

Research Update:

# Luzerner Kantonalbank Affirmed At 'AA', Despite Fast Lending Growth And Volatile Liquidity Buffers; Outlook Stable

November 8, 2019

## Overview

- Luzerner Kantonalbank has been among Switzerland's fastest growing lenders since 2018, relying increasingly on the wholesale market to fuel its expansion and on short-term interbank transactions to improve earnings.
- We are affirming our 'AA/A-1+' ratings on Luzerner Kantonalbank, continuing to base them predominantly on our expectation of an extremely high likelihood the Canton of Lucerne would provide extraordinary support.
- The outlook is stable because we expect the likelihood of support from the canton will remain unchanged in the next two years.

### PRIMARY CREDIT ANALYST

**Michal Selbka**  
Frankfurt  
+49 (0) 69-33999-300  
michal.selbka  
@spglobal.com

### SECONDARY CONTACT

**Anna Lozmann**  
Frankfurt  
(49) 69-33-999-166  
anna.lozmann  
@spglobal.com

## Rating Action

On Nov. 8, 2019, S&P Global Ratings affirmed its 'AA/A-1+' long- and short-term issuer credit ratings on Swiss-based Luzerner Kantonalbank. The outlook is stable.

## Rationale

To mitigate strong margin pressures from persistent historic low interest rates, we estimate that Luzerner Kantonalbank's customer lending will grow by about 7%-8% in 2019, more than doubling the market's average pace. The bank already reported one of the quickest increases in the loan book among Swiss banks in 2018, at about 9%, predominantly driven by mortgage-secured products granted both inside and outside of the canton.

Those developments mean a continuous overshooting of the financial planning in Luzerner Kantonalbank's multiyear strategy, and we have thus also revised our forecasts. We believe that Luzerner Kantonalbank may have been attracting new business by compromising on pricing, but not yet meaningfully on underwriting standards, in our view. We expect loan growth to begin to

moderate to about 4% per year from 2020-2021 only.

In order to defend the return on its equity, Luzerner Kantonalbank expanded its use of short-term funding, now constituting more than 15% of its funding base, versus 10%-11% previously. We have therefore revised our liquidity assessment to adequate from strong. The regulatory LCR remains volatile. It was only 104.2% as of year-end 2018 (against the 100% regulatory minimum from 2019), but improved as of June 2019 to 142.7%. Our stable funding ratio, calculated according to our internal specifications, dropped to about 100% in 2018-2019, with our liquidity ratio falling toward 1.0x-1.1x for the same period. We expect our ratios to improve only slightly in the next two years if the bank's current strategy does not alter.

One of the main drivers explaining the drop in our liquidity ratio is the fact that Luzerner Kantonalbank fully utilizes the possibility of earning an additional spread, by creating and placing excess liquidity (repurchasing transactions with securities lending) at the Swiss National Bank within Luzerner Kantonalbank's maximum threshold at a zero percent rate. In the negative interest rate environment, this allows the bank to earn interest with short-term inter-bank transactions, on the liabilities side of its balance sheet. Another use of liquidity is an increase of short-term mortgage financing, e.g., to real estate funds for their cash flow management.

We note that, since 2018, the bank no longer adheres to its internal 75% minimum level of the so-called "self-financing" ratio of loans coverage by customer deposits that was set in 2010. Luzerner Kantonalbank's overall funding base consisted of about 70% of customer deposits, in accordance with our calculation assumptions, as of year-end 2017. This percentage dropped to 60% by year-end 2018, and we expect it to remain at a similar level in the next 24 months.

Accelerated lending growth leads also to accelerated risk-weighted assets development. Thus, in order to support the decreasing regulatory capital ratio buffers, Luzerner Kantonalbank issued Swiss franc 250 million Tier 1 instruments in May 2019, which we also recognize in our risk-adjusted capital (RAC) ratio calculation. We expect this issuance to support relatively slow organic capital build-up and sustain Luzerner Kantonalbank's RAC ratio in the range of 17.0%-17.5% over the next 24 months, which is at one of the lower levels if compared with other cantonal banks that we rate.

We continue to project the bank's cost of risk will remain low, at or slightly below 5 basis points 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 remained at a stable 0.2% as of June 30, 2019, compared with similarly low levels in 2018-2017. We expect it to slightly increase but remain below 0.3% in the next 18-24 months.

Overall, our reassessment of the liquidity factor has no immediate effect on our ratings on the bank or on our assessment of the bank's stand-alone credit profile (SACP), because we also reflect some intrinsic advantages from cantonal ownership and guarantee in the SACP assessment. We note that the cantonal backbone improves availability and lowers the costs of market funding for the bank, including expected "flight to quality" in case of market stress.

## **Outlook**

The outlook is stable because we expect Luzerner Kantonalbank will continue to benefit from an extremely high likelihood of support from the Canton of Lucerne in the next two years.

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

## Downside scenario

We could lower the issuer credit rating if we saw a weakening in the bank's role for or link with the canton, or changes in the statutory guarantee, both of which could lead us to reassess the bank's status as a government-related entity. Such a scenario could mean a multi-notch downgrade. Otherwise, the sensitivity of the rating level to a potential downward change of our SACP assessment on the bank remains very limited.

We could, however, lower our issue ratings on Luzerner Kantonalbank's subordinated debt if we concluded that lending growth or underwriting had become overall aggressive compared with that of the bank's peers.

We could also lower the hybrid debt ratings if the bank's compliance with regulatory capital ratios minima depended on their issuance. If we saw a risk our RAC ratio would near 15% in the next 24 months, we could also lower the ratings on the hybrids.

## Upside scenario

Ratings upside as regards any ratings on Luzerner Kantonalbank is unlikely, given we are unlikely to revise up our assessment of the 'a+' SACP, owing to the bank's comparatively concentrated business profile. Otherwise, an upgrade would require us to see an even higher support potential coming from the canton, which we also don't see as likely.

## Ratings Score Snapshot

	To	From
Issuer Credit Rating	AA/Stable/A-1+	AA/Stable/A-1+
SACP	a+	a+
Anchor	a-	a-
Business Position	Adequate (0)	Adequate (0)
Capital and Earnings	Very Strong (+2)	Very Strong (+2)
Risk Position	Adequate (0)	Adequate (0)
Funding	Average	Average
and Liquidity	Adequate (0)	Strong(0)
Support	(+2)	(+2)
ALAC Support	(0)	(0)
GRE Support	(+2)	(+2)
Group Support	(0)	(0)
Government Support	(0)	(0)
Additional Factors	(0)	(0)

SACP--Stand-alone credit profile.

## Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, 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
- 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: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Related Research

- Summary: Switzerland, Aug. 23, 2019
- Swiss Cantonal Banks: Ratings As High As The Alps, Jan. 31, 2019
- Luzerner Kantonalbank AG, Dec. 03, 2018
- Banking Industry Country Risk Assessment: Switzerland, Nov. 30, 2018

## Ratings List

### Ratings Affirmed

#### Luzerner Kantonalbank

Issuer Credit Rating	AA/Stable/A-1+
Senior Unsecured	AA
Subordinated	A-
Junior Subordinated	BBB

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