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Ratings

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Basler Kantonalbank

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Basler Kantonalbank

SACP	a

+

Support	+4

+

Additional Factors	0

Anchor	a-	
Business Position	Adequate	0
Capital and Earnings	Very Strong	+2
Risk Position	Moderate	-1
Funding	Average	0
Liquidity	Strong	

ALAC Support	0
GRE Support	+4
Group Support	0
Sovereign Support	0

Issuer Credit Rating
AA+/Stable/A-1+

Major Rating Factors

Strengths:	Weaknesses:
• Very strong capitalization, supported by stable earnings. • Very strong customer franchise in home region. • Extremely high likelihood of support from the Swiss Canton of Basel-City, facilitated by full ownership and a statutory guarantee.	• Limited growth prospects in the saturated Basel-City banking market. • Comparably low profitability of majority-owned subsidiary, Bank Cler (not rated; formerly Bank Coop). • Low-interest-rate cycle challenges earnings capacity.

Outlook: Stable

S&P Global Ratings' stable outlook on Switzerland-based Basler Kantonalbank (BKB) reflects that on its owner and guarantor, the Swiss Canton of Basel-City (AAA/Stable/A-1+). Over at least the next two years, we expect BKB will continue to benefit from an extremely high likelihood of timely and sufficient extraordinary support from the Canton of Basel-City in the event of financial distress.

In addition, we expect that BKB will maintain its sound market position and financial profile, underpinned by its very strong capitalization over our two-year horizon.

Downside scenario

In our view, a downside scenario is currently remote. It could be triggered if we lowered our ratings on the Canton of Basel-City by one or more notches, which is a very unlikely scenario considering the canton's stable outlook. Alternatively, we could consider a negative rating action if there is a change in BKB's role for or link with the Canton of Basel-City, or changes in the statutory guarantee, potentially leading to a weaker assessment of BKB's status as a government-related entity (GRE). However, we currently consider this scenario as very unlikely and would expect BKB's existing obligations to be grandfathered. In our view, unchanged potential extraordinary support from the canton would cushion a material multi-notch deterioration of BKB's stand-alone creditworthiness, with the ratings on the senior unsecured debt remaining unchanged. Ratings on the subordinated instruments could, however, be directly affected if the bank's stand-alone credit profile (SACP) deteriorated.

Upside scenario

A positive rating action is currently very remote. This could only be triggered if BKB's stand-alone creditworthiness improved by two or more notches, which we regard as unlikely given our expectation that the bank will not materially change its concentrated business model, or be able to materially improve its funding position in addition to improving its risk to be on par with cantonal peers. Ratings on the subordinated instruments could be directly affected if the bank's SACP improved.

Rationale

We take into account that BKB benefits from operating in Switzerland's highly diversified and competitive economy, the country's very high household income levels, and Swiss banks' prudent loan underwriting standards. Therefore, considering these factors, BKB's anchor remains 'a-', which is the starting point of our ratings assessment for banks mainly operating in Switzerland.

We also consider BKB's business profile as neutral to its stand-alone creditworthiness, based on the bank's strong, sustainable, but regionally concentrated market position as the eighth-largest bank in Switzerland.

We continue to consider the bank's capital position and earnings as a particular rating strength, mainly reflecting our projection that its risk-adjusted capital (RAC) ratio will remain very strong at around 22%.

We also believe that the BKB's risk position is a relative weakness compared with many Swiss Cantonal peers, reflecting its lower earnings buffer due to lower efficiency, comparably higher single-name concentrations, and a higher share of more cyclical commercial real estate lending. We also take into account an untested track record of managing Bank Cler through the cycle, and its related above-market growth in nationwide residential mortgage lending and small and midsize enterprise (SME) lending. BKB had increased its stake in Bank Cler to 99% by October 2018 from 76% at year-end 2017. We note that BKB has demonstrated significant progress in improving its risk-management systems in recent years. Moreover, the bank recently settled its legal prosecution by the U.S. tax authorities related to the acceptance of undeclared funds from U.S. clients against a payment of $60.4 million. This resolution resulted in a Swiss franc (CHF) 33 million ($33 million) one-time gain in 2018, due to the release of related conservative over-provisioning from previous years.

We also continue to assess BKB's combined funding and liquidity as a neutral rating factor, and in line with that of most of its Swiss cantonal bank peers, because of its solid base of granular customer deposits and the cantonal guarantee.

Our issuer credit rating (ICR) on BKB is four notches above our 'a' assessment of the bank's SACP, reflecting the uplift for the GRE support.

For our issue ratings on BKB's additional perpetual tier-1 capital notes, we don't expect the issues to benefit from the extraordinary government support from the canton. Consequently, we notch down from our SACP assessment for the bank.

Anchor: 'a-' for a commercial bank operating in Switzerland

Our criteria use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor stand-alone credit profile (SACP), the starting point in assigning an issuer credit rating (ICR). Our anchor for a bank operating mainly in Switzerland is 'a-'. We view the trends for both economic and industry risk as stable.

Our economic risk score of '2' for Switzerland is supported by the country's highly diversified and competitive economy, very high household income levels, and banks' prudent loan underwriting standards. However, it also reflects that risks remain, owing to the cumulative rise in Swiss house prices over the past several years. Although imbalances remain moderate in a global context, they have led the regulator to enact macroprudential measures to rein growth in mortgage indebtedness. We recognize that house price growth has cooled down since beginning 2014, while lending has recently picked up again after several years of moderate growth. In our view, house prices and household indebtedness remain historically high. The very high mortgage debt level is mitigated by the large amount of financial assets, including pensions, held by Swiss households.

Our industry risk score of '2' primarily reflects the banking sector stability and a relatively high share of deposit funding. Banks' net interest margins continue to decline gradually, given the pressure on deposit margins from the negative-yield environment. This is partly offset, however, by higher margins on lending products, fee income from investment advisory-related activities, and cost management. As a result, banks are still able to generate adequate returns on core banking products to meet their cost of capital. Moreover, in our view, the Swiss regulatory measures are more stringent than those of other European banking regulators.

Table 1

Basler Kantonalbank Key Figures

		--Year-ended Dec. 31--			
(Mil. CHF)	**2018***	**2017**	**2016**	**2015**	**2014**
Adjusted assets	41,125.8	40,770.3	38,512.3	38,513.6	38,062.2
Customer loans (gross)	29,379.3	28,719.2	27,791.2	27,187.0	27,089.9
Adjusted common equity	3,817.2	3,687.5	3,605.5	3,556.1	3,398.5
Operating revenues	286.6	597.0	564.7	575.5	577.6
Noninterest expenses	183.4	411.7	351.6	350.0	334.2
Core earnings	107.3	187.7	204.1	180.6	204.0

*Data as of June 30. CHF--Swiss franc.

Business position: Strong and sustainable, but regionally focused market share

We continue to consider BKB's business profile adequate and therefore neutral for its ratings in line with that of domestically focused cantonal Swiss banks. This balances the bank's strong and sustainable, but also regionally focused market position. BKB is the eighth-largest bank in Switzerland with total assets of CHF41.13 billion as of June 30, 2018 (CHF40.7 billion as of December 2017), consolidating its subsidiary Bank Cler, which had total assets of CHF17.72 billion at the same date.

While BKB benefits from its strong franchise on its retail and corporate lending business in the wealthy Basel region, we believe that BKB will increasingly also benefit from growth in diversified and lower risk countrywide residential mortgage lending and lending to SMEs through its subsidiary Bank Cler. BKB increased its stake to better manage the subsidiaries comparably low profitability, leverage cost income ratios, and allow for a prudent but higher growth strategy. We believe this is in line with the bank's well-managed strategic refocus on its core competencies and products, moderate growth, and digitalization in recent years. Ancillary private banking and trading business lines provide diversity, but we expect these will continue to contribute a modest proportion of up to one-third of operating revenues. Trading revenues--which we expect will continue to represent between 10%-15% of operating revenues in the next two years--are mainly client-initiated foreign exchange and precious metals trading operations, and the bank shut down its certificate business some years ago to avoid inherent risk. Against an ultra-low-interest-rate environment, we expect noninterest income to gradually improve from prudent growth strategies and remain between 35%-40% of operating revenues in the next two years.

We anticipate that Bank Cler will experience higher loan growth than BKB's wider group over the medium term due to propelled Swisswide growth initiatives, which is an additional business opportunity that most other cantonal banks with a traditional sole regional focus do not have. As such, we expect Bank Cler's profitability (representing about one-third of the group's half-year 2017 operating revenues) will narrow, becoming more in line with the wider group in the medium term due to a prudent leverage and growth. For structural reasons, like most other Swiss cantonal banks, BKB parent's lending growth potential is constrained by the saturated banking market in Basel-City. We expect that BKB's management will continue to demonstrate a strong track record, underpinned by prudent underwriting standards and conservative risk management, despite a recent change in the CEO.

Table 2

Basler Kantonalbank Business Position					
		--Year-ended Dec. 31--			
(%)	**2018***	**2017**	**2016**	**2015**	**2014**
Total revenues from business line (mil. CHF)	296.5	680.7	601.8	642.6	593.7
Commercial & retail banking/total revenues from business line	83.5	85.4	84.5	82.9	78.7
Asset management/total revenues from business line	16.5	14.6	15.5	17.1	21.3
Return on average common equity	3.2	5.2	3.7	3.5	3.2

*Data as of June 30. CHF--Swiss francs.

Capital and earnings: Maintaining main strength from very strong capitalization

We expect BKB's capital position and earnings to remain a particular rating strength that compares well in a domestic and global context. This mainly reflects our projection that the bank will maintain its very strong RAC ratio at around 22% in the medium term along with its moderate growth strategies. BKB's RAC ratio was 22% at year-end 2017, which is at the upper end of our very strong range in line with the superior capitalization of many Swiss cantonal banks, and well above the levels of most other banks we rate globally. This incorporates that we foresee growth in the bank's risk-weighted assets (RWAs) of around 3%, which is only slightly higher than our expectation Swiss GDP growth, reflecting limited growth opportunities in saturated Basle-City region, but Bank Cler's growth initiatives. Furthermore, we regard the bank's owner as supportive of BKB's very strong capital position and would expect timely additional support in times in a stress scenario.

We view as supportive of the ratings that BKB settled recently in August 2018 its legal prosecution by the U.S. tax authorities related to acceptance of undeclared funds from U.S. clients in the past against a payment of $60.4 million, which results in a CHF33 million one-time gain in 2018, due to release of related provisioning (CHF100 million) from previous years.

In our view, BKB's earnings became very predictable and stable in recent years, and we do not expect any changes to the bank's dividend policy of distributing 40%-50% of earnings to the home canton. Pressured by low interest rates, we estimate that BKB will be able to cover 50 basis points (bps) losses of its RWAs in a credit stress with its annual earnings (measured by our three-year-average earnings buffer). BKB's capacity to cover normalized losses is below that of many Swiss cantonal peers, but we note that BKB's average annual real credit losses in the past five years were only a fraction (7%) of our normalized loss assumptions.

Table 3

Basler Kantonalbank Capital And Earnings					
		--Year-ended Dec. 31--			
(%)	**2018***	**2017**	**2016**	**2015**	**2014**
Tier 1 capital ratio	N/A	18.4	18.2	17.6	15.3
S&P Global Ratings' RAC ratio before diversification	N/A	22.0	16.8	16.7	16.1
S&P Global Ratings' RAC ratio after diversification	N/A	15.9	12.9	14.1	14.1
Adjusted common equity/total adjusted capital	97.4	97.4	97.3	97.3	100.0
Net interest income/operating revenues	62.5	60.4	63.1	60.1	60.1
Fee income/operating revenues	21.6	20.9	22.0	23.6	26.7

Table 3

Basler Kantonalbank Capital And Earnings (cont.)

		--Year-ended Dec. 31--			
(%)	**2018***	**2017**	**2016**	**2015**	**2014**
Market-sensitive income/operating revenues	13.8	17.2	13.4	13.2	11.1
Noninterest expenses/operating revenues	64.0	69.0	62.3	60.8	57.9
Preprovision operating income/average assets	0.5	0.5	0.6	0.6	0.6
Core earnings/average managed assets	0.5	0.5	0.5	0.5	0.5

*Data as of June 30. N/A--Not applicable.

Table 4

Basler Kantonalbank Risk-Adjusted Capital Framework Data

(CHF 000s)	**Exposure***	**Basel III RWA**	**Average Basel III RW (%)**	**S&P Global RWA**	**Average S&P Global RW (%)**
Credit risk					
Government and central banks	8,595,888	564,875	7	87,863	1
	--				
Institutions and CCPs	3,859,169	610,900	16	429,511	11
Corporate	6,954,120	5,348,550	77	4,768,748	69
Retail	23,059,343	10,453,775	45	6,754,631	29
Of which mortgage	19,320,631	7,102,413	37	4,475,787	23
Securitization§	0	0	0	0	0
Other assets†	65,254	49,200	75	73,786	113
Total credit risk	42,533,774	17,027,300	40	12,114,540	28
Credit valuation adjustment					
Total credit valuation adjustment	--	803,338	--	0	--
Market risk					
Equity in the banking book	53,593	80,388	150	401,948	750
Trading book market risk	--	1,874,238	--	3,592,915	--
Total market risk	--	1,954,625	--	3,994,863	--
Operational risk					
Total operational risk	--	1,079,425	--	1,119,399	--
		Basel III RWA		**S&P Global Ratings' RWA**	**% of S&P Global Ratings' RWA**
Diversification adjustments					
RWA before diversification		21,077,161		17,228,802	100
Total Diversification/Concentration Adjustments		--		6,596,654	38
RWA after diversification		21,077,161		23,825,456	138
		Tier 1 capital	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings' RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		3,869,975	18.4	3,787,452	22.0

Table 4

Basler Kantonalbank Risk-Adjusted Capital Framework Data (cont.)				
Capital ratio after adjustments‡	3,869,975	18.4	3,787,452	15.9

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Other assets includes Deferred Tax Assets (DTAs) not deducted from ACE. ‡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. CHF--Swiss franc. Sources: Company data as of Dec. 31, 2017, S&P Global.

Risk position: Very Sound asset quality, despite some concentrations

We expect BKB's risk position will remain a relative weakness compared with many Swiss Cantonal peers, reflecting its comparably higher single-name concentrations, and a higher share of more cyclical commercial real estate lending. We also take into account an untested track record of managing Bank Cler through the cycle, and its related above-market growth in nationwide residential mortgage lending and SME lending.

We view as supportive of the rating BKB's sound asset quality with prudent underwriting; low-risk collateralized residential mortgage lending and lending to SMEs; and its pronounced progress in improving risk-management systems in recent years. We also acknowledge positively BKB's settlement of and conservative over-provisioning in its legal prosecution by the U.S. tax authorities.

We expect BKB's loan growth will remain between 2%-3%, which is roughly in line with the average of the Swiss banking industry and reflects the bank's cautious approach to mortgage lending and prudent risk management. We believe that limited growth perspectives in its saturated home market are balanced in the medium term by increasing diversification in lower risk countrywide residential mortgage lending and SME lending through its subsidiary Bank Cler. We note, however, that BKB's share in commercial lending--which we generally view as riskier than residential real estate lending--represents about one-third of BKB's loan portfolio. In addition, we observe that single-name concentration in BKB's corporate portfolio is higher than peers'. We estimate that its top-10 corporate loans account for about 10% of its total commercial loan portfolio. Nevertheless, risk arising from BKB's corporate loan portfolio partly reflects the narrowness of Basel-City's economic structure. In addition, we understand that BKB focuses only on high-quality names, and therefore we expect tail-risk will be relatively remote. At the same time, we regard the asset quality of the bank's sizable securities portfolio, which is mainly used for liquidity purposes, as very sound.

Table 5

Basler Kantonalbank Risk Position					
		--Year-ended Dec. 31--			
(%)	**2018***	**2017**	**2016**	**2015**	**2014**
Growth in customer loans	4.6	3.3	2.2	0.4	0.2
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	38.3	29.8	18.3	14.0
Total managed assets/adjusted common equity (x)	10.8	11.1	10.7	10.8	11.2
New loan loss provisions/average customer loans	(0.1)	(0.0)	(0.0)	0.1	0.1
Net charge-offs/average customer loans	N.M.	(0.0)	0.0	(0.0)	0.0
Gross nonperforming assets/customer loans + other real estate owned	N/A	0.1	0.2	0.3	1.0
Loan loss reserves/gross nonperforming assets	N/A	113.8	87.1	51.4	19.3

*Data as of June 30. N/A--Not applicable. N.M.--Not meaningful.

Funding and liquidity: Favorable funding profile from retail deposits and supported by cantonal guarantee

In line with most peers, we believe that BKB's combined funding and liquidity position will remain neutral in our assessment of BKB's stand-alone creditworthiness. We assess BKB's funding as average relative to peers, but consider its liquidity stronger because of its solid base of customer deposits.

BKB's funding is in line with our assessment of low funding risk in the Swiss banking system. The bank's stable core customer deposits account for 65% of its funding base and for 77% of its loan portfolio as of mid-year 2018, which is on top of the comparably large equity position on BKB's balance sheet. We consider the bank's funding to be line with many domestic peers', which is indicated, for example, by our calculation of the bank's stable funding ratio that remained clearly above 100% over the past five years and was 108% as of mid-year 2018. In addition, we continue to consider the bank's core customer deposit base as very stable due to its franchise in its home region and the cantonal guarantee, which we expect will remain in place for the foreseeable future. Moreover, the shareholder and guarantee structure gives BKB access to low-cost, long-term wholesale funding (22% of its total funding base) and the ability to issue covered bonds. Due to the bank's GRE status, we expect both funding sources would remain stable even in more much more challenging economic conditions.

BKB's liquidity will remain a strength, in our view, compared with many banks globally, give than its liquidity position would allow it to endure more than 12 months without access to market funding. This is facilitated by its broad liquid assets to short-term wholesale funding being significantly above 1.0x for the past five years. The ratio was 1.7x as of mid-year 2018. This supports our view that BKB's liquid assets comfortably cover its short-term wholesale funding needs. BKB's solid customer base, superior capitalization, and GRE status will likely help it weather potential capital market stress, in our opinion.

Table 6

Basler Kantonalbank Funding And Liquidity

		--Year-ended Dec. 31--			
(%)	**2018***	**2017**	**2016**	**2015**	**2014**
Core deposits/funding base	65.2	67.1	69.2	69.0	71.3
Customer loans (net)/customer deposits	123.1	118.2	118.5	115.7	112.7
Long-term funding ratio	88.3	89.2	89.3	87.6	87.5
Stable funding ratio	108.3	107.0	108.0	104.6	107.9
Short-term wholesale funding/funding base	13.0	12.0	12.0	13.8	13.8
Broad liquid assets/short-term wholesale funding (x)	1.7	1.6	1.7	1.4	1.6
Net broad liquid assets/short-term customer deposits	13.6	11.6	12.7	7.4	11.4
Short-term wholesale funding/total wholesale funding	37.0	36.0	38.5	44.0	48.2
Narrow liquid assets/3-month wholesale funding (x)	2.4	2.4	2.4	2.3	1.9

*Data as of June 30.

Support: Four notches of uplift for extremely high likelihood of extraordinary government support

We strongly believe that BKB will remain a GRE, and see an extremely high likelihood that BKB would receive timely and sufficient extraordinary support from the Canton of Basel-City if needed. We base our assessment on our view of the bank's:

- Integral link with the canton. We expect the canton will provide considerable and timely credit support to BKB in all circumstances. Our assessment is underpinned by the canton's full ownership of BKB and possession of 100% of the voting rights, as well as its provision of a statutory guarantee for BKB.
- Very important role in the canton, owing to the large impact of BKB's activities on the local economy.

Because of these factors, we incorporate a four-notch uplift into the long-term rating on BKB. We do not envisage that the bank's GRE status or our view of an extremely high likelihood of extraordinary government support will change in the foreseeable future.

BKB benefits from Basel's statutory guarantee, which ultimately covers all of its liabilities as stipulated by law. We note, however, that the guarantee does not ensure timely repayment, as defined by our criteria, but we believe that the canton has strong incentives to help BKB meet its obligations on time, due to the bank's importance to the regional economy.

Hybrid Issue Ratings

Our 'BBB-' ratings on BKB's junior subordinated (additional tier-1 instruments) reflect our analysis of the instruments and our assessment of BKB's SACP at 'a'. We understand that the bonds do not benefit from the cantonal guarantee provided by the City of Basel, and consequently we notch down from our SACP assessment for the bank. We rate BKB's additional tier-1 instruments four notches lower than the SACP, reflecting our deduction of:

- One notch for contractual subordination;
- Two notches for the notes' status as tier-1 regulatory capital; and
- One notch because the instruments allow for the full or partial temporary write-down of the principal amount

We do not apply additional notching beyond the four notches, given that the 5.125% mandatory write-down trigger at BKB level, which we consider to be a nonviability capital trigger. As of Dec. 31, 2017, the relevant common equity tier 1 ratio for the bank was 18.0%, based on RWAs under Basel III.

Related Criteria

- 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
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- 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: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Anchor Matrix

Industry Risk	Economic Risk									
	1	**2**	3	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	**a-**	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of December 14, 2018)	
Basler Kantonalbank	
Issuer Credit Rating	AA+/Stable/A-1+
Junior Subordinated	BBB-
Senior Unsecured	AA+
Issuer Credit Ratings History	
12-Nov-2018	AA+/Stable/A-1+
13-Nov-2017	AA/Positive/A-1+
06-Aug-2013	AA/Stable/A-1+
Sovereign Rating	
Switzerland	AAA/Stable/A-1+
Related Entities	
Basel-City (Canton of)	
Issuer Credit Rating	AAA/Stable/A-1+
Senior Unsecured	AAA

*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.