S&P Global Ratings

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Luzerner Kantonalbank

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Luzerner Kantonalbank

SACP: a+ → **Support: +2** → **Additional factors: 0**

Anchor	a-	
Business position	Adequate	0
Capital and earnings	Very strong	+2
Risk position	Adequate	0
Funding	Adequate	0
Liquidity	Adequate	
CRA adjustment		0

ALAC support	0
GRE support	+2
Group support	0
Sovereign support	0

Issuer credit rating
AA/Stable/A-1+

ALAC--Additional loss-absorbing capacity. CRA--Comparable ratings analysis. GRE--Government-related entity. ICR--Issuer credit rating. SACP--Stand-alone credit profile.

Credit Highlights

Issuer Credit Rating
AA/Stable/A-1+

Overview

Key strengths	Key risks
Close ties with the Canton of Lucerne, facilitated by its majority ownership of the bank and a state guarantee.	Higher lending growth than that of cantonal bank peers, which might lead to additional risk taking.
Very strong capitalization accompanied by low risk costs and negligible nonperforming assets.	Concentration risk in the region of North-Western Switzerland
Strong retail franchise in the Canton of Lucerne.	Reliance on additional Tier 1 (AT1) instruments to support regulatory and S&P Global Ratings' capital ratio buffers.

LUKB's importance to the canton and for the local economy will continue to support its creditworthiness. LUKB has an important role in contributing to the development of canton's economy and benefits from a guarantee. In the event of financial stress, we believe there is an extremely high likelihood that the canton would provide sufficient and timely support to the bank as a default could severely damage the canton's reputation.

Capitalization will continue to be a rating strength. LUKB's risk-adjusted capital (RAC) ratio stood at 16.8% as of Dec. 31, 2020 and we expect it to remain between 15.8%-16.8% over the next 18-24 months. LUKB has been supporting its capitalization buffer with the issuance of AT1 capital and shows a higher proportion (about 20%) of hybrid instruments in total adjusted capital (TAC) than most cantonal peers, which is a relative weakness, but not to the extent that it impacts its overall creditworthiness.

We expect LUKB to show above-average growth rates while adhering to sound risk management and lending standards. LUKB's prudent risk management and cautious lending standards will continue to safeguard the strong asset quality of its loan portfolio. LUKB's portfolio is granular and highly collateralized with an average loan-to-value (LTV) ratio of around 57% as of June 30, 2021.

Outlook

Our stable outlook on LUKB reflects our expectation that the bank will continue to benefit from an extremely high likelihood of support from the Canton of Lucerne in the next two years.

Our ratings on LUKB are sensitive to our assessment of the owner's ability and willingness to support the bank.

Downside scenario

We could lower our issuer credit rating if LUKB's ties with the canton weaken or if there were changes to the canton's state guarantee. Both these scenarios could lead us to reassess the bank's GRE status and the stand-alone credit profile (SACP) and potentially result in a multi-notch downgrade. However, we currently consider this unlikely and, if it happens, we expect LUKB's existing obligations would be grandfathered.

The sensitivity of the rating to a potential downward revision of its SACP remains very limited. However, if we concluded that lending growth had become aggressive, leading to an increased risk profile compared with peers, or to our RAC ratio weakening below 15% in the next 24 months, we could revise down the SACP and consequently lower our issue ratings on Luzerner Kantonalbank's subordinated debt.

We could also revise down the SACP, leading us to lower our hybrid ratings, if the bank's compliance with regulatory capital ratio minimums became increasingly dependent on the issuance of hybrid instruments.

Upside scenario

A positive rating action stemming solely from the improvement of LUKB's SACP is remote over the next two years because we do not expect LUKB to significantly adjust its comparatively concentrated business model.

Key Metrics

Luzerner Kantonalbank--Key Ratios And Forecasts

	--Fiscal year ended Dec. 31 --				
(%)	**2020a**	**2021a**	**2022f**	**2023f**	**2024f**
Growth in operating revenue	6.0	8.9	0.6-0.7	2.7-3.3	2.1-2.6
Growth in customer loans	6.9	6.5	4.9-5.9	5.8-7.0	5.9-7.3
Growth in total assets	14.7	8.4	6.0-7.4	8.1-9.9	7.7-9.4
Net interest income/average earning assets (NIM)	1.0	0.9	0.8-0.9	0.8-0.9	0.8-0.9
Cost to income ratio	52.5	51.0	51.2-53.9	52.2-54.8	52.9-55.6
Return on average common equity	7.2	7.3	7.0-7.7	6.9-7.6	6.7-7.5
Gross nonperforming assets/customer loans	0.2	0.1	0.2-0.2	0.2-0.2	0.0-0.0
Risk-adjusted capital ratio	16.8	N/A	16.4-17.3	15.8-16.6	15.5-16.3

All figures are S&P Global Ratings-adjusted. a--Actual. e--Estimate. f--Forecast. NIM--Net interest margin.

Anchor: 'a-' For Banks Solely Operating In Switzerland

Our anchor for banks operating mainly in Switzerland is 'a-'. We consider the trend for economic and industry risk in Switzerland to be stable.

We view positively the country's very high household income levels, proven stress-resilient corporate sector, and prudent loan underwriting standards and high collateralization of residential mortgage loans in the banking sector--which dominate most banks' customer portfolios.

We also expect that price growth in the owner-occupied real estate segment will remain at moderate levels. However, in our view, the investment property segment remains a particular risk after showing signs of a price correction before the pandemic.

Our view of industry risk in Switzerland encompasses the stability of the domestic banking sector and our expectation that damage from the COVID-19 pandemic will remain negligible. We view positively banks' high capitalization levels in an international comparison, and their low reliance on capital markets for funding. In our view, the Swiss Financial Market Supervisory Authority (FINMA) remains ahead of its peers in terms of both regulatory oversight and innovations.

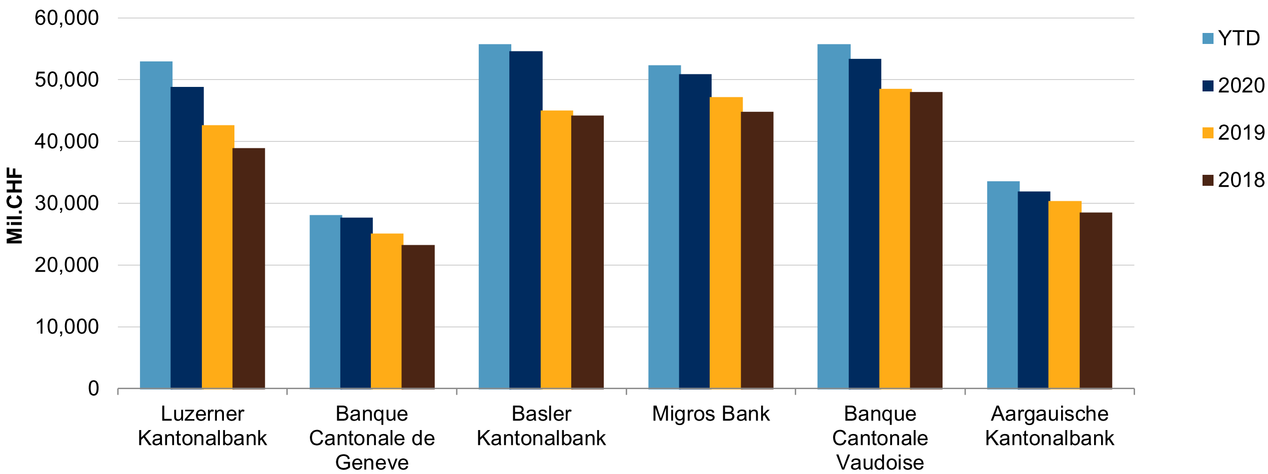
We consider Swiss banks to currently face limited risks from technology disruption given the small size of the market, with high barriers to entry and technologically well-equipped banks.

Business Position: Solid Retail Franchise With Geographical Concentration

Based on LUKB's stable but predominantly regionally focused market position, we consider its business profile on par with that of its domestically focused Swiss peers. LUKB is a midsize cantonal bank with a high market share of about 30% in retail and corporate banking in the canton of Lucerne and its surrounding, financing especially small and midsize enterprises.

Chart 1

LUKB Closing The Gap To Other Midsized Swiss Cantonal Banks
Total assets

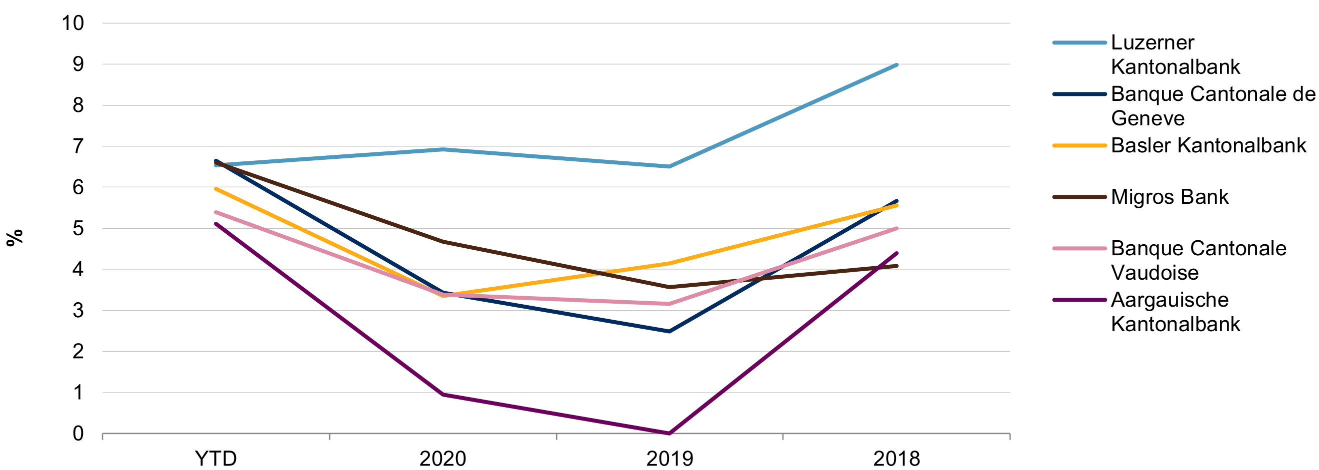


Source: Company filings.

We expect the bank to expand further outside its home canton, focusing mainly on residential mortgage lending. In addition, the bank has been increasingly involved in short-term mortgage financing to real estate funds, which contributes to an above-average balance sheet growth of about 8.4% in 2021. Growth figures are above those of many cantonal bank peers and we note that the bank also intends to substantially increase its business in structured products, so as to become one of the larger players in Switzerland. LUKB is also active in private banking, with its assets under management amounting to Swiss franc (CHF) 37 billion as of December 2021. If strong growth outside the home canton or, more generally, in businesses prone to higher volatility--such as structured products--result in a material increase in its share of volatile revenues, we might reconsider our assessment of its business position.

Chart 2

LUKB With Stronger Loan Growth Than Peer Group
Growth in customer loans

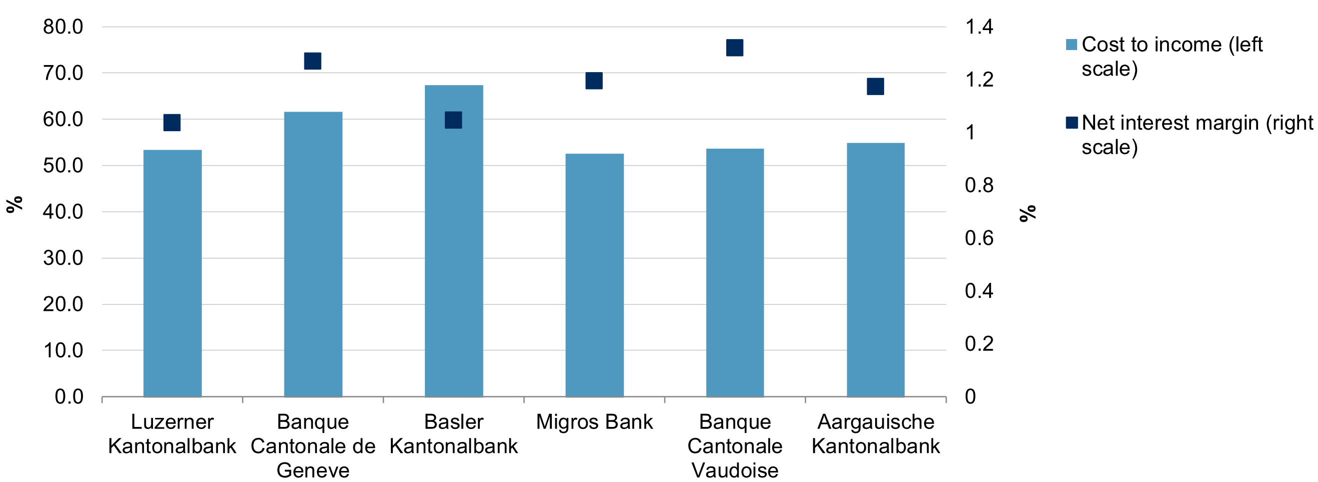


Source: S&P Global Ratings.

With a cost-to-income ratio of 51% (S&P Global Ratings calculation) as of year-end 2021, efficiency is good and in line with cantonal bank peers.

Chart 3

LUKB With Sound Efficiency And Comparable Margins
Cost to income and net interest margin



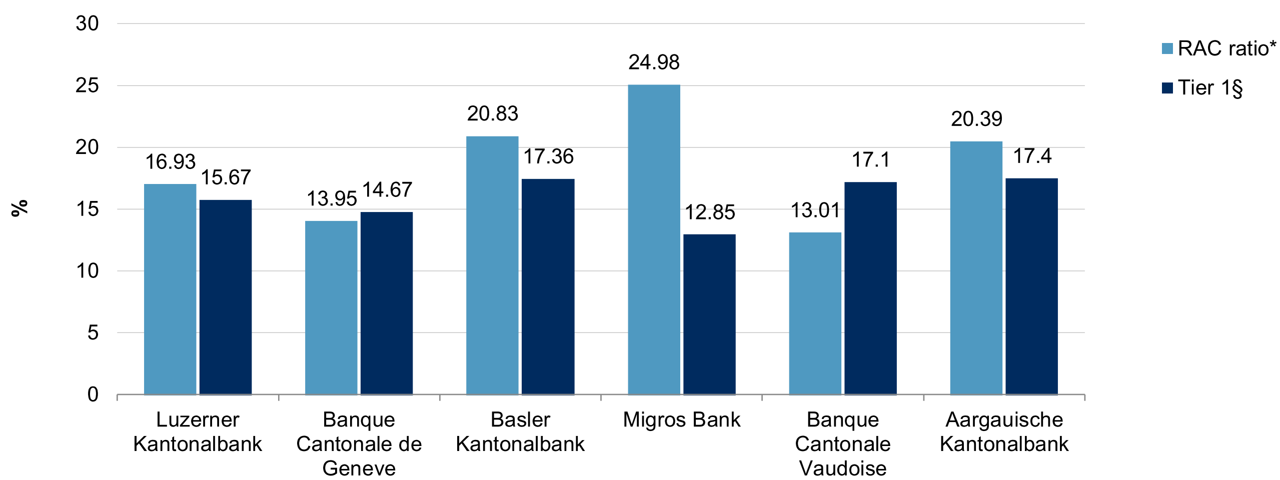
Note: Net interest income to average earning assets. Source: S&P Global Ratings.

Capital And Earnings: High Capitalization Remains Rating Strength, But The Bank Relies Increasingly On AT1 Issuances

We assess LUKB's capital and earnings as very strong compared with other banks we rate globally. This is mainly based on our expectation that the bank's RAC ratio will be 15.8%-16.8% in the next 18-24 months (compared with 16.8% at year-end 2020). We expect a moderate increase in the bank's risk-weighted assets and customer loan growth, which will offset the impact of internal capital generation.

Chart 4

LUKB's High Capital Ratios Places It Well In Peer Group
S&P Global Ratings risk-adjusted capital versus Tier 1 ratios



*As of Dec. 2020. §as of Jun. 30, 2021. Source: S&P Global Ratings.

LUKB has been supporting its capitalization buffer with the issuance of AT1 capital instruments, most recently CHF200 million in March 2021. We fully recognize that amount in the TAC, our base for calculating our RAC ratio. In our view, its planned capital increase of CHF500 million in 2023 by the canton is beneficial for supporting the bank's future growth.

We project LUKB's three-year average earnings buffer, which measures the capacity for a bank's earnings to cover normalized losses, will reduce to around 0.7% (an earnings buffer of about 1.0% indicates adequate earnings capacity). Still, this figure is only slightly below the average for the cantonal banks we rate and does not impact our assessment of the bank's capital and earnings.

Risk Position: Accelerated Lending And Asset Management Business But Still Strong Risk Metrics

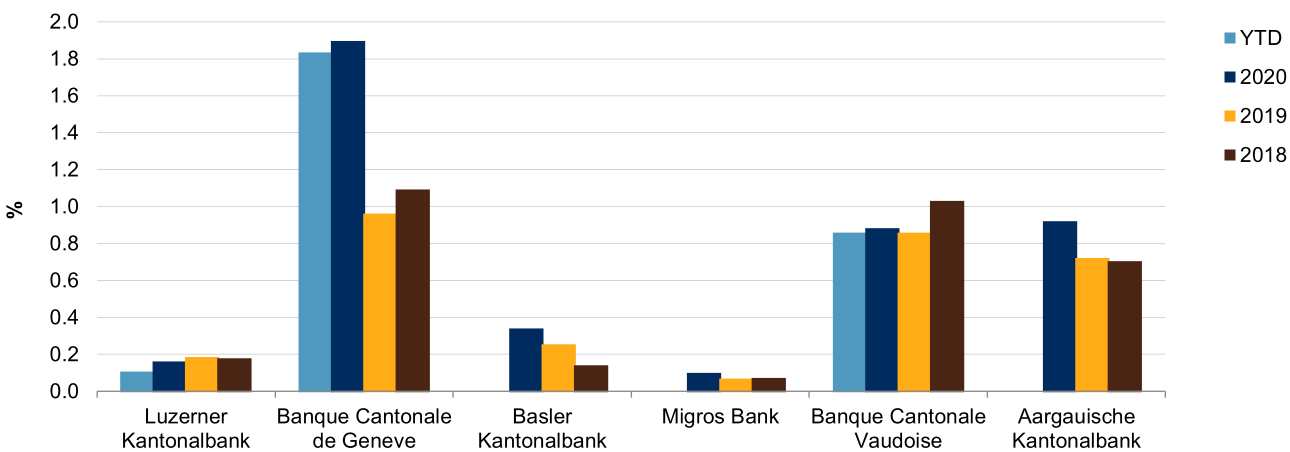
We estimate that LUKB's customer lending will increase by about 5%-6% in 2022, slightly higher than the market's average pace. This continues the trend of recent years. The bank reported one of the quickest increases in its balance sheet among Swiss banks in 2021, predominantly driven by mortgage-secured products granted both inside and outside the canton. Nevertheless, we believe LUKB's underwriting standards have not been compromised by the attraction of new business.

The loan book is dominated by residential real estate loans, which, as of June 30, 2021, accounted for over 70% of the loan portfolio and expose the bank to material concentration risk. We note, however, that the mortgage portfolio is granular and highly collateralized, with an average loan-to-value ratio of about 57% as of first-half 2021, partly mitigating the concentration risk. Also, we note that the number of loans for residential properties originating outside the canton now exceed 25% of the total residential financing portfolio, which mitigates the bank's regional concentration.

Chart 5

LUKB Showing Very Low Non-Performing Exposure In Peer Comparison

Nonperforming assets* (%)



*Adjusted nonperforming assets/customer loans + other real estate owned. Source: S&P Global Ratings.

Like other Swiss banks, LUKB remains exposed to risks related to a potential correction in Swiss residential real estate markets, which we do not consider imminent.

LUKB's participation in syndicated corporate loans, representing less than 5% of total loans, exposes it to somewhat higher credit risk. However, we acknowledge LUKB's selective participation in this type of lending, and its adherence to sound underwriting standards.

We expect the bank to further accelerate its structured products business, potentially broadening its earnings base. While LUKB aims to target predominantly institutional clients, it might also become a source of additional litigation risk in the future.

We consider LUKB's nonperforming exposures to total customer loans of 0.1% to be very low, even compared with other cantonal banks.

Funding And Liquidity: Strong Retail Deposit Franchise With Higher Reliance On Wholesale Funding Than Most Peers

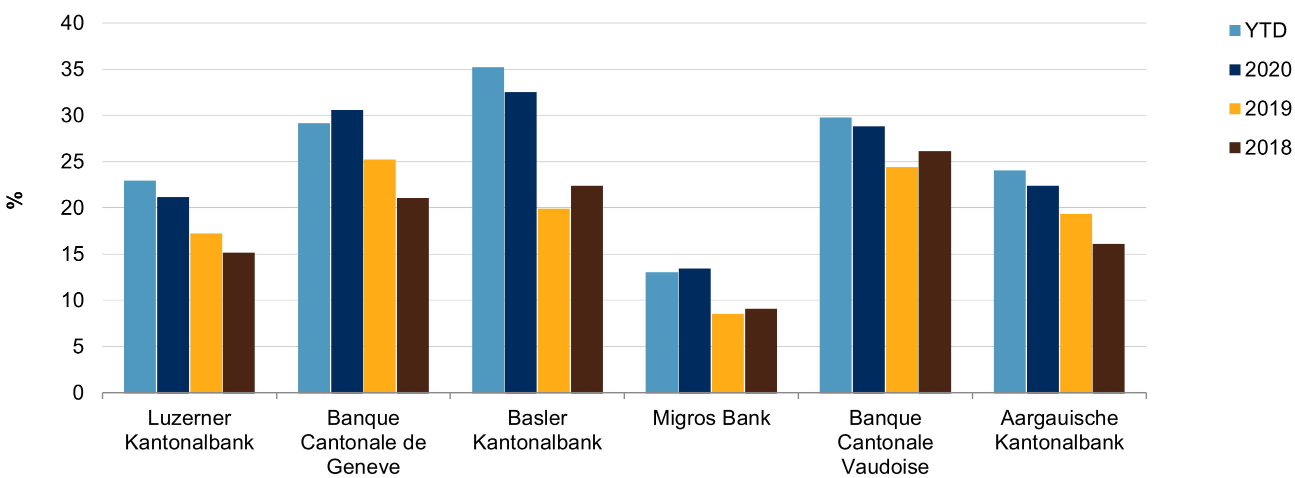
We view LUKB's customer deposit base as stable given the bank's strong franchise, supported by the state guarantee for its senior liabilities. Our stable funding ratio for LUKB increased to about 110% in 2021, which is in line with the peer average.

At the same time, customer deposits' share of LUKB's overall funding base has been declining over the last few years and amounted to 67% at year-end 2021 due to a higher share of hybrid instruments. We expect the funding structure will remain similar in the next 24 months, including about 15% of short-term wholesale refinancing.

Chart 6

LUKB With Lower Share Of Customer Deposits Compared To Cantonal Bank Peers

Customer loans (net)/customer deposits (%)



Source: S&P Global Ratings.

Our liquidity ratio was 1.7x for the same period, indicating a good buffer to cover short-term wholesale funding by broad liquid assets. We expect LUKB will tightly manage its liquidity by placing excess liquidity (repurchase transactions with securities lending) at the Swiss National Bank. Therefore, we don't expect ratios will increase materially. Importantly, we also factor some intrinsic advantages from the cantonal ownership and guarantee into the bank's SACP. We note that the cantonal backbone improves availability and lowers the cost of market funding for the bank.

Support: Two Notches Of Uplift

We consider LUKB a government-related entity. The long-term rating on LUKB is two notches above the SACP, reflecting our view that there is an extremely high likelihood of timely and sufficient extraordinary support from its major stakeholder, the Canton of Lucerne. This view is mainly supported by LUKB's importance to the regional economy of the Canton of Lucerne and the state guarantee, provided by law.

We expect the canton to maintain the existing guarantee for the medium term. Beyond our outlook horizon, we see a risk that future agreements between Switzerland and the EU regarding preferential market access for Switzerland might include the removal of the remaining guarantees for all cantonal banks.

Environmental, Social, And Governance

ESG Credit Indicators

E-1	**E-2**	E-3	E-4	E-5	S-1	**S-2**	S-3	S-4	S-5	G-1	**G-2**	G-3	G-4	G-5

ESG credit indicators provide additional disclosure and transparency at the entity level and reflect S&P Global Ratings' opinion of the influence that environmental, social, and governance factors have on our credit rating analysis. They are not a sustainability rating or an S&P Global Ratings ESG Evaluation. The extent of the influence of these factors is reflected on an alphanumerical 1-5 scale where 1 = positive, 2 = neutral, 3 = moderately negative, 4 = negative, and 5 = very negative. For more information, see our commentary "ESG Credit Indicators: Definition And Applications," published Oct. 13, 2021.

ESG factors have an overall neutral influence on our credit rating analysis of LUKB. The cantonal bank's franchise and mandate are focused on providing basic services to the canton's population and supporting economic development in the region. Also, the bank intends to reduce its carbon footprint by 2025 in line with the canton's climate strategy. However, these environmental and social factors are only marginally supportive of our credit rating analysis.

Hybrids

Our 'A-' rating on LUKB's Tier 2 subordinated bond issuance reflects our analysis of the instrument and our assessment of LUKB's SACP at 'a+'. We understand that the subordinated debt is specifically excluded from the state guarantee granted by the Canton of Lucerne, and consequently we notch down from the bank's SACP. The issue ratings are two notches below our SACP assessment for LUKB: one notch for the instruments' subordination and one notch for their contingent capital clause.

Our 'BBB' issue rating on LUKB's AT1 capital notes similarly reflects our analysis of the proposed instrument and LUKB's SACP. We consider that the bank's majority shareholder, the Canton of Lucerne, would not support payments on those issued notes. The issue rating stands four notches below the SACP, due to the following deductions:

- One notch for contractual subordination;
- Two notches reflecting the notes' regulatory Tier 1 capital status; and
- One notch because the notes contain a contractual write-down clause if extraordinary support were provided to LUKB.

Key Statistics

Table 1

Luzerner Kantonalbank--Key Figures					
	--Fiscal year end Dec. 31--				
(Mil. CHF)	2021	2020	2019	2018	2017
Adjusted assets	52,804.9	48,697.9	42,493.1	38,761.0	35,881.6
Customer loans (gross)	37,229.0	34,945.8	32,684.0	30,687.6	28,157.8
Adjusted common equity	2,943.4	2,834.4	2,759.3	2,663.6	2,568.3
Operating revenues	582.4	534.6	504.4	491.0	475.1
Noninterest expenses	297.2	280.6	260.7	261.1	258.4
Core earnings	246.4	214.0	204.9	194.1	183.2

CHF--Swiss franc.

Table 2

Luzerner Kantonalbank--Business Position					
	--Fiscal year end Dec. 31--				
(%)	2021	2020	2019	2018	2017
Total revenues from business line (currency in millions)	582.4	539.0	504.5	498.6	478.9
Return on average common equity	7.3	7.2	7.3	7.4	7.6

Table 3

Luzerner Kantonalbank--Capital And Earnings					
	--Fiscal year end Dec. 31--				
(%)	2021	2020	2019	2018	2017
Tier 1 capital ratio	N/A	15.8	16.5	15.7	16.1
S&P Global Ratings' RAC ratio before diversification	N/A	16.8	17.4	16.9	18.3
S&P Global Ratings' RAC ratio after diversification	N/A	13.1	13.4	13.2	14.3
Adjusted common equity/total adjusted capital	78.4	79.3	84.4	91.1	90.8
Net interest income/operating revenues	63.9	68.4	69.1	68.7	70.4
Fee income/operating revenues	20.7	19.3	19.7	19.0	18.8
Market-sensitive income/operating revenues	14.3	11.0	10.0	10.8	9.4
Cost to income ratio	51.0	52.5	51.7	53.2	54.4
Preprovision operating income/average assets	0.6	0.6	0.6	0.6	0.6
Core earnings/average managed assets	0.5	0.5	0.5	0.5	0.5

Table 4

Luzerner Kantonalbank RACF [Risk-Adjusted Capital Framework] Data					
(Mil. CHF)	Exposure*	Basel III RWA	Average Basel III RW(%)	S&P Global RWA	Average S&P Global RW (%)
Credit risk					
Government & central banks	7,598	12	0	1	0
Of which regional governments and local authorities	0	0	0	0	0

Table 4

Luzerner Kantonalbank RACF [Risk-Adjusted Capital Framework] Data (cont.)					
Institutions and CCPs	2,978	1,006	34	534	18
Corporate	11,460	8,343	73	7,570	66
Retail	27,564	9,583	35	7,509	27
Of which mortgage	25,009	8,702	35	5,800	23
Securitization§	0	0	0	0	0
Other assets†	294	268	91	292	99
Total credit risk	49,895	19,212	39	15,907	32
Credit valuation adjustment					
Total credit valuation adjustment	--	189	--	0	--
Market Risk					
Equity in the banking book	468	1,417	303	3,131	669
Trading book market risk	--	838	--	1,257	--
Total market risk	--	2,255	--	4,389	--
Operational risk					
Total operational risk	--	953	--	1,007	--
	Exposure	**Basel III RWA**	**Average Basel II RW (%)**	**S&P Global RWA**	**% of S&P Global RWA**
Diversification adjustments					
RWA before diversification	--	22,622	--	21,302	100
Total Diversification/ Concentration Adjustments	--	--	--	6,047	28
RWA after diversification	--	22,622	--	27,350	128
		Tier 1 capital	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		3,576	15.8	3,573	16.8
Capital ratio after adjustments‡		3,576	15.8	3,573	13.1

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' 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.CHF -- Swiss Franc. Sources: Company data as of 'Dec. 31 2020', S&P Global Ratings.

Table 5

Luzerner Kantonalbank--Risk Position					
	--Fiscal year end Dec. 31--				
(%)	**2021**	**2020**	**2019**	**2018**	**2017**
Growth in customer loans	6.5	6.9	6.5	9.0	5.0
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	28.4	29.8	28.3	28.2
Total managed assets/adjusted common equity (x)	18.0	17.2	15.4	14.6	14.0
New loan loss provisions/average customer loans	0.0	0.0	0.0	0.0	0.0
Net charge-offs/average customer loans	N.M.	0.1	0.1	0.0	0.0
Gross nonperforming assets/customer loans + other real estate owned	0.1	0.2	0.2	0.2	0.2

Table 5

Luzerner Kantonalbank--Risk Position (cont.)					
	--Fiscal year end Dec. 31--				
(%)	2021	2020	2019	2018	2017
Loan loss reserves/gross nonperforming assets	597.4	301.0	268.7	307.3	354.2

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

Table 6

Luzerner Kantonalbank--Funding And Liquidity					
	--Fiscal year end Dec. 31--				
(%)	2021	2020	2019	2018	2017
Core deposits/funding base	59.2	57.2	58.9	63.3	68.1
Customer loans (net)/customer deposits	129.6	137.3	143.7	137.3	127.3
Long-term funding ratio	86.1	82.9	85.4	85.9	90.0
Stable funding ratio	110.7	104.3	102.3	100.5	105.2
Short-term wholesale funding/funding base	15.0	18.5	15.8	15.4	10.9
Broad liquid assets/short-term wholesale funding (x)	1.7	1.3	1.2	1.1	1.5
Broad liquid assets/total assets	22.9	21.1	17.1	15.0	15.0
Broad liquid assets/customer deposits	42.3	40.6	32.1	26.2	24.4
Net broad liquid assets/short-term customer deposits	17.1	8.3	5.3	2.0	8.7
Short-term wholesale funding/total wholesale funding	35.3	41.6	37.3	41.0	33.3
Narrow liquid assets/3-month wholesale funding (x)	2.2	1.6	1.4	1.2	1.8

Related Criteria

- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015

Ratings Detail (As Of March 2, 2022)*	
Luzerner Kantonalbank	
Issuer Credit Rating	AA/Stable/A-1+
Junior Subordinated	BBB
Senior Unsecured	AA
Subordinated	A-

Ratings Detail (As Of March 2, 2022)*(cont.)	
Issuer Credit Ratings History	
01-Dec-2014	AA/Stable/A-1+
03-Jul-2012	AA+/Negative/A-1+
12-Sep-2008	AA+/Stable/A-1+
Sovereign Rating	
Switzerland	AAA/Stable/A-1+

*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.