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Luzerner Kantonalbank

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Table Of Contents

Table Of Contents (cont.)

Luzerner Kantonalbank

Ratings Score Snapshot

Issuer Credit Rating
AA/Positive/A-1+

SACP: a → **Support: +3** → **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		-1

ALAC support	0
GRE support	+3
Group support	0
Sovereign support	0

Issuer credit rating
AA/Positive/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

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 many cantonal bank peers, which might lead to higher risk accumulation.
Very strong capitalization and asset quality.	Concentrated in central Switzerland
Strong retail franchise in the Canton of Lucerne.	Material share of additional Tier 1 (AT1) instruments supporting regulatory and S&P Global Ratings' capital ratio buffers.

Support from the Canton of Lucerne due to LUKB's importance for the local economy. LUKB contributes to the development of the canton's economy and benefits from its guarantee. In the event of financial stress, we believe it extremely likely that the Canton will provide sufficient and timely support to the bank, as a default could severely damage its reputation. Extraordinary support from canton leads to a rating uplift three notches above LUKB's 'a' stand-alone credit profile (SACP), resulting in a 'AA' long-term rating.

Dependence on volatile income sources may make LUKB sensitive to market developments but earnings remain resilient for now. We believe investments outside LUKB's home turf, while diversifying its portfolio, may result in higher risks due to fiercer competition with strong banks in those markets. LUKB's risk-adjusted core earnings, measured by core earnings to S&P Global Ratings' risk-weighted assets, were 0.99% as of year-end 2022. This is the lowest of all Swiss cantonal banks, reflecting LUKB's dependence on market-sensitive income.

Capitalization will continue to be a rating strength, although LUKB has become increasingly reliant on hybrid instruments. We expect LUKB's risk-adjusted capital (RAC) ratio to increase to around 17% over the next 18-24 months, driven by the bank's sound earnings retention and its owner's planned capital increase. LUKB supports 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 its cantonal peers. We consider hybrid capital lower quality capital.

Outlook

Our positive outlook on LUKB reflects our view that the bank may benefit from the Cantone of Lucerne's continued improved fiscal performance, potentially increasing the canton's ability and willingness to provide extraordinary support for the bank in times of stress. Over the coming two years, we expect LUKB will continue to benefit from an extremely high likelihood of support from Lucerne.

Upside scenario

We could consider upgrading LUKB over the next two years if we considered the canton's continued improved fiscal performance to materially strengthen its ability and willingness to provide extraordinary support to the bank.

We could revise upward our assessment of the bank's SACP and raise our issue ratings on LUKB's subordinated debt if we concluded that the bank's risk appetite has become more in line peers' or if our RAC ratio became less dependent on the issuance of hybrid instruments. Improvements in LUKB's SACP would not result in us raising the ICR.

Downside scenario

We would consider revising our outlook on LUKB to stable if Lucerne's financial prospects were to wane. We could lower our ICR if LUKB's ties with the canton weakened or if there were changes to the canton's state guarantee, which we deem unlikely for the time being.

Key Metrics

Luzerner Kantonalbank--Key Ratios And Forecasts

	--Fiscal year ended Dec. 31 --				
(%)	**2021a**	**2022a**	**2023f**	**2024f**	**2025f**
Growth in operating revenue	8.9	1.8	1.8-2.2	3.0-3.7	5.1-6.2
Growth in customer loans	6.5	5.7	3.5-4.3	4.4-5.4	5.1-6.3
Growth in total assets	8.4	7.8	3.2-3.9	4.2-5.1	4.7-5.7
Cost to income ratio	51.0	52.1	52.3-55.0	52.9-55.6	51.8-54.5
Return on average common equity	7.3	7.2	6.2-6.9	5.9-6.5	6.2-6.9
Gross nonperforming assets/customer loans	0.1	0.1	0.1-0.1	0.1-0.1	0.0-0.0
Risk-adjusted capital ratio	16.3	16.1	17.4-17.5	17.1-17.2	16.9-17.0

All figures are S&P Global Ratings-adjusted. a--Actual. f--Forecast.

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

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

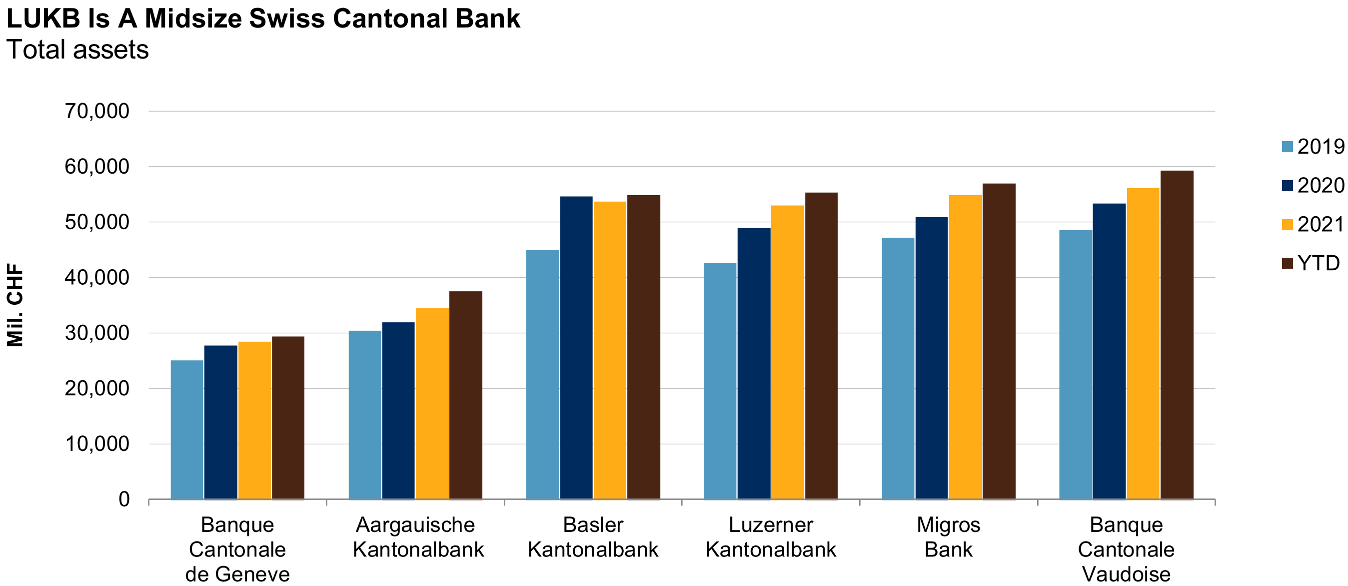
Amid more difficult economic conditions, we expect Swiss banks' asset quality to continue to outperform peers'. This reflects the superior financial strength of Swiss households and corporations, and banks' prudent underwriting standards, which focus on collateralized lending (mainly residential mortgages or Lombard loans). Overall, we see limited risk to Swiss households'debt servicing capacity from rising rates. This is because banks' existing stock of mortgage loans are predominately fixed-rate, with an average of four to six years until their next interest reset date, and underwriting standards already integrate much higher interest rates into affordability assessments. We predict the housing market will continue to beresilient because a sharp house price correction would likely require a steep rise in unemployment.

Our view of industry risk in Switzerland acknowledges the superior stability of the domestic banking sector. Domestic banks can earn their cost of capital despite high competition between local players. Revenue prospects will improve from rising policy rates, though less so than foreign peers. This is because rate hikes are likely to remain moderate in Switzerland and Swiss banks had benefited from the central bank's broad exemption to sight deposits being subject to negative rates. We also see as positive the system's high capitalization and reliance on stable customer deposits for funding. In our view, the Swiss Financial Market Supervisory Authority (FINMA) remains on top of both regulatory oversight and innovations and Swiss banks face limited risks from technology disruption.

Business Position: Solid Retail Franchise With Geographical Concentration And Relatively Higher Lending Growth

Based on LUKB's stable but predominantly regionally focused market position, we consider its business profile on par with that of 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 the surrounding area, financing especially small and midsize enterprises. Over recent years, LUKB's real estate exposure outside its home canton of Lucerne has increased and was about 33% as of March 2022. While this adds to diversification, in our view, these revenues are less stable compared to those from local business.

Chart 1



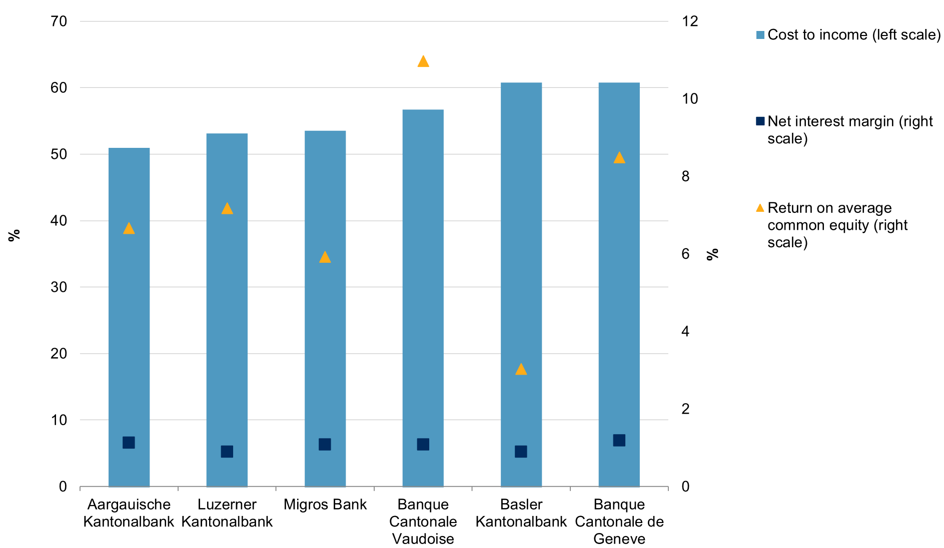
CHF--Swiss Franc. Source: Company filings.

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 over recent years. Total assets were around CHF 57 billion as of Dec. 31, 2022. Growth figures are above those of many cantonal bank peers and we note the bank also intends to substantially increase its business in structured products, aiming to become one of the larger players in Switzerland. This might positively contribute to LUKB's earnings diversification but could become a source of additional operational and litigation risk in the long-run. Since 2018, LUKB has offered structured products to retail clients, issuing a total volume of CHF 1.47 billion as of June 30, 2022. LUKB is also active in private banking, with assets under management amounting to CHF 27 billion as of December 2022. If strong growth outside the home canton or, more generally, in businesses prone to higher volatility--such as structured products--result in a further material increase in share of volatile revenues, we might reconsider our assessment of business position.

The bank has been able to consistently deliver higher levels of return on equity (ROE) compared to peers, reflected positively in our analysis. The bank targets ROE of 7%-12% as part of its new strategy and as of Dec. 31, 2022 ROE stood at 7.18% (S&P Global Ratings' calculation). With a cost-income ratio of 52.06% (S&P Global Ratings' calculation) as of Dec. 31, 2022, efficiency is good and in line with cantonal bank peers. In our view, management has effectively contained costs while pushing for important projects, including digitization, the reshaping of its organization and ESG adoption.

Chart 2

LUKB With Sound Efficiency, Good Returns, And Similar Margins As Peers
Cost to income, net interest margin, and returns on average common equity as of June 30, 2022



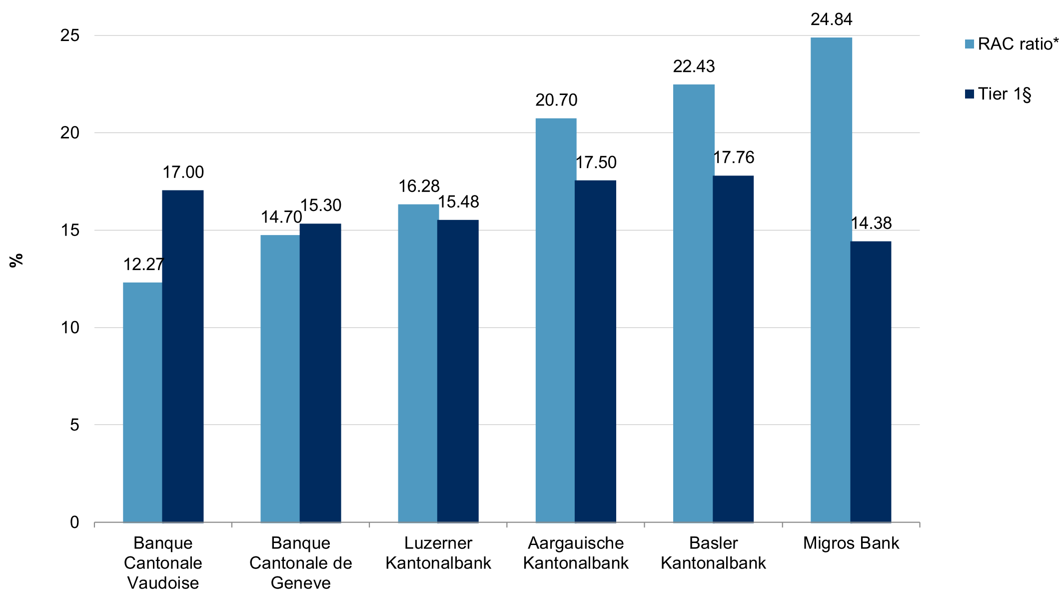
Note: Net interest margin = net interest income to average earning assets. Source: S&P Global Ratings.

Capital And Earnings: High Capitalization Remains Rating Strength, But Increasing Reliance 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 17.0%-17.5% in the next 18-24 months (compared with 16.28% at year-end 2021). The bank has planned a capital increase of up to CHF 500 million, of which 61.5% will be derived from the Canton of Lucerne, supporting our capital forecast for the bank. We expect a moderate increase in the bank's risk-weighted assets and customer loan growth, which will slightly offset the impact of internal capital generation. Total capital ratio as of Dec. 31, 2022, stood at 17.2%, which was in line with the bank's new target of 16%-20%, and well above the FINMA requirement of 12%. LUKB supported its capitalization buffer by issuing CHF 810 million worth of AT1 capital instruments. We fully recognize that amount in the total adjusted capital, our base for the calculation of our RAC ratio.

Chart 3

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



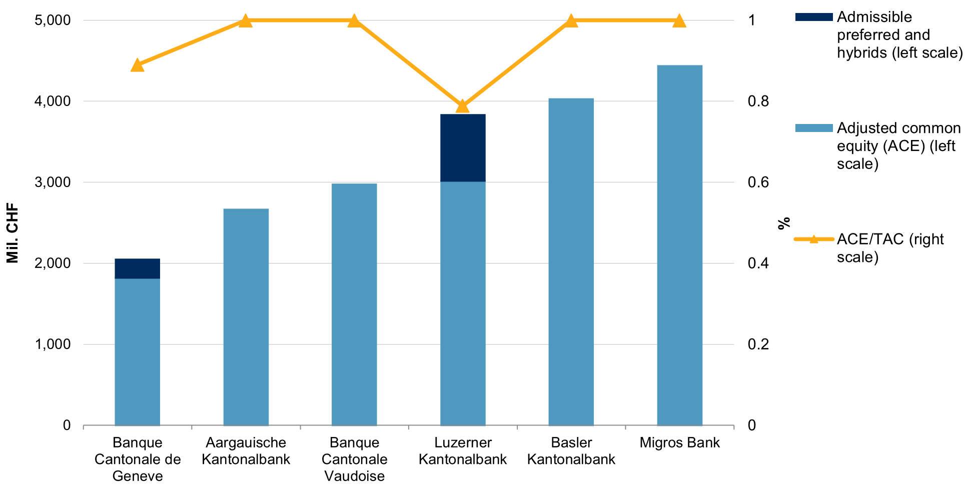
*As of Dec. 31, 2021. RAC--Risk-adjusted capital. §as of Jun. 30, 2022. Source: S&P Global Ratings.

Dividend strategy and pay-out ratio remained unchanged, including the fee paid for the cantonal guarantee. In fiscal year 2021, LUKB paid CHF 106.3 million to its owner and we expect a similar payout in the next 24-36 months.

LUKB supports its capitalization by issuing capital instruments, namely AT1 and Tier 2, and shows a higher proportion (about 21%) of hybrid instruments in TAC than its cantonal peers.

Chart 4

LUKB With A Higher Dependence On Hybrid Capital Instruments
S&P Global Ratings total adjusted capital* (TAC) as of June 30, 2022



*Total adjusted capital = adjusted common equity + admissible preferred and hybrids. Source: S&P Global Ratings.

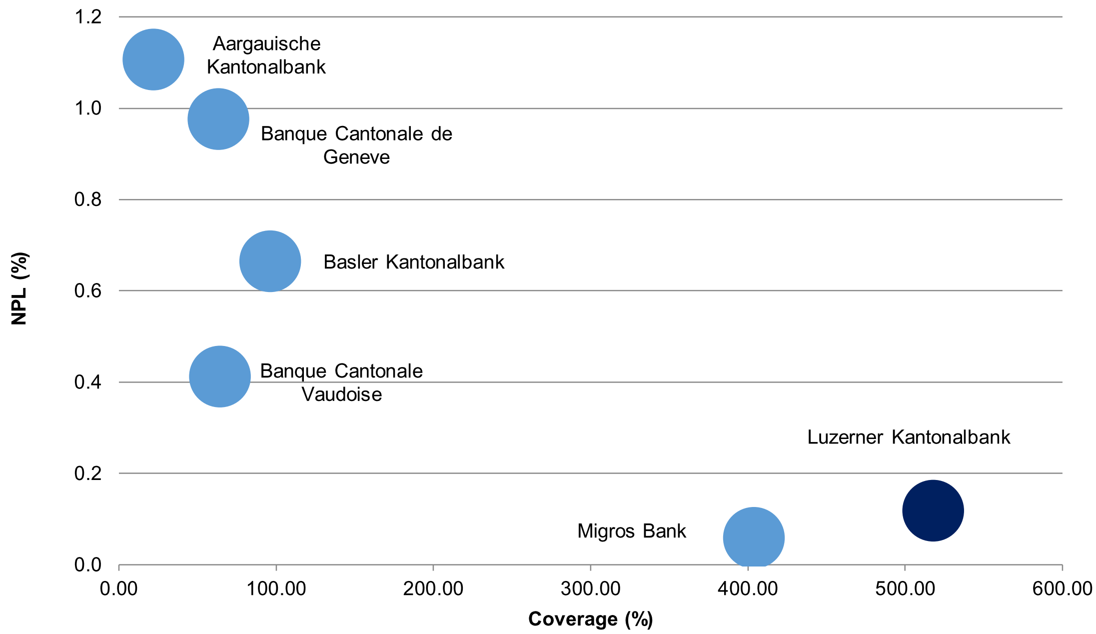
Risk Position: Accelerated Lending And Asset Management Business But Still Strong Risk Metrics

We estimate LUKB's customer lending will increase by about 3.9% in 2023. The bank reported a 5.7% increase in customer loans in 2022, partly driven by mortgage-secured products granted inside and outside the canton. In addition, LUKB entered several real estate projects on its own risk. As demonstrated by the number of new contracts, LUKB is increasingly successful in replacing loans from third parties, based on its competitive and partially predatory pricing structure. We believe LUKB's underwriting standards have not been compromised to attract new business.

The loan book is dominated by residential real estate loans, which, accounts for about 75% of the loan portfolio and exposes 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 55.6% as of Dec. 31, 2021, partly mitigating the concentration risk. Also, we note that the number of loans for residential properties originating outside the canton now exceed 33% of the total residential financing portfolio, which also mitigates the bank's regional concentration.

Chart 5

LUKB With Very Low NPL Exposure And High Coverage In Peer Comparison
Non-performing loans and coverage as of June 30, 2022



NPL--Gross nonperforming assets/customer loans + other real estate owned (%). Coverage--Loan loss reserves/gross nonperforming assets (%). Bubble size represents total assets. 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.

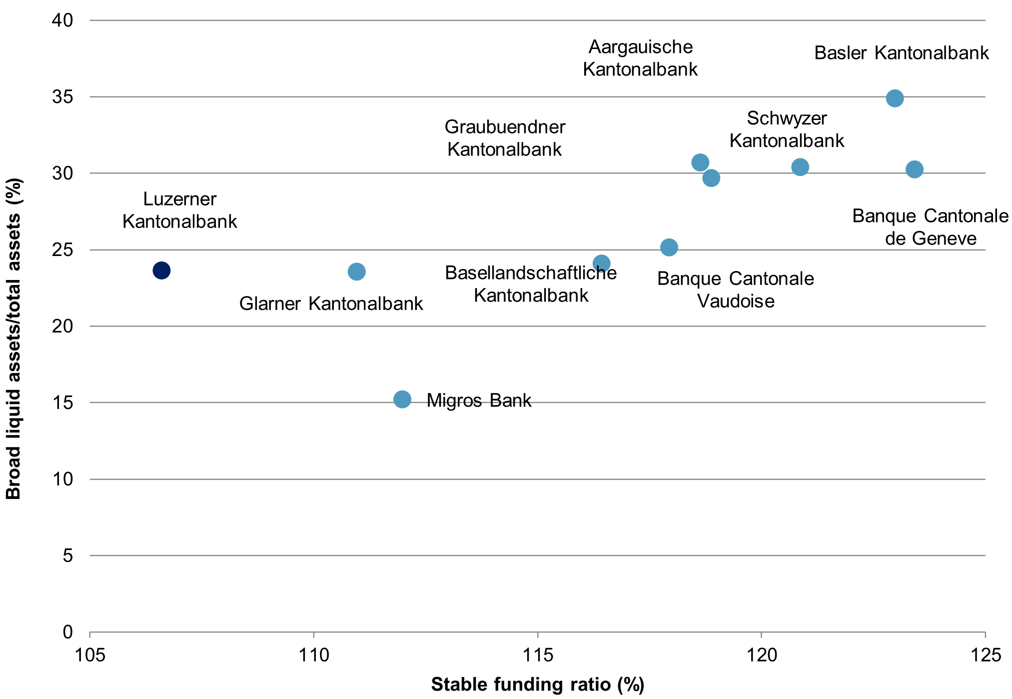
We consider LUKB's non-performing exposure to total customer loans of 0.10% as of Dec. 31 2022, as very low, even in peer comparison with other cantonal banks.

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

We view LUKB's customer deposit base as stable given the bank's strong franchise. Our stable funding ratio for LUKB was at 102.4% as of Dec. 31, 2022, which is in line with the peer average.

Chart 6

Funding And Liquidity Metrics Are Below Peers
Funding and liquidity profile as of June 30, 2022



Source: S&P Global Ratings

At the same time, customer deposits' share of LUKB's overall funding base has declined over the last few years and amounted to 52% as of Dec. 31, 2022 (-7 percentage points compared to 2021), due to a higher share of senior and hybrid instruments. We expect the funding structure will remain similar medium-term, including about one quarter of short-term wholesale refinancing.

Our liquidity ratio (broad liquid assets to total assets) was 23.1% for the same period, indicating adequate liquid assets to withstand a lack of access to wholesale funding for more than 12 months in an adverse scenario. We don't expect ratios will increase materially going forward as LUKB will continue to tightly manage its liquidity. Importantly, we also reflect some intrinsic advantages from the cantonal ownership and guarantee in the bank's SACP. We note that the cantonal backbone improves availability and lowers the costs of market funding for the bank.

Support: Three Notches Of Uplift

We consider LUKB a government-related entity (GRE). The long-term rating on LUKB is three 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 removing 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 to support the economic development in the region. Also, the bank intends to reduce its carbon footprint by the year 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 'BBB+' issue 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 Additional Tier 1 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 is provided to LUKB.

Key Statistics

Table 1

Luzerner Kantonalbank--Key Figures

	--Fiscal year end Dec. 31--				
(Mil. CHF)	**2022**	**2021**	**2020**	**2019**	**2018**
Adjusted assets	56,956	52,804.9	48,697.9	42,493.1	38,761.0
Customer loans (gross)	39,348	37,229.0	34,945.8	32,684.0	30,687.6
Adjusted common equity	3,205	2,943.4	2,834.4	2,759.3	2,663.6
Operating revenues	593	582.4	534.6	504.4	491.0
Noninterest expenses	309	297.2	280.6	260.7	261.1
Core earnings	248	246.4	214.0	204.9	194.1

Table 2

Luzerner Kantonalbank--Business Position

	--Fiscal year end Dec. 31--				
(%)	**2022**	**2021**	**2020**	**2019**	**2018**
Total revenues from business line (currency in millions)	597.0	582.4	539.0	504.5	498.6
Return on average common equity	7.2	7.3	7.2	7.3	7.4

Table 3

Luzerner Kantonalbank--Capital And Earnings

	--Fiscal year end Dec. 31--				
(%)	**2022**	**2021**	**2020**	**2019**	**2018**
Tier 1 capital ratio	N/A	15.7	15.8	16.5	15.7
S&P Global Ratings' RAC ratio before diversification	N/A	16.3	16.8	17.4	16.9
S&P Global Ratings' RAC ratio after diversification	N/A	12.5	13.1	13.4	13.2
Adjusted common equity/total adjusted capital	79.82	78.4	79.3	84.4	91.1
Net interest income/operating revenues	65.83	63.9	68.4	69.1	68.7
Fee income/operating revenues	20.10	20.7	19.3	19.7	19.0
Market-sensitive income/operating revenues	13.12	14.3	11.0	10.0	10.8
Cost to income ratio	52.06	51.0	52.5	51.7	53.2
Preprovision operating income/average assets	0.52	0.6	0.6	0.6	0.6
Core earnings/average managed assets	0.45	0.5	0.5	0.5	0.5

Table 4

Luzerner Kantonalbank--Risk-Adjusted Capital Framework Data

	Exposure*	**Basel III RWA**	**Average Basel III RW(%)**	**S&P Global Ratings RWA**	**Average S&P Global Ratings RW (%)**
Credit risk					
Government & central banks	9,486.1	18.0	0.2	0.9	0.0
Of which regional governments and local authorities	0.0	0.0	0.0	0.0	0.0
Institutions and CCPs	2,927.7	1,014.2	34.6	552.3	18.9

Table 4

Luzerner Kantonalbank--Risk-Adjusted Capital Framework Data (cont.)					
Corporate	11,382.7	8,499.6	74.7	7,516.8	66.0
Retail	30,133.6	10,469.0	34.7	8,574.0	28.5
Of which mortgage	26,557.8	9,217.7	34.7	6,159.3	23.2
Securitization§	0.0	0.0	0.0	0.0	0.0
Other assets†	313.2	292.2	93.3	311.3	99.4
Total credit risk	54,243.3	20,293.1	37.4	16,955.2	31.3
Credit valuation adjustment					
Total credit valuation adjustment	--	97.9	--	0.0	--
Market Risk					
Equity in the banking book	533.8	1,582.6	296.5	3,587.5	672.0
Trading book market risk	--	943.9	--	1,415.9	--
Total market risk	--	2,526.5	--	5,003.4	--
Operational risk					
Total operational risk	--	1,014.1	--	1,097.3	--
	Exposure	**Basel III RWA**	**Average Basel II RW (%)**	**S&P Global Ratings RWA**	**% of S&P Global Ratings RWA**
Diversification adjustments					
RWA before diversification	--	23,946.6	--	23,055.9	100.0
Total Diversification/ Concentration Adjustments	--	--	--	6,931.4	30.1
RWA after diversification	--	23,946.6	--	29,987.3	130.1
		Tier 1 capital	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		3,751.1	15.7	3,753.1	16.3
Capital ratio after adjustments‡		3,751.1	15.7	3,753.1	12.5

*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 2021', S&P Global Ratings.

Table 5

Luzerner Kantonalbank--Risk Position					
	--Fiscal year end Dec. 31--				
(%)	**2022**	**2021**	**2020**	**2019**	**2018**
Growth in customer loans	5.69	6.5	6.9	6.5	9.0
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	30.1	28.4	29.8	28.3
Total managed assets/adjusted common equity (x)	17.78	18.0	17.2	15.4	14.6
New loan loss provisions/average customer loans	-0.00	0.0	0.0	0.0	0.0
Net charge-offs/average customer loans	N.M.	0.0	0.1	0.1	0.0
Gross nonperforming assets/customer loans + other real estate owned	0.11	0.1	0.2	0.2	0.2
Loan loss reserves/gross nonperforming assets	522.22	601.4	301.0	268.7	307.3

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

Table 6

Luzerner Kantonalbank--Funding And Liquidity					
	--Fiscal year end Dec. 31--				
(%)	**2022**	**2021**	**2020**	**2019**	**2018**
Core deposits/funding base	52.11	59.2	57.2	58.9	63.3
Customer loans (net)/customer deposits	144.62	129.6	137.3	143.7	137.3
Long-term funding ratio	79.00	85.7	82.9	85.4	85.9
Stable funding ratio	102.36	110.2	104.3	102.3	100.5
Short-term wholesale funding/funding base	22.63	15.5	18.5	15.8	15.4
Broad liquid assets/short-term wholesale funding (x)	1.12	1.6	1.3	1.2	1.1
Broad liquid assets/total assets	23.16	22.9	21.1	17.1	15.0
Broad liquid assets/customer deposits	48.80	42.3	40.6	32.1	26.2
Net broad liquid assets/short-term customer deposits	5.41	16.3	8.3	5.3	2.0
Short-term wholesale funding/total wholesale funding	45.75	36.4	41.6	37.3	41.0
Narrow liquid assets/3-month wholesale funding (x)	1.36	2.0	1.6	1.4	1.2

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- European Housing Prices: A Sticky, Gradual Decline, Jan. 11, 2023
- Luzerner Kantonalbank 'AA' Ratings Affirmed Despite Weaker Stand-Alone Creditworthiness; Outlook Positive, Sep 21, 2022
- Switzerland, Feb. 13, 2023
- Banking Industry Country Risk Assessment: Switzerland, May 30, 2022
- Luzerner Kantonalbank Outlook Revised To Positive On The Canton's Improved Fiscal Performance; Ratings Affirmed, May 24, 2022

Ratings Detail (As Of March 14, 2023)*	
Luzerner Kantonalbank	
Issuer Credit Rating	AA/Positive/A-1+
Junior Subordinated	BBB-
Senior Unsecured	AA
Subordinated	BBB+
Issuer Credit Ratings History	
24-May-2022	AA/Positive/A-1+
01-Dec-2014	AA/Stable/A-1+
03-Jul-2012	AA+/Negative/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.