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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	Average	0
Liquidity	Strong	

ALAC Support	0
GRE Support	+2
Group Support	0
Sovereign Support	0

Issuer Credit Rating
AA/Stable/A-1+

Major Rating Factors

Strengths:	Weaknesses:
• Close ties with the Canton of Lucerne, facilitated by its majority ownership of the bank and a statutory guarantee. • Sound financial profile, characterized by very strong capitalization and a low risk appetite. • Strong retail franchise in the Canton of Lucerne.	• Limited regional, business, and earnings diversity. • Concentration risk owing to the focus on real estate lending in the home region. • Pressure on earnings, resulting from the continued low-interest-rates environment while being a public-law joint-stock company.

Outlook: Stable

The stable outlook on Luzerner Kantonalbank (LUKB) reflects S&P Global Ratings' expectation that the likelihood of support to the bank from the Canton of Lucerne will remain extremely high in the next two years. We also expect that LUKB will be able to maintain its sound financial profile over the next 24 months.

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

We could lower the rating if we saw a change in LUKB's role for or link with the canton, or changes in the statutory guarantee, that could lead us to reassess the bank's status as a government-related entity (GRE). However, we currently consider this scenario to be unlikely and would, in such a case, expect LUKB's existing obligations to be grandfathered.

We are unlikely to revise upward our assessment of LUKB's 'a+' stand-alone credit profile (SACP), given the bank's comparatively concentrated business profile.

Rationale

Our ratings on LUKB reflect the 'a-' anchor for banks operating in Switzerland, as well as our assessments of its adequate business position, very strong capital and earnings, adequate risk position, average funding, and strong liquidity. We assess the SACP at 'a+'.

We continue to view LUKB as a GRE with an extremely high likelihood of receiving timely and sufficient extraordinary government support in times of stress. We base this opinion on LUKB's very important role for, and integral link with, its home canton, Lucerne. For this reason, we rate LUKB two notches above our assessment of its 'a+' SACP.

Anchor:'a-' for banks operating only in Switzerland

Our criteria use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating (ICR). Our anchor for a bank operating only or 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 have increased, owing to the cumulative rise in Swiss house prices and domestic lending over past several years. Although these imbalances are still low in a global context, they have also led the regulator to enact macroprudential measures to rein in robust growth in mortgage indebtedness. We recognize that house prices and lending growth have cooled since the beginning of 2014. However, in our view, house prices and household indebtedness remain historically high, in particular when considering the low rate of home ownership in Switzerland. The very high mortgage debt level is mitigated by the large amount of financial assets, including pensions, held by households in Switzerland.

Our industry risk score of '2' primarily reflects the banking sector's stability and a 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 returns on core banking products that are adequate to meet their cost of capital. Moreover, in our view, the Swiss regulator's regulatory initiatives are more stringent than those in other European banking industries.

Table 1

Luzerner Kantonalbank Key Figures

		--Year ended Dec. 31--			
(Mil. CHF)	**2016***	**2015**	**2014**	**2013**	**2012**
Adjusted assets	34,231.3	33,271.5	29,363.8	28,443.7	28,043.8
Customer loans (gross)	26,270.5	25,489.3	24,405.8	23,424.1	22,785.7
Adjusted common equity	2,484.9	2,394.7	2,191.5	2,090.8	2,037.6
Operating revenues	218.3	431.1	451.6	446.6	442.0
Noninterest expenses	118.4	224.5	221.8	221.1	228.8
Core earnings	85.6	178.5	181.5	179.3	175.2

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

Business position: A strong retail banking franchise constrained by geographic concentration

Based on LUKB's stable but regionally focused market position and its conservative management, we consider its business profile to be adequate, in line with our assessment of Switzerland's industry risk.

LUKB is a midsize cantonal bank, and its assets totaled Swiss franc (CHF) 34.2 billion (about €31.5 billion) as of June 30, 2016. It is the leading commercial bank in the region of Lucerne, with a large market share of about 30% in retail and corporate banking, especially in business with small and midsize enterprises. Like most other cantonal banks, we expect LUKB to continue operating mainly in its home region and neighboring cantons, focusing on residential mortgage lending. However, we view LUKB's business concentration, broadly on one Swiss canton, as a rating weakness because it exposes the bank to economic swings in a comparably small economy. We don't expect the bank's narrow business focus and operating region to change in the near future.

On the positive side, thanks to LUKB's reputable brand and a statutory guarantee from the canton, we expect it to continue to enjoy strong customer confidence, reflected in its sustainable revenues dominated by net interest income and its stable deposit base. The net interest income as a portion of the total income amounted to 70.8% in 2015, while about 20% of the income came from fees and commissions. A slightly higher portion of 10% could be assigned to the market-sensitive income. We expect this split to remain at a similar level in the future, as well as some balanced portion of noninterest income to be searched for as compensation in the current low-interest-rate environment.

Furthermore, LUKB is active in private banking; we estimate that its assets under management increased to over CHF16 billion in 2015. LUKB targets mainly affluent clients in the Canton of Lucerne. We expect LUKB's private banking business to further expand organically and to steadily contribute about a quarter of its revenues. While this will result in revenue diversification--which we assess as slightly more positive than other Swiss cantonal banks--we don't believe this activity will offset our view of regional and business concentration or lift our overall assessment of the bank's business position.

Unlike most cantonal banks, LUKB is a public-law joint-stock company. We believe the Canton of Lucerne will maintain its majority stake in LUKB at the current 61.5%, as stated in its shareholder strategy. Consequently, we believe that the stable shareholder structure will provide the bank with continuous business stability. At the same time, however, LUKB's legal and ownership structure means that it experiences slightly more pressure to report reasonable returns on equity to satisfy its owners. Given that fact, we will monitor how LUKB operates to achieve satisfactory dividends to its shareholders over the next years, as we expect the prolonged low interest rate environment to continue putting pressure on earnings. Nevertheless, we generally believe that the management will maintain its prudent and conservative underwriting standards, despite significant and increasing competition also from the nonbanks, such as insurance companies, in the canton. The conservative new business approach will, in our view, allow LUKB to preserve its sound financial position.

In addition, we expect the management to proactively follow industry trends regarding digitalization and standardization to maintain and improve the bank's business standing over the next few years. A solid example is the recently announced transformation and digitalization strategy for 2016-2020. This further supports our assessment of LUKB's business position as adequate.

Table 2

Luzerner Kantonalbank Business Position					
		--Year ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Loan market share in country of domicile	2.3	2.3	2.2	2.2	2.3
Deposit market share in country of domicile	1.9	1.9	1.8	1.9	2.0
Total revenues from business line (mil. CHF)	218.3	445.4	451.7	446.6	445.5
Commercial & retail banking/total revenues from business line	87.8	89.1	88.2	87.3	89.9
Other revenues/total revenues from business line	12.2	10.9	11.8	12.7	10.1
Return on equity	7.0	7.5	8.1	8.1	8.2

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

Capital and earnings: Very strong capital remains the key rating strength

We assess LUKB's capital and earnings as very strong, compared with the banks we rate globally. This is mainly based on our expectation that the bank's risk-adjusted capital ratio will remain at 18.5%-19.0% in the next 18-24 months, compared with 18.1% at year-end 2015. The most recent increase in the capital levels compared with our previous forecast follows the equity content recognition of the two recently issued five-year additional Tier 1 (AT1) hybrid capital instruments, each with a CHF130 million notional. The first was issued in March 2015, and the second in March 2016.

LUKB's regulatory core tier-1 ratio equaled 15.8% as of June 30, 2016, and its leverage ratio was 7.2%. We consider these measures to be comparable with other Swiss cantonal banks. We understand that solid capitalization remains one of LUKB's strategic targets, and we believe that the canton remains supportive of keeping LUKB's capital at the current level. We expect LUKB to maintain its 50% dividend payout ratio and to preserve sufficient internal capital generation to finance loan growth. We understand, however, that, unlike other cantonal banks, LUKB faces constraints in its ongoing build-up of capital, because it needs to provide its owners with reasonable returns on equity.

We view LUKB's earnings capacity as strong and stable, supporting the bank's very strong capital position over the next few years. We project LUKB's three-year average earnings buffer, which measures the capacity for a bank's earnings to cover normalized losses, at an adequate 85 basis points (bps). Still, this figure is lower than the average for cantonal banks we rate.

Table 3

Luzerner Kantonalbank Capital And Earnings					
		--Year ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Tier 1 capital ratio	15.8	15.4	13.8	14.1	14.1
S&P Global Ratings' RAC ratio before diversification	N.A.	18.1	15.3	18.2	16.6
S&P Global Ratings' RAC ratio after diversification	N.A.	15.0	13.5	15.4	14.5
Adjusted common equity/total adjusted capital	90.5	94.9	100.0	100.0	100.0
Net interest income/operating revenues	70.8	70.4	73.7	72.4	74.9
Fee income/operating revenues	18.2	19.2	18.6	18.1	17.3
Market-sensitive income/operating revenues	9.8	8.8	6.7	8.2	6.9

Table 3

Luzerner Kantonalbank Capital And Earnings (cont.)

		--Year ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Noninterest expenses/operating revenues	54.2	52.1	49.1	49.5	51.8
Preprovision operating income/average assets	0.6	0.7	0.8	0.8	0.8
Core earnings/average managed assets	0.5	0.6	0.6	0.6	0.6

*Data as of June 30. N.A.--Not available.

Table 4

Luzerner Kantonalbank Risk-Adjusted Capital Framework Data

(Mil. CHF)	**Exposure***	**Basel II RWA**	**Average Basel II RW (%)**	**S&P Global Ratings' RWA**	**Average S&P Global Ratings' RW (%)**
Credit risk					
Government and central banks	3,809	14	0	114	3
Institutions	3,308	1,112	34	606	18
Corporate	7,615	6,220	82	5,065	67
Retail	19,567	7,045	36	5,375	27
Of which mortgage	17,949	6,240	35	4,308	24
Securitization§	-	-	-	-	-
Other assets	251	191	76	248	99
Total credit risk	34,549	14,583	42	11,408	33
Market risk					
Equity in the banking book†	167	203	122	1,147	688
Trading book market risk	--	232	--	348	--
Total market risk	--	436	--	1,495	--
Insurance risk					
Total insurance risk	--	--	--	--	--
Operational risk					
Total operational risk	--	816	--	1,061	--
(Mil. CHF)		**Basel II RWA**		**S&P Global Ratings' RWA**	**% of S&P Global Ratings' RWA**
Diversification adjustments					
RWA before diversification	--	15,835	--	13,964	100
Total Diversification/concentration Adjustments	--	--	--	2,819	20
RWA after diversification	--	15,835	--	16,783	120
(Mil. CHF)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings' RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments	--	2,525	15.9	2,525	18.1
Capital ratio after adjustments‡	--	2,525	15.4	2,525	15.0

Table 4

Luzerner Kantonalbank Risk-Adjusted Capital Framework Data (cont.)

*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). CHF--Swiss franc. RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of Dec. 31, 2015, S&P Global Ratings.

Risk position: Focus on residential mortgage lending, but strong risk metrics

The concentration risks in LUKB's lending book to the regional economy and especially to the residential real estate market are mitigated by LUKB's prudent risk management and low risk appetite. These factors are reflected in the high asset quality of its loan portfolio. Even though it slightly accelerated in the first half of 2016, loan growth has been broadly in line with that of peers at about 4%-5% over the recent years. Moreover, despite margin pressure and amid record low interest rates, we expect that LUKB will further expand its lending portfolio, in line with the market, by 4%-5% over the next two years.

The loan book is dominated by residential real estate loans, which, as of Dec. 31, 2015, accounted for over 70% of the loan portfolio and expose the bank to material concentration risk. We see, however, that the mortgage portfolio is granular and highly collateralized, with an estimated average loan-to-value ratio of slightly below 60% for mortgage loans, partly mitigating the concentration risk. Like its domestic peers, LUKB is exposed to risks related to the increase in residential real estate prices. Although we understand that LUKB also finances real estate in the so-called "hot spots" in the area along Lake Lucerne, we expect it to maintain its conservative underwriting practices in mortgage lending.

Consequently, we project LUKB's cost of risk to remain low at 5 bps in the next 18-24 months, given our expectation of a prolonged low-interest-rate environment in Switzerland. The share of nonperforming loans in the total loan portfolio has slightly decreased and we expect it to remain at its current low level of about 30 bps in the next 18-24 months.

LUKB's limited participation in syndicated corporate loans exposes it to higher credit risk. This is partly mitigated by borrowers' generally sound creditworthiness, LUKB's selective participation in this type of lending, and its adherence to conservative underwriting standards. Therefore, we believe that this activity does not provide any significant diversification benefit for LUKB; neither will it deteriorate the risk assessment if it stays at the current magnitude.

LUKB caters to private banking clients in its home canton and neighboring regions following its decision in 2007-2008 to withdraw from international business. Because some of LUKB's clients might have broken U.S. tax laws in the past, the bank provisioned appropriate amounts on its balance sheet in 2013 to account for potential fines and related costs associated with investigations by U.S. tax authorities. Ultimately, it agreed to pay a US$11 million fine in a settlement with the U.S. Department of Justice in 2015. In our view, the company seems to have implemented the necessary means to be able to avoid any serious reputational risks that could significantly influence this part of its business in the future.

Table 5

Luzerner Kantonalbank Risk Position

		--Year ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Growth in customer loans	6.1	4.4	4.2	2.8	4.2

Table 5

Luzerner Kantonalbank Risk Position (cont.)					
		--Year ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Total diversification adjustment / S&P Global Ratings' RWA before diversification	N.A.	20.2	13.4	18.2	14.5
Total managed assets/adjusted common equity (x)	13.8	13.9	13.4	13.6	13.8
New loan loss provisions/average customer loans	0.0	0.0	0.1	0.1	0.0
Net charge-offs/average customer loans	N.A.	0.1	0.0	0.0	0.1
Gross nonperforming assets/customer loans + other real estate owned	0.3	0.3	0.3	0.3	0.3
Loan loss reserves/gross nonperforming assets	233.4	233.4	384.8	456.5	415.0

*Data as of June 30. N.A.--Not available.

Funding and liquidity: A stable funding base, owing to a strong retail franchise

We assess LUKB's funding as average and its liquidity as strong.

We view LUKB's customer deposit base as stable, owing to the bank's strong franchise and the statutory guarantee for its liabilities. Core customer deposits accounted for 70% of its funding base as of June 30, 2016.

The core deposit funds are complemented by wholesale funding, mainly issuance of covered bonds and unsecured bonds. Short-term wholesale funding increased to about 11% of the funding base toward the end of 2015 and in 2016, driven mainly by repo transactions and short-term deposits owed to banks, whereas the respective liquid assets are held in the account at the Swiss National Bank (SNB; the central bank). Nevertheless, we expect LUKB's stable funding ratio according to our internal specifications to remain at a comfortable level of around 105%-110% over 2016-2017. It amounted to 107% as of Dec. 31, 2015. The bank's status as a GRE leads us to expect its wholesale funding sources to remain stable or even benefit from a flight-to-quality effect in more challenging economic conditions.

Our assessment of liquidity as strong mirrors our view of a very favorable liquidity position, which enables LUKB to operate for more than 12 months with no access to market funding, in line with our criteria.

The lower level of our adjusted liquidity ratio (at 1.6x as of 2015 year-end compared with about 4.0x in 2014) results from an increase in short-term wholesale funding. However, the respective liquid assets are mainly held in the account at the central bank. The liquid assets kept at the SNB increased by about CHF2.8 billion compared with 2014, and do not result from additional short-term funding needs for day-to-day activities. We believe Swiss banks are able to earn an additional spread by placing excess liquidity at the SNB within their threshold (equivalent of 20x the minimum reserve at a zero rate on its accounts) under current negative interest rate environment. Thus, we expect LUKB's liquidity ratio to remain at 1.5x-2.0x in 2016-2017.

Furthermore, the excess of net broad liquid assets over short-term wholesale funding remained stable and still covers about 11% of the short-term customer deposits. Notably, the regulatory liquidity coverage ratio that is based on the 30-day time horizon has remained at 120% for several quarters This is significantly above the 70% minimum required by the financial market supervisory authority in Switzerland.

We believe that LUKB's close ties with the Lucerne canton and the canton's statutory guarantee would protect LUKB from exposure to large withdrawals of customer deposits in times of stress. Owing to the loyalty of its customer deposit base, we anticipate that LUKB could cover maturing short-term wholesale debt and keep operating for more than 12 months without access to wholesale funding.

Table 6

Luzerner Kantonalbank Funding And Liquidity

		--Year ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Core deposits/funding base	68.7	70.4	78.3	81.3	77.9
Customer loans (net)/customer deposits	124.8	120.5	118.1	112.2	115.9
Long term funding ratio	88.1	89.7	97.8	97.5	95.4
Stable funding ratio	104.8	107.4	106.9	108.4	107.3
Short-term wholesale funding/funding base	13.0	11.2	2.4	2.7	4.9
Broad liquid assets/short-term wholesale funding (x)	1.4	1.7	4.6	4.8	2.8
Net broad liquid assets/short-term customer deposits	7.9	11.3	11.7	13.0	12.1
Short-term wholesale funding/total wholesale funding	40.6	37.3	11.2	14.3	22.4
Narrow liquid assets/3-month wholesale funding (x)	3.3	2.3	6.0	5.9	3.7

*Data as of June 30.

Support: Extremely high likelihood of extraordinary government support

We consider LUKB to be a GRE. 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, if needed. We base this on our view of the bank's integral link with and very important role for the canton. This view is mainly supported by LUKB's importance to the regional economy of the Canton of Lucerne and the cantonal guarantee, provided by law. We think a default by LUKB would have a significant systemic impact on the local economy. We do not anticipate any change to the bank's current integral link with and very important role for the canton in the medium term.

We believe that the prospect of extraordinary government support for Swiss banks is now uncertain, because Switzerland has implemented several legislative measures in recent years to address the "too big to fail" issue and has established a functioning resolution regime. However, we generally believe that resolution frameworks are less likely to impede the state owners' willingness to provide extraordinary support to GRE banks, including LUKB. Despite the reduced predictability of government support to systemically important commercial banks, however, we expect that the canton's government will remain highly supportive of LUKB. Furthermore, the government has sufficient financial resources to support LUKB.

We don't expect that additional loss-absorbing capacity (ALAC) will result in uplift to our rating on the bank, as we see a resolution scenario for LUKB as unlikely because of its GRE status. Generally, we view the Swiss resolution regime as effective under our ALAC criteria as, among other factors, we believe they contain 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.

The issue ratings

Our issue rating on LUKB's outstanding senior debt guaranteed by the Canton of Lucerne is at the same level as the rating on the bank's unguaranteed issues. Reflecting the specifics of the guarantee, it is not consistent with our criteria to allow rating substitution with the guarantor. Consequently, we rate LUKB's guaranteed senior unsecured debt at the same level as its other senior unsecured debt instruments.

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 bond does not benefit from the cantonal guarantee provided by the Canton of Lucerne, and consequently we notch down from our SACP assessment for the bank. 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 (see paragraphs 83-85 and 90 in our "Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions," published Jan. 29, 2015, on RatingsDirect).

Additional rating factors: None

No additional factors affect the ratings.

Related Criteria And Research

Related Criteria

- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions - July 17, 2013
- Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks - May 04, 2010
- Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions - January 29, 2015
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework - June 22, 2012
- Banks: Rating Methodology And Assumptions - November 09, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions - November 09, 2011
- Bank Capital Methodology And Assumptions - December 06, 2010
- Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Banking Industry Country Risk Assessment: Switzerland, September 2, 2016
- Swiss Confederation 'AAA/A-1+' Ratings Affirmed; Outlook Stable, May 20, 2016

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 September 29, 2016)

Luzerner Kantonalbank	
Counterparty Credit Rating	AA/Stable/A-1+
Counterparty 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	
Swiss Confederation	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.

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