

RATING AGENCY COMMENTS ON LLOYDS & RBS

Lloyds Banking Group plc

Throughout the crisis, major rating agencies viewed Lloyds Bank as a bank of systemic importance to the UK. This implied that high levels of support would likely be available to the bank from the UK authorities, if required. This view remains unchanged. The first quarter results for 2014 showed a rise in pre-tax profit, impairments falling 57% to £431m and costs falling by 5% to £2.3bn. Looking at the capital adequacy, the bank's Common Equity Tier 1 ratio (fully loaded to meet future Basel III requirements) was 10.8%, some way above the minimum 7.5% requirement and its Leverage ratio was 4.1%, above the 3.5% minimum.

After the first sell off of the government stake on 16th September 2013, Fitch reaffirmed its view that "support for the banks from the UK authorities (AA+/Stable), in case of need, is still highly likely."

Fitch: Key Rating Drivers

Systemically Important: The Long Term Rating of Lloyds Bank plc reflects Fitch Ratings' view that as a systemically important bank, support from the UK authorities in case of need is highly likely.

Strong Franchise Drives Viability Rating: Lloyds Bank's Viability Rating is underpinned by strong UK retail and commercial banking franchises, a reduced risk profile due to deleveraging and healthy liquidity. The Viability Rating also take into account risks, especially those linked to commercial real estate and potential future conduct charges.

Asset Quality Risks Remain: Non-performing loans have steadily reduced since end-2010, but remain higher than most UK peers, at 7.7% of gross loans at end-H113 (end-2012: 8.7%). Impairment charges reduced significantly in H113, representing 0.64% of average gross loans 2012: 0.95%). Fitch expects impairment charges to remain moderately high as a result of subdued UK economic growth and high unemployment.

Evolving Assumptions on Support: In Fitch's view, there is a clear intention to ultimately reduce implicit state support for systemically important banks in the UK (and more broadly in the EU), as demonstrated by a series of legislative, regulatory and policy initiatives at UK and EU levels. The bank's ratings could be revised down if Fitch concluded that potential sovereign support had either weakened relative to its previous assessment or that it could no longer be relied upon.

Viability Rating on Upward Path: An improving UK operating environment, helping to sustain profitability and further strengthen capitalisation, could support positive momentum in the bank's Viability Rating.

Support Rating: Lloyds Bank has a Support Rating of '1' which is designated for banks for which there is an extremely high probability of external support. The potential provider of support is very highly rated in its own right and has a very high propensity to support the bank in question. This probability of support indicates a minimum Long Term Rating floor of 'A-'.

Moody's: Key Rating Drivers (June 2014)

- Solid capital and leverage ratios

- Leading retail and commercial banking franchise combined with revenue diversification from its subsidiaries provide material "shock absorbers"
- Conduct remediation costs and potential litigation charges introduce potential earnings volatility
- Improved asset quality reduces downside risk arising from legacy portfolio, though run-off book remains sizeable
- Liquidity and funding profile has improved, though use of wholesale funding remains high

According to Moody's, Lloyds's capital and leverage ratios continue to improve as the bank reduces its risk-weighted assets (RWAs) through disposals, positioning the bank well relative to regulatory requirements. The agency expects that the bank's improved ability to generate earnings will increasingly contribute to further strengthening of its capital levels as the deleveraging process comes to an end.

S&P (30th May 2014) base their ratings on Lloyds "strong" business position, "adequate" capital and earnings, "moderate" risk position, "average" funding, and "adequate" liquidity, as defined by their criteria.

S&P assess Lloyds' business position as "strong," based on Lloyds' position as the largest mortgage and retail savings provider in the UK, and its good revenue diversity across a wide range of banking business lines. Lloyds' UK insurance franchise also adds to our view of its revenue diversity.

S&P view Lloyds' capital and earnings as "adequate" and they project its RAC (risk adjusted capital) ratio will be in the range of 8.0%-8.5% by the end of 2015. We calculate this ratio to have been a relatively low 6.3% as of 31st December 2013.

S&P regard Lloyds' funding as "average" and its liquidity position as "adequate." Deposit growth was healthy in Lloyds' retail and commercial banking divisions in 2013, and this has continued into 2014. Lloyds reported that its loan-deposit ratio improved to 111% as of 31st March 2014, from 119% a year before, and a material improvement from 176% in mid-2009.

Royal Bank of Scotland Group plc

According to the recent credit reports on Royal Bank of Scotland Group plc, the bank is considered as being well diversified with strong franchises in core and making good progress in run-down of non-core assets markets. In addition, the banks has an adequate capital position following significant equity injections from the UK government, the majority shareholder, and substantial balance sheet deleveraging (S&P, June 2014).

This positive view on the bank was reaffirmed by the credit report issued by Moody's on 1st August 2014. In its report, Moody's outline their view that that systemic support for the banks from the UK government would be available to senior depositors and bondholders, if required. The positive views on the bank are supported by (1) strong underlying earnings from non-investment banking activities (which are however currently being eroded by high conduct-related cost and litigation charges); (2) the strong track record of the current management in de-risking and restructuring the group; (3) adequate capitalisation levels, which we expect to be volatile in the run-up to the completion of the group's overall restructuring plan and therefore constrain financial flexibility during this period; and (4) sound liquidity and funding positions.

Fitch: (24th July 2014)

Royal Bank of Scotland Group plc (RBSG), The Royal Bank of Scotland Plc (RBS) and NatWest are managed as a group and Fitch assesses their creditworthiness on a consolidated basis. The risks of the subsidiary banks are incorporated into our assessment of the group and vice versa. They have therefore assigned a Viability Rating (VR) to NatWest at the same level as its immediate parent's, RBS, and of its ultimate parent, RBSG. This reflects the high degree of integration across the group and large relative size of the entity in the group context.

RBS's and NatWest's VR reflects the significant progress made in improving the group's overall risk profile. The strategy unveiled by its new CEO in February 2014 should result in a better capitalised bank in the medium term, with a much simpler organisational structure. As a result, Fitch expects its operating profitability to improve in the medium term and for the large one-off costs reported in recent years to reduce.

Profitability is set to benefit from a more targeted focus on its strong UK franchise where it has leading market shares in SME and mid-corporate business. The group has concentrated on deleveraging and restructuring over the past five years, and much investment is still required for its IT systems and processes. The new transformation and simplification projects should allow for a much leaner organisation, with better systems, procedures and controls. Internal capital generation should become steady and sustainable into the medium term. However, it is likely that some cross winds will impact the group's profitability at least in the short term as it puts through a significant level of transformation costs.

The bank now operates with a much more balanced funding profile, with an improved balance between the maturities of its assets and liabilities, with a much reduced reliance on wholesale (particularly short-term) funds, and a large, good quality liquidity buffer. Capitalisation has also been improving, and, by 2016 should compare well with peers. However, capital generation will partly depend on the achievement of the sale of its US subsidiary, Citizens, which is subject to execution risk. The group is targeting a common equity Tier 1 capital ratio of over 12% by 2016.

While the proportion of impaired loans on its balance sheet remains high, they have been significantly covered by impairment reserves, reducing the proportion of the bank's capital, which is still at risk from asset valuations.

Moody's: Key Rating Drivers (August 2014)

- RBS's ambitious and complex overall restructuring poses risk to bondholders, given RBS's constrained financial flexibility, but it will eventually improve its credit profile
- RBS's capital markets activities are still sizeable and will continue to constrain its credit profile, until material reduction in investment banking is achieved
- Asset quality is currently poor overall but it is gradually improving, as the RBS Capital Resolution (RCR) wind-down is progressed and credit conditions in the UK and Ireland further improve
- We expect RBS's capitalisation to improve in the medium term as the bank continues to deleverage, but it remains vulnerable to short-term shocks
- RBS has sizeable shock-absorbers because of its earnings from retail and commercial banking activities but their value has been eroded by ongoing conduct and litigation costs
- Liquidity and funding are currently sound

S&P (3rd June 2014) provide assessment of RBS' business position as "adequate" balancing their view of the group's leading franchises in UK retail, corporate, and private banking with its extended and long-running restructuring program, management transitions, and underperformance in key divisions. S&P view capital and earnings as "adequate."

S&P expect that the group's risk-adjusted capital (RAC) ratio (before diversification adjustments) will increase to the 8.5%-9% range by year-end 2015 (from 7.7% at end-2013).

S&P view the group's risk position as "moderate," reflecting the continued high impairment losses and the group's substantial exposure to conduct and litigation-related risks.

S&P consider funding as "average" and liquidity as "adequate" in light of the bank's stable deposit franchise and the progress that RBS has made in reducing its dependence on wholesale funding and enhancing its liquidity buffers over the past few years.