MOODY'S
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Credit Opinion: TSB Banking Group plc

Global Credit Research - 31 Jul 2015

United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating -Dom Curr	Baa3
Subordinate -Dom Curr	Baa3
Parent: Banco Sabadell, S.A.	
Outlook	Stable
Bank Deposits	Baa3/P-3
Baseline Credit Assessment	ba3
Adjusted Baseline Credit Assessment	ba3
Senior Unsecured -Dom Curr	Ba1
Senior Subordinate -Dom Curr	B1
Pref. Stock Non-cumulative -Dom Curr	Caa1
TSB Bank plc	
Outlook	Positive
Bank Deposits -Dom Curr	Baa2/P-2
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2
Issuer Rating -Dom Curr	Baa2

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Key Indicators

TSB Banking Group plc (Consolidated Financials)[1]

	[2]**12-14**	[2]**12-13**	**Avg.**
Total Assets (GBP million)	**27,171.4**	**24,954.4**	[3]**8.9**
Total Assets (EUR million)	**35,012.7**	**29,994.7**	[3]**16.7**
Total Assets (USD million)	**42,367.3**	**41,331.0**	[3]**2.5**
Tangible Common Equity (GBP million)	**1,634.0**	**1,298.4**	[3]**25.8**
Tangible Common Equity (EUR million)	**2,105.6**	**1,560.7**	[3]**34.9**
Tangible Common Equity (USD million)	**2,547.8**	**2,150.5**	[3]**18.5**
Problem Loans / Gross Loans (%)	**0.9**	**1.2**	[4]**1.1**
Tangible Common Equity / Risk Weighted Assets (%)	**23.6**	**20.9**	[5]**22.2**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**11.9**	**17.3**	[4]**14.6**
Net Interest Margin (%)	**2.9**	**1.9**	[4]**2.4**
PPI / Average RWA (%)	**3.3**	**2.7**	[5]**3.0**
Net Income / Tangible Assets (%)	**0.3**	**0.7**	[4]**0.5**
Cost / Income Ratio (%)	**77.3**	**68.7**	[4]**73.0**
Market Funds / Tangible Banking Assets (%)	**1.2**	**1.5**	[4]**1.4**
Liquid Banking Assets / Tangible Banking Assets (%)	**18.4**	**17.8**	[4]**18.1**

Gross Loans / Total Deposits (%)	**88.1**	**86.5**	[4]**87.3**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Compound Annual Growth Rate based on IFRS reporting periods [4] IFRS reporting periods have been used for average calculation [5] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

We rate TSB Bank plc's (TSB's) long-term deposits and issuer rating Baa2. The bank's short-term deposit rating is P-2. These ratings are underpinned by (1) the bank's baa2 baseline credit assessment (BCA); (2) the results of our Advanced Loss Given Failure (LGF) analysis which leads to a Preliminary Rating Assessment (PRA) for both deposits and senior unsecured debt at the same level as the BCA and; (3) a low expectation of government support, resulting in no uplift above the PRA for both deposit and senior unsecured debt ratings. The outlook on the long-term deposits and issuer ratings of TSB is positive.

We also assign a Counterparty Risk Assessment (CRA) of A2(cr)/P-1(cr) to the bank.

The long-term issuer rating of TSB's holding company, TSB Banking Group plc, is Baa3. The rating of TSB Banking Group's dated subordinated debt is also Baa3. The outlook on TSB Banking Group's long-term issuer ratings is stable.

TSB's baa2 BCA reflects the (1) high quality of its existing loan portfolio; (2) protection provided by Lloyds Banking Group plc (LBG, Baa1 positive) against legacy litigation and conduct remediation costs; (3) strong capital and leverage metrics; and (4) very low reliance on wholesale funding given its stable retail deposit base. These strengths are balanced against its (1) relatively short track record as an independent entity with limited financial history; (2) plans for accelerated credit growth above market average within an increasingly competitive environment; (3) high operational risk arising from the need to migrate its IT platform within ten years; and (4) expected low levels of profitability given the large cost base it has inherited.

TSB'S BCA IS SUPPORTED BY THE UK'S VERY STRONG- MACRO PROFILE

As a domestic UK bank with a large deposit and lending base, TSB's operating environment is influenced by the UK's economic performance and its Macro profile is thus aligned with that of the UK at Very Strong-. UK banks benefit from operating in a wealthy and developed country with a very high degree of economic, institutional and government financial strength as well as very low susceptibility to event risk. The main risks to the banking system stem from the high level of indebtedness of UK households, which are thus sensitive to changes in interest rates. UK banks are largely funded by deposits and banks' funding structures have remained relatively stable in the past few years, with slight increases in capital as well as declines in short-term funding. The UK banking sector is relatively concentrated, but the price-setting power of large banks is somewhat challenged by competition from the shadow banking market.

RATING DRIVERS

- High quality of loan portfolio and limited exposure to conduct remediation costs

- Limited track record operating as a standalone bank

- Plans for rapid expansion of loan portfolio and potentially high execution risk from migration of IT platform

- Strong capital and leverage metrics

- Expected low levels of profitability given high cost base

- Low reliance of wholesale funding

- Adequate liquidity buffers

- Large volume of deposits but presently no senior unsecured debt resulting in moderate loss-given failure for the bank's deposits and senior unsecured ratings

RATING OUTLOOK

The positive outlook on TSB's deposit and issuer ratings reflect its funding plans, which will likely involve the issue of senior unsecured debt at the holding company level. This would provide additional protection to depositors and creditors of the operating entity. The stable outlook on TSB Banking Group's issuer ratings reflects our expectation that creditors at this level would only moderately benefit from a reduction in expected loss upon the issuance of senior unsecured given no debt issuance at this level to date.

WHAT COULD CHANGE THE RATING - UP

An upgrade in the bank's deposits and issuer ratings of the operating company could be triggered by the issue of senior or subordinated debt instruments at the holding company, which would provide protection to depositors and creditors. An upgrade in the BCA driven by a longer track record, reduced execution risk and improved levels of profitability could also lead to an upgrade of all ratings. Any such movement in TSB's BCA would however continue to be constrained by the BCA of Banco Sabadell.

WHAT COULD CHANGE THE RATING - DOWN

A downgrade of TSB's rating could be driven by a deterioration in the bank's asset quality, which could in turn pressure capital. Sizable losses or successive periods of low/negative profits due to failure to achieve a low cost base while increasing revenues would also put pressure on the ratings. Negative pressure could also arise from higher than expected deterioration in the bank's liquidity and profitability metrics. Any increasing linkages between TSB and its parent, could also lead to a reassessment of the rating relative to the ratings of Banco Sabadell. In the absence of an upgrade of Banco Sabadell's BCA, this situation could result in negative rating pressure for the bank's ratings.

DETAILED RATING CONSIDERATIONS

The financial data in the following sections are sourced from TSB Banking Group's financial statements unless otherwise stated.

STRONG ASSET QUALITY AND LIMITED EXPOSURE TO CONDUCT RISK OFFSET BY LIMITED TRACK RECORD, RAPID LOAN GROWTH AND EXECUTION RISK

TSB was specifically designed to become a challenger bank after the European Commission required LBG to divest part of its retail business in 2009. Since European and UK authorities wanted TSB to have very strong foundations, the bank received a high quality mortgage portfolio from LBG when it was created. According to our calculations, TSB's problem loan ratio as of December 2014 was 0.9%, down from 1.2% as of December 2013. Although we note that the bank does not include a proportion of 90 days past due loans as impaired, the addition of these loans would only increase the problem loan ratio as of December 2014 to 1.2%.

However, TSB plans a rapid expansion of its loan portfolio over the next five years to close the gap between the scale of its infrastructure -- it is the UK's seventh largest bank in terms of branches -- and the size of its balance sheet, the latter placing the bank in twelfth position among rated UK banks. Although the bank benefits from a favourable operating environment in the UK with expected low unemployment and relatively solid economic growth, we believe that competition will continue to increase among UK lenders. This will make achieving growth targets more difficult and could lead to a relaxation in underwriting standards, resulting in greater downside risk, a credit negative in our view.

As a mortgage lender, the bank currently has a very granular lending portfolio with no particular borrower concentrations and a very low average loan-to-value ratio of 41.5%. This includes the 'Mortgage Enhancement' portfolio received from LBG which is expected to boost profitability, although it is subject to a call option once it generates GBP230 million in profits. Nonetheless, the overall mortgage portfolio gives the bank material protection under adverse economic circumstances.

Due to the recent establishment of TSB as an independent entity outside of LBG, TSB's through-the-cycle performance has not yet been demonstrated. As a relatively new independent bank now facing a transition process to become a subsidiary of Banco Sabadell S.A, (Baa3/Ba1 stable, ba3), a new entrant into the UK market, TSB will face a high level of operational risk and potentially high execution risk in migrating into the IT platform of its new parent. Despite Banco Sabadell's track record of successfully integrating acquired banks into its IT platform, there is always uncertainty around the timing, costs and effect on customers and employees of such a transition. Offsetting these integration related risks, however, we note positively the protection from losses arising from legacy misconduct or litigation as covered under an indemnity provided by LBG. This limits significantly the downside risk arising from potential fines or legal settlements, giving the bank a financial advantage compared to peers.

We also believe that TSB's management team will face significant challenges, given both the relatively short history of the bank and the tasks they will face in integrating with a new parent from a cultural point of view and potentially from an operational perspective.

In summary, the bank has a high quality loan portfolio but has a limited track record and faces significant challenges due to its expansion plans and the change in control. We assign a baa3 Asset Risk score to reflect all these factors.

SOLID CAPITAL AND LEVERAGE METRICS PROTECT THE BANK AGAINST DOWNSIDE RISK

TSB's tangible common equity (TCE) to risk-weighted assets (RWAs) stood at 23.6% as of December 2014. However, the pro forma ratio reflecting the changes in the method to calculate its RWAs for credit cards, overdrafts and business banking from a Standardised to an Internal Ratings-Base basis, shows a decline by approximately 270 basis points to 20.9%. We believe that despite this material difference, the ratio remains high and provides the bank with sufficient capital to absorb unexpected losses and support growth ambitions. The bank's leverage ratio is also strong and relatively high compared to UK peers, at 5.8% as of December 2014.

On both a current and forward looking basis, we see capital as one of TSB's main strengths and this results in a score of aa3. This score, incorporates TSB's presently strong capital metrics, but also our expectation that capital and leverage ratios will decline as the bank increases its lending. It also incorporates the results of our stress test, as the expected levels of profitability under an adverse scenario would trigger a significant decline in the regulatory capital ratio. However, even under this scenario, using its current portfolio composition, the bank would remain well above regulatory minimums.

EXPECTED LOW LEVELS OF PROFITABILITY, GIVEN HIGH COST BASE

We consider that the main challenge for TSB is to improve its profitability levels. TSB has a very large cost base due to its large branch network, which compares unfavourably with the relatively small size of its asset base. According to our calculations, TSB's cost-to-income ratio was 77.3% as of December 2014. Despite the GBP230 million total profit that TSB will likely receive from the mortgage enhancement portfolio provided by LBG and the GBP450 million contribution from LBG to compensate the bank for the implementation costs of IT migration, profitability will likely remain under pressure until the bank is able to increase the size of its credit portfolio or reduce its cost base. Since profitability is a relative weakness and is not expected to remediate for a number of years, we assign a score of b1, two notches below the bank's macro-adjusted score.

LOW RELIANCE ON WHOLESALE FUNDING AND GRANULAR DEPOSIT BASE

In addition to capital, we consider TSB's funding profile as a strength. The bank's liability structure has been designed with spare capacity for growth, including a significant amount of excess deposits and a very low reliance on wholesale funding. According to our calculations, market funds as a proportion of tangible banking assets was 1.2% as of December 2014. We understand that the bank would like to increase the size of its loan book faster than the size of its deposit balances to improve profitability. Although the bank also plans to increase the proportion of wholesale funds on its balance sheet, we believe that these will remain at a relatively low level and therefore assign an aa2 score to TSB's Funding Structure.

ADEQUATE LIQUIDITY BUFFERS

We believe that the bank has adequate liquidity buffers. According to our calculations, the bank's liquid assets as a proportion of its tangible banking assets, stood at 18.4% as of December 2014. We expect this ratio to show only a slight decline as the bank uses some of this liquidity to expand its loan portfolio. However, the bank could also maintain an increasing amount of additional liquidity in the form of securitized bonds. As a result, we assign a baa3 Liquidity score to reflect these factors.

In aggregate, we assign a Financial Profile of baa1 to TSB.

Given that TSB's business activity will be initially limited to retail banking operations, this relatively narrow focus results in our decision to include a one-notch negative qualitative adjustment in respect of business diversification resulting in a BCA of baa2.

At the moment TSB's BCA at baa2 exceeds the standalone rating of its parent Banco Sabadell by four notches. This differential reflects the very limited connections between the two institutions, plans to retain the TSB brand name and expectations that the UK Prudential Regulation Authority will continue to ensure that TSB maintains adequate solvency and liquidity positions before any dividends are allowed to be paid. We expect that over time increasing operational linkages are likely to develop between the two institutions, which could affect TSB's stability in the event its parent faces financial or operational challenges. Therefore the current four-notch differential could narrow as the IT migration plans are completed or Banco Sabadell's BCA improves before TSB is able to build a stronger track record.

NOTCHING CONSIDERATIONS

LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING

LONG-TERM DEPOSIT RATINGS

TSB is domiciled in the UK, a jurisdiction which is subject to the EU Bank Resolution and Recovery Directive (BRRD), which we consider to be an Operational Resolution Regime. We assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and assigns a 25% probability to deposits being preferred to senior unsecured debt. These are in line with our standard assumptions. Particular to TSB and most mortgage lenders in the UK, we assume the proportion of deposits considered junior at 10%, relative to the standard assumption of 26%, due to their largely retail-oriented deposit base.

Our Advanced loss-given failure (LGF) analysis indicates that TSB's deposits and senior unsecured debt are likely to face moderate loss-given-failure, due to the loss-absorption provided by the dated subordinated debt issued by the holding company, TSB Banking Group, as well as the volume of deposits themselves. This results in a Preliminary Rating Assessment for TSB's deposits and potentially for senior unsecured debt at the same level as the bank BCA at baa2. The positive outlook reflects TSB's funding plans, which will likely involve the issue of senior unsecured debt at the holding company, which would provide additional protection to depositors and creditors of the operating entity.

TSB Banking Group's senior unsecured and subordinated instruments are likely to face a high loss-given-failure according to our LGF analysis given the relatively small volume of existing debt and very limited protection from more subordinated instruments and residual equity. As a result, we assign an issuer rating of Baa3 to TSB Banking Group and a Baa3 rating to its existing tier 2 dated subordinated bonds.

GOVERNMENT SUPPORT

The implementation of BRRD has caused us to reconsider the potential for government support to benefit certain creditors. Given the limited interconnection with other financial institutions and the relatively small size of its operations, we believe there is a low probability of government support for TSB's deposits and its potential senior unsecured debt, resulting in no uplift to the PRA. The same assumption applies to the future bondholders of TSB Banking Group since holding company creditors would be expected to bear losses if necessary.

COUNTERPARTY RISK ASSESSMENT

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than both the likelihood of default and the expected financial loss suffered in the event of default and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (e.g. swaps), letters of credit, guarantees and liquidity facilities.

The CR Assessment is positioned at A2(cr)/P-1(cr). The CR Assessment is positioned three notches above the Adjusted BCA of baa2, based on the cushion against default provided to the senior obligations represented by the CR Assessment by more subordinated instruments. The main difference with our Advanced LGF approach used to determine instrument ratings is that the CR Assessment captures the probability of default on certain senior obligations, rather than expected loss, therefore we focus purely on subordination and take no account of the volume of the instrument class.

The CR Assessment does not benefit of any government support, in line with our support assumptions on deposits and senior unsecured debt ratings.

About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

TSB Banking Group plc

Macro Factors	
Weighted Macro Profile	**Very Strong -**

Financial Profile						
Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	1.1%	aa2	↓↓	baa3	Operational risk	Loan growth
Capital						
TCE / RWA	23.6%	aa1	↓↓	aa3	Expected trend	Capital retention
Profitability						
Net Income / Tangible Assets	0.3%	ba2	↓↓	b1	Expected trend	
Combined Solvency Score		a1		baa2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	1.2%	aa1	↓↓	aa2	Expected trend	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	18.4%	baa2	↓	baa3	Expected trend	
Combined Liquidity Score		a1		a2		

Financial Profile	**baa1**

Qualitative Adjustments	**Adjustment**
Business Diversification	-1
Opacity and Complexity	0
Corporate Behavior	0
Total Qualitative Adjustments	**-1**

Sovereign or Affiliate constraint	Baa2

Scorecard Calculated BCA range	**baa1 - baa3**

Assigned BCA	**baa2**
Affiliate Support notching	**0**
Adjusted BCA	**baa2**

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency rating**	**Foreign Currency rating**
Deposits	0	0	baa2	0	Baa2	
Dated subordinated holding company debt	-1	0	baa3	0	Baa3	

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.

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