see chart 6). It has a high concentration in U.K. exposures, but we see this as a relatively large economy and the exposures to be relatively well diversified geographically and across sectors. The risk-adjusted capital framework (RACF) does not capture the nontrading market risk of Lloyds' large defined-benefit pension fund exposure and, while future pension asset volatility could yet play through the bank's capital base, we note that management has undertaken a substantial risk mitigation program in recent years.
Like its large U.K. peers, Lloyds has made strides in recent years to address the legacy conduct problems, notably from PPI, and to overhaul its products and practices with the aim of mitigating the risk of future conduct problems. Like peers, Lloyds hoped to have drawn a line under PPI with its £4.0 billion provision in 2015, but has taken a further provision of £1.0 billion in 2016 and £350 million so far in 2017. While we anticipate that related charges will drop further, we remain somewhat cautious: the anticipated 2019 time-bar for further claims is not yet confirmed, and customer claims could yet rise substantially ahead of any such deadline (see "U.K. Banks Start To Emerge From Their Past Misdemeanors," published June 7, 2017). Furthermore, the intense regulatory scrutiny of U.K. banks' conduct means that charges (whether for compensation, fines, remediation) remain, in our view, an affordable inevitability for the large U.K. banks that offer the full range of banking services.

### Table 5

**Lloyds Banking Group PLC Risk Position**

<table>
<thead>
<tr>
<th>(%)</th>
<th>2016</th>
<th>2015</th>
<th>2014</th>
<th>2013</th>
<th>2012</th>
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<tbody>
<tr>
<td>Growth in customer loans</td>
<td>(1.6)</td>
<td>(5.6)</td>
<td>(5.0)</td>
<td>(4.3)</td>
<td>(7.1)</td>
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<tr>
<td>Total diversification adjustment / S&amp;P RWA before diversification</td>
<td>(16.3)</td>
<td>(17.0)</td>
<td>(17.7)</td>
<td>(16.4)</td>
<td>(18.2)</td>
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<tr>
<td>Total managed assets/adjusted common equity (x)</td>
<td>25.3</td>
<td>25.0</td>
<td>24.9</td>
<td>27.2</td>
<td>29.5</td>
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Table 5

Lloyds Banking Group PLC Risk Position (cont.)

<table>
<thead>
<tr>
<th>(%)</th>
<th>2016</th>
<th>2015</th>
<th>2014</th>
<th>2013</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>New loan loss provisions/average customer loans</td>
<td>0.2</td>
<td>0.1</td>
<td>0.2</td>
<td>0.5</td>
<td>0.9</td>
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<tr>
<td>Net charge-offs/average customer loans</td>
<td>0.3</td>
<td>0.7</td>
<td>1.2</td>
<td>1.1</td>
<td>1.4</td>
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<tr>
<td>Gross nonperforming assets/customer loans + other real estate owned</td>
<td>2.8</td>
<td>3.4</td>
<td>4.7</td>
<td>8.7</td>
<td>12.4</td>
</tr>
<tr>
<td>Loan loss reserves/gross nonperforming assets</td>
<td>19.4</td>
<td>19.8</td>
<td>28.4</td>
<td>27.3</td>
<td>23.4</td>
</tr>
</tbody>
</table>

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

Funding and liquidity: Strong franchise, satisfactory ratios

We regard Lloyds' funding as average compared with U.K. peers, and its liquidity position as adequate. This assessment reflects the sizable adjustment in the group's funding profile since the financial crisis started, exemplified by now comfortable ratios that we expect to be maintained, and our qualitative view that Lloyds continues to benefit from a strong, stable deposit franchise and diversified term funding base by market and currency.

Lloyds reported a loan-to-deposit ratio of 107% as of March 31, 2017, which is around the median for the top 20 U.K. banks by revenues. We expect Lloyds' S&P Global Ratings stable funding ratio--103% as of end-2016--to remain above the 100% mark. Total wholesale funding of £106 billion at March 2017, was £20 billion lower than a year before, having fallen by over 75% since the end of 2008. The reported proportion of wholesale funding due within one year remains steady at about one-third. The group expects to meet the regulatory NSFR requirement once it takes effect.

With the deleveraging now complete and likely modest growth in customer loan balances requiring little additional funding, we expect that Lloyds will focus on further improving the quality and cost of its deposit base and diversity across retail and commercial banking. While Lloyds' leading market position does confer an ability to influence pricing 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, in our view (see chart 7). We note also that Lloyds has made substantial use of the Bank of England's Funding for Lending scheme (FLS) with peak drawings of £33 billion, and Term Funding Scheme (£4.5 billion drawn at end-2016). We see this as opportunistic and anticipate that the bank will be able to comfortably refinance associated borrowings as they come due in the coming years, albeit at a modestly higher cost than now.
Lloyds’ broad liquid assets-to-short-term wholesale funding ratio has been consistently healthy at around 1.5x since end-2013, and we expect this metric to remain robust. Lloyds has stated that it continued to meet the regulatory liquidity coverage ratio requirement at end-March 2017, though does not yet specify the ratio. LCR coverage was supported by £133 billion of eligible assets at end-March 2017, held in sterling, dollar and euro. We note that Lloyds’ mortgage loan book in particular also offers substantial secured access to the BOE discount window in case of need, despite the existing £237 billion (or 29% of total assets) encumbrance at end-2016, that stems from activities like its issuance of covered bonds and ABS and use of BOE funding facilities.

Table 6

<table>
<thead>
<tr>
<th>(%)</th>
<th>2016</th>
<th>2015</th>
<th>2014</th>
<th>2013</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Core deposits/funding base</td>
<td>71.0</td>
<td>70.7</td>
<td>72.0</td>
<td>71.0</td>
<td>65.0</td>
</tr>
<tr>
<td>Customer loans (net)/customer deposits</td>
<td>107.2</td>
<td>107.4</td>
<td>105.8</td>
<td>112.4</td>
<td>121.2</td>
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<tr>
<td>Long term funding ratio</td>
<td>85.6</td>
<td>85.2</td>
<td>85.3</td>
<td>86.8</td>
<td>84.4</td>
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<tr>
<td>Stable funding ratio</td>
<td>103.9</td>
<td>103.5</td>
<td>102.4</td>
<td>99.0</td>
<td>99.7</td>
</tr>
<tr>
<td>Short-term wholesale funding/funding base</td>
<td>15.5</td>
<td>15.9</td>
<td>15.8</td>
<td>14.0</td>
<td>16.6</td>
</tr>
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</table>
Table 6

Lloyds Banking Group PLC Funding And Liquidity (cont.)

<table>
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<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Broad liquid assets/short-term wholesale funding (x)</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
<td>1.4</td>
<td>1.2</td>
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<tr>
<td>Net broad liquid assets/short-term customer deposits</td>
<td>11.8</td>
<td>11.3</td>
<td>10.8</td>
<td>8.7</td>
<td>7.0</td>
</tr>
<tr>
<td>Short-term wholesale funding/total wholesale funding</td>
<td>51.6</td>
<td>52.5</td>
<td>54.3</td>
<td>48.0</td>
<td>46.8</td>
</tr>
<tr>
<td>Narrow liquid assets/3-month wholesale funding (x)</td>
<td>2.0</td>
<td>2.0</td>
<td>1.8</td>
<td>1.9</td>
<td>1.7</td>
</tr>
</tbody>
</table>

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

External Support: Substantial ALAC issuance expected

In our view, Lloyds has high systemic importance in the U.K., mainly reflecting its material market share in the country’s 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 going concerns following a bail-in of eligible liabilities.

For Lloyds, we apply a 4.5% threshold for one notch of ALAC uplift (50 basis points lower than the standard 5% threshold) because our ALAC ratio includes the full weight of Lloyds’ insurance operations, but we expect that they may be wholly or partially outside the scope of required bail-in capitalization. We calculate that ALAC was 4.5% of S&P Global Ratings RWAs as of year-end 2016, but expect that Lloyds’ ALAC buffer will grow substantially, aided by material issuance of senior and subordinated issuance from Lloyds Banking Group PLC and relatively flat S&P Global Ratings RWAs, reaching 7% by end-2019.

Table 7

Summary Of ALAC Calculation As Of Dec. 31, 2016

<table>
<thead>
<tr>
<th>(Mil. £)</th>
<th>% Of S&amp;P Global Ratings RWA</th>
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<tr>
<td>A</td>
<td>Adjusted common equity</td>
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<tr>
<td>B</td>
<td>Hybrids in TAC</td>
</tr>
<tr>
<td>C (A+B)</td>
<td>Total adjusted common equity</td>
</tr>
<tr>
<td>D</td>
<td>TAC in excess of our 7% threshold</td>
</tr>
<tr>
<td>E</td>
<td>ALAC-eligible instruments</td>
</tr>
<tr>
<td></td>
<td>Of which NOHC senior</td>
</tr>
<tr>
<td></td>
<td>Of which dated subordinated</td>
</tr>
<tr>
<td></td>
<td>Of which minimal equity content hybrids</td>
</tr>
<tr>
<td>F (=D+E)</td>
<td>ALAC buffer</td>
</tr>
<tr>
<td></td>
<td>S&amp;P Global Ratings RWA</td>
</tr>
</tbody>
</table>

Additional rating factors

No additional factors affect the ratings.

Group structure, rated subsidiaries and hybrids

Lloyds is the ultimate and nonoperating holding company (NOHC) of the group that it heads. It operates through two principal banking subsidiaries: Lloyds Bank PLC and its subsidiary Bank of Scotland PLC (BOS), which it holds via HBOS PLC, an intermediate NOHC. 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, both Lloyds and HBOS are rated two notches below the GCP, leading to a long-term issuer credit rating one notch below the 'a-' unsupported GCP.

We continue to see Lloyds Bank and BOS 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 their senior obligations are honored. Our ratings on these entities are therefore in line with the ALAC-supported GCP. By contrast, we view Scottish Widows Ltd., the group's main life assurance company, as only strategically important to Lloyds because we do not perceive the group's insurance businesses to be as integral to the group as its core banking activities. The 'A'
long-term rating on Scottish Widows reflects no group-related uplift, being in line with the company's 'a' stand-alone credit profile and the 'a' GCP of Lloyds.

The AT1 and Tier 2 hybrid capital instruments issued by the NOHC are notched down from the unsupported GCP, being notched down in accordance with tables 1 and 2 of the bank hybrid criteria, depending on their features.

**Ratings impact of U.K. ring-fencing regulation**

While see Lloyds as less affected by ring-fencing than peers such as Barclays, HSBC, and Royal Bank of Scotland. While ring-fencing presents an operational challenge for Lloyds with some associated set-up and ongoing friction costs, we do not expect that it will in itself weaken our view of the group's 'a-' unsupported GCP. Many of the constraints to fungibility of group resources that ring-fencing will formalize are recognized in our assessment today. Examples of this include the prudential requirements on the group's few overseas subsidiaries, pre-positioning requirements for future TLAC/MREL, and the separate funding, liquidity, capital, large exposure and governance structures of each legal entity relative to the rest of the group.

Lloyds has indicated that less than 5% of the group's loan book will be positioned outside the ringfence following their transfer in mid-2018. We anticipate that Lloyds Bank and BOS will be inside the ringfence, and as a result we consider adverse rating implications from ringfencing to be highly unlikely for them. Since insurance businesses cannot be owned by ringfenced entities, Lloyds is due to complete an internal reorganization later in 2017, leaving the Scottish Widows subgroup directly owned by Lloyds Banking Group plc.

On July 17, we assigned preliminary ratings to two Lloyds subsidiaries that will comprise the nonringfenced subgroup—Lloyds Bank Corporate Markets PLC and Lloyds Bank International Ltd. The anticipated 'A-/A-2' ratings reflect our view that we will see the subgroup as highly strategic to Lloyds. The preliminary ratings will likely be finalized once Lloyds receives U.K. court approval under Part VII of the Financial Services and Markets Act 2000 (FSMA) for the associated transfer of business. We currently expect this to occur late in the first half of 2018.

**Related Criteria And Research**

**Related Criteria**

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, June 1, 2016
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
• Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
• 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
• Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions, Dec. 6, 2010
• General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
• Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

Related Research
• Prospective Lloyds Bank Non-Ring-Fenced Entities Assigned Preliminary 'A-/A-2' Ratings; Outlook Negative, July 17, 2017
• Scottish Widows Ltd., July 14, 2017
• Comparative Statistics: Top 25 U.K. Banks, July 10, 2017
• Which Way Now: The U.K.'s "Challenger Banks" Reach A Fork In The Road, July 10, 2017
• U.K. Banks Start To Emerge From Their Past Misdemeanors, June 7, 2017
• Banking Industry Country Risk Assessment: United Kingdom, May 31, 2017
• Various U.K. Banks' Ratings Affirmed; Outlooks Still Mainly Negative On Continued Economic Uncertainty Related To Brexit, May 31, 2017
• Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative, April 28, 2017
• The Resolution Story For Europe's Banks: A Job Not Yet Half Done, So Plenty More Work To Come, April 5, 2017
• U.K. Bank Credit Losses In 2017 Are Nothing To Be Afraid Of, March 23, 2017
• Major U.K. Banks Report Aggregate Year-On-Year Underlying Pre-Tax Profit Growth In 2016, March 1, 2017
• Stress Test Results Highlight U.K. Banks' Enhanced Resilience, Dec. 1, 2016
• Rating U.K. Banking Groups Affected By Ring-Fencing: Why One Size May Not Fit All Subsidiaries, Nov. 24, 2016

### Anchor Matrix

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### Ratings Detail (As Of July 19, 2017)

**Lloyds Banking Group PLC**

Counterparty Credit Rating  
BBB+ / Negative / A-2
### Ratings Detail (As Of July 19, 2017) (cont.)

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<thead>
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<th>Rating Type</th>
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<td>Short-Term Debt</td>
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</table>

### Counterparty Credit Ratings History

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<td>09-Jun-2015</td>
<td>BBB+/Stable</td>
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<td>03-Feb-2015</td>
<td>BBB/Positive</td>
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<td>08-Nov-2012</td>
<td>A-/Negative</td>
<td>A-2</td>
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### Sovereign Rating

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### Related Entities

#### Bank of Scotland Capital Funding L.P.

<table>
<thead>
<tr>
<th>Rating Type</th>
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<tbody>
<tr>
<td>Preferred Stock</td>
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#### Bank of Scotland PLC

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<tr>
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<tbody>
<tr>
<td>Issuer Credit Rating</td>
<td>A/Negative/A-1</td>
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<tr>
<td>Junior Subordinated</td>
<td>BB+</td>
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<tr>
<td>Junior Subordinated</td>
<td>BBB-</td>
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<td>Senior Secured</td>
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#### HBOS Capital Funding L.P.

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#### HBOS PLC

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<td>BB+</td>
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<td>Senior Unsecured</td>
<td>BBB+</td>
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<td>Short-Term Debt</td>
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#### LBG Capital No. 1 PLC

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<td>Subordinated</td>
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#### LBG Capital No. 2 PLC

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#### Lloyds Bank Capital 2 L.P.

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#### Lloyds Bank PLC

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<td>Certificate Of Deposit</td>
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### Ratings Detail (As Of July 19, 2017) (cont.)

<table>
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<td>Senior Unsecured</td>
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<td>Greater China Regional Scale</td>
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<td>Senior Unsecured</td>
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<tr>
<td>Subordinated</td>
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</table>

**Scottish Widows Ltd.**

- **Financial Strength Rating**
  - *Local Currency*: A/Negative/--
- **Issuer Credit Rating**
  - *Local Currency*: A/Negative/--
- **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.*

### Additional Contact:

Financial Institutions Ratings Europe; FIG_Europe@spglobal.com