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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 its home region. • Pressure on earnings, resulting from the continued low-interest-rate 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 remote 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 reflecting its sound franchise in its home region; very strong capital and earnings due to having a risk-adjusted capital ratio of about 18%-19% in the next 24 months; adequate risk position; average funding; and strong liquidity. We see LUKB's customer deposit base as loyal and foresee a likely "flight-to-quality" in a stress scenario. 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 of Lucerne. For this reason we rate LUKB two notches above 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 price 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 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)	**2017***	**2016**	**2015**	**2014**	**2013**
Adjusted assets	35,739.0	34,854.9	33,271.5	29,363.8	28,443.7
Customer loans (gross)	27,459.1	26,820.2	25,489.3	24,405.8	23,424.1
Adjusted common equity	2,533.0	2,481.5	2,394.7	2,191.5	2,090.8
Operating revenues	236.1	448.4	431.1	451.6	446.6

Table 1

Luzerner Kantonalbank Key Figures (cont.)

		--Year-ended Dec. 31--			
(Mil. CHF)	**2017***	**2016**	**2015**	**2014**	**2013**
Noninterest expenses	122.7	235.7	224.5	221.8	221.1
Core earnings	96.2	180.0	178.5	181.5	179.3

*Data as of June 30.

CHF--CHF-Swiss Franc. N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

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. Its assets totaled Swiss franc (CHF) 35.7 billion (about €32.6 billion) as of June 30, 2017. It is the leading commercial bank in the region of Lucerne, with a high market share of about 30% in retail and corporate banking, especially 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 regional economy. We don't expect the bank's narrow business focus and operating region to change in the near future, despite the ongoing development of on-line distribution channels for its products.

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 and its stable deposit base. The revenue base is dominated by the net interest income amounting to 71% of total revenues in 2016, while over 18% is from fees and commissions. About 10% of its revenue base is from market-sensitive income. We expect this split to remain, with some slight volatility in market sensitive income driven mainly by customer-related trading.

LUKB is also active in private banking; we estimate that its assets under management increased to over CHF19 billion in 2016. LUKB targets mainly affluent clients in the Canton of Lucerne. We expect LUKB's private banking business to expand organically and to steadily contribute about a quarter of total 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.

We expect management will proactively follow industry trends regarding digitalization and standardization to improve the bank's business standing over the next few years. A solid example is its recently announced transformation and digitalization strategy for 2016-2020.

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, LUKB's legal and ownership structure means that it experiences slightly more pressure to report reasonable returns on equity to satisfy its owners in the prolonged low interest rate environment, which is already putting pressure on earnings. Nevertheless, we generally believe that management will maintain its prudent and conservative underwriting standards, despite significant competition in the canton, including from nonbanks such as insurance companies.

Table 2

Luzerner Kantonalbank Business Position					
		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Loan market share in country of domicile	2.4	2.4	2.3	2.2	2.2
Deposit market share in country of domicile	1.9	1.9	1.9	1.8	1.9
Total revenues from business line (currency in millions)	236.1	452.1	445.4	451.7	446.6
Commercial & retail banking/total revenues from business line	100.0	100.0	89.1	88.2	87.3
Return on equity	7.5	7.4	7.5	8.1	8.1

*Data as of June 30.

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 between 18.0%-19.0% in the next 18-24 months, compared with 18.8% at year-end 2016. LUKB strengthened its capitalization through the issuance of two five-year additional Tier 1 (AT1) hybrid capital instruments in March 2015 and in 2016, each with a CHF130 million notional. We understand that there are no plans for further issuance in the near to mid-term, on the assumption that the regulatory total capital ratio remains in the target corridor of 14%-18% (16.4% as of June, 30 2017). Major changes resulting from our July 2017 RAC criteria amendment are not relevant to LUKB, because it does not clear its derivatives transactions with central counterparties nor do we assign any capital charges related to the credit valuation adjustments. This is because derivatives receivables represent less than 3% of the LUKB's total assets and we expect them to remain below this threshold over the next two years.

LUKB's regulatory tier-1 ratio equaled 15.9% as of June 30, 2017 and we expect it to remain stable over time, given the further capitalization levels of annual profits. The regulatory leverage ratio was 7.6%, well above the regulatory minimum of 3%. 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, allowing some flexibility on the dividend payout ratio. We expect LUKB to maintain its 50%-60% dividend payout ratio over the next two years (55% in 2016) and to preserve sufficient internal capital generation to finance loan growth. We understand, however, that, unlike other cantonal banks, LUKB faces higher constraints in its ongoing build-up of capital, because it needs to provide its private stockholders 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 0.9% (an earnings buffer of about 1.0% indicates adequate earnings capacity). Still, this figure is lower than the average for the cantonal banks we rate.

Table 3

Luzerner Kantonalbank Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Criteria reflected in RAC ratios	N/A	2017 RAC Criteria	2010 RAC Criteria	2010 RAC Criteria	2010 RAC Criteria
Tier 1 capital ratio	15.9	16.5	15.4	13.8	14.1
S&P RAC ratio before diversification	N/A	18.8	18.1	15.3	18.2
S&P RAC ratio after diversification	N/A	14.2	15.0	13.5	15.4
Adjusted common equity/total adjusted capital	90.7	90.5	94.9	100.0	100.0
Net interest income/operating revenues	71.9	71.1	70.4	73.7	72.4
Fee income/operating revenues	18.2	18.4	19.2	18.6	18.1
Market-sensitive income/operating revenues	8.7	9.6	8.8	6.7	8.2
Noninterest expenses/operating revenues	52.0	52.6	52.1	49.1	49.5
Preprovision operating income/average assets	0.6	0.6	0.7	0.8	0.8
Core earnings/average managed assets	0.5	0.5	0.6	0.6	0.6

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

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 and central banks	4,404	0	0	2	0
Institutions and CCPs	2,825	983	35	519	18
Corporate	8,127	6,246	77	5,388	66
Retail	20,687	7,355	36	5,555	27
Of which mortgage	18,967	6,596	35	4,399	23
Securitization§	0	0	0	0	0
Other assets†	242	229	95	239	99
Total credit risk	36,284	14,813	41	11,703	32
Credit valuation adjustment					
Total credit valuation adjustment	--	543	--	0	--
Market risk					
Equity in the banking book	200	228	114	1,499	750
Trading book market risk	--	173	--	260	--
Total market risk	--	402	--	1,759	--
Operational risk					
Total operational risk	--	820	--	1,091	--
(Mil. CHF)		**Basel III RWA**		**S&P Global RWA**	**% of S&P Global RWA**
Diversification adjustments					
RWA before diversification		16,618		14,552	100

Table 4

Luzerner Kantonalbank RACF [Risk-Adjusted Capital Framework] Data (cont.)				
Total Diversification/Concentration Adjustments	--		4,798	33
RWA after diversification	16,618		19,351	133
(Mil. CHF)	**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global RAC ratio (%)**
Capital ratio				
Capital ratio before adjustments	2,742	16.5	2,742	18.8
Capital ratio after adjustments‡	2,742	16.5	2,742	14.2

*Exposure at default. §Securitisation Exposure includes the securitisation 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, 2016, S&P Global.

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, as we believe, still-low risk appetite. These factors are reflected in the high asset quality of its loan portfolio. Even though the loan growth accelerated to over 5% per year in 2016, we expect it to stay broadly in line with that of peers at about 4%-5% over the next two years.

The loan book is dominated by residential real estate loans, which, as of Dec. 31, 2016, 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. It has an estimated slightly decreasing average loan-to-value ratio of about 58.5% for mortgage loans as of March 2017, partly mitigating the concentration risk. Also, we note a slowly increasing trend of loan origination for residential properties outside the canton exceeding 20% of the total residential financing portfolio in early 2017. 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 where property prices are booming, around Lake Lucerne, we expect it to maintain its conservative risk profile practices.

Consequently, we project LUKB's cost of risk to remain low at 5 basis points (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 been continuously decreasing since 2014 and amounted to 0.2% as of June 30, 2017. We expect it to slightly increase but remain low at about 0.2%-0.3% in the next 18-24 months.

LUKB's participation in syndicated corporate loans, representing less than 5% of total loans as of June 30, 2017, exposes it to somewhat 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 sound underwriting standards. That said, we believe that this activity does not provide any significant diversification benefit for LUKB.

LUKB caters to private banking clients in its home canton and neighboring regions following its decision in 2007-2008 to withdraw from international business. We note that the bank settled its litigation issues with the U.S. Department of Justice in 2015 and, in our view, LUKB seems to have implemented the necessary means 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--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Growth in customer loans	4.8	5.2	4.4	4.2	2.8
Total diversification adjustment / S&P RWA before diversification	N/A	33.0**	20.2	13.4	18.2
Total managed assets/adjusted common equity (x)	14.1	14.0	13.9	13.4	13.6
New loan loss provisions/average customer loans	0.0	0.0	0.0	0.1	0.1
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	0.2	0.2	0.3	0.3	0.3
Loan loss reserves/gross nonperforming assets	305.3	305.3	233.4	384.8	456.5

*Data as of June 30. **The increase results mainly from the revised concentration factor parameters implemented under our updated risk-adjusted capital criteria published on July 20, 2017. N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

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 68% of its funding base as of June 30, 2017.

The core deposit funds are complemented by wholesale funding, mainly issuance of covered bonds and unsecured bonds. Following the significant increase in 2015, short-term wholesale funding remained stable at about 11% of the funding base over 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). Nevertheless, we expect LUKB's stable funding ratio according to our internal specifications to remain at a comfortable level of around 105%-110% over 2017-2018. It amounted to 108% as of Dec. 31, 2016.

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 S&P Global Ratings-adjusted liquidity ratio of 1.7x at the end of both 2015 and 2016 (from 4.6x in 2014) results from an increase in short-term wholesale funding, not related to day-to-day activities. We observe that the Swiss banks are able to earn an additional spread by creating and placing excess liquidity at the SNB within their threshold (equivalent to 20x the minimum reserve at a zero rate on its accounts) under current negative interest rate environment. As a result LUKB's cash position placed at the SNB amounted to about CHF4.3 billion in December 2016 and we expect LUKB to continue the repo transactions reflected in liquidity ratio in the range of 1.5x-2.0x over 2017-2018.

Furthermore, the excess of net broad liquid assets over short-term wholesale funding remained stable and still covers about 11%-12% of the short-term customer deposits. Notably, the regulatory liquidity coverage ratio that is based on the 30-day time horizon has remained over 120% for several quarters. This is significantly above the 80% minimum required in 2017 by the financial market supervisory authority in Switzerland.

We believe that owing to LUKB's close ties with the Canton of Lucerne and the canton's statutory guarantee, LUKB would benefit from "flight-to-quality" in more challenging economic conditions.

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--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Core deposits/funding base	68.3	69.2	70.4	78.3	81.3
Customer loans (net)/customer deposits	124.1	123.1	120.5	118.1	112.2
Long term funding ratio	90.5	90.1	89.7	97.8	97.5
Stable funding ratio	108.3	107.8	107.4	106.9	108.4
Short-term wholesale funding/funding base	10.4	10.8	11.2	2.4	2.7
Broad liquid assets/short-term wholesale funding (x)	1.8	1.7	1.7	4.6	4.8
Net broad liquid assets/short-term customer deposits	12.6	11.9	11.3	11.7	13.0
Short-term wholesale funding/total wholesale funding	31.9	34.3	37.3	11.2	14.3
Narrow liquid assets/3-month wholesale funding (x)	2.7	1.8	2.3	6.0	5.9

*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.

LUKB benefits from the Canton of Lucerne's statutory guarantee, which ultimately covers all of LUKB's liabilities, However, we note that the guarantee does not explicitly ensure timely repayment, as defined by our criteria. Nevertheless, we believe that the canton has strong incentives to help LUKB meet its obligations on time, owing to the bank's importance to the regional economy and to prevent reputational damage.

We believe that the prospect of extraordinary government support for Swiss banks is 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 cantonal owners' willingness to provide extraordinary support to cantonal banks, including LUKB.

The issue ratings

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.

Significant accounting considerations

Related Criteria

- Risk-Adjusted Capital Framework Methodology, July 20, 2017
- Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions - July 17, 2013
- Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions - January 29, 2015
- Banks: Rating Methodology And Assumptions - November 09, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions - November 09, 2011
- Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Banking Industry Country Risk Assessment Update: October 2017, Oct 4, 2017
- Research Update: Switzerland Ratings Affirmed At 'AAA/A-1+', Outlook Stable, May 19, 2017
- Banking Industry Country Risk Assessment: Switzerland, September 2, 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 October 27, 2017)	
Luzerner Kantonalbank	
Counterparty Credit Rating	AA/Stable/A-1+
Senior Unsecured	AA
Subordinated	A-
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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