

Research Update:

Switzerland-Based Luzerner Kantonalbank Upgraded To 'AA+' On The Canton's Improved Fiscal Performance; Outlook Stable

June 5, 2024

Overview

- In our view, Luzerner Kantonalbank's (LUKB's) credit quality benefits from its status as a government-related entity with an extremely high likelihood of receiving support from its majority owner and guarantor, the Canton of Lucerne.
- The canton's financial performance has improved, indicating a stronger ability to support LUKB, if needed.
- We therefore raised our long-term issuer credit rating on LUKB to 'AA+' from 'AA' and affirmed our 'A-1+' short-term rating on the bank.
- The stable outlook reflects our expectation that LUKB will continue to benefit from an extremely high likelihood of support from the Canton of Lucerne in the next two years.

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Rating Action

On June 05, 2024, S&P Global Ratings raised its long-term issuer credit rating on Switzerland-based Luzerner Kantonalbank (LUKB) to 'AA+' from 'AA'. The outlook is stable. At the same time, we affirmed our 'A-1+' short-term issuer credit ratings on LUKB.

In addition, we raised to 'AA+' our issue ratings on LUKB's senior unsecured debt and affirmed our ratings on the bank's subordinated and junior subordinated debt.

Rationale

The upgrade follows the canton's improved ability to support Luzerner Kantonalbank (LUKB) in times of stress. LUKB benefits from its high stand-alone creditworthiness in conjunction with its owner, the Canton of Lucerne. The canton received stronger-than-expected tax revenue, thereby improving its financial headroom and enabling it to maintain excellent financial performance over

the coming two years. We assume that the canton's enduring stronger fiscal performance suggests that it is better placed to support LUKB in times of stress, prompting us to widen the rating uplift for extraordinary support to four notches from three above our 'a' stand-alone credit profile (SACP) for LUKB. This leads to a 'AA+' long-term rating on the bank.

We expect LUKB to maintain its integral link and very important role for the Canton of Lucerne.

We continue to consider LUKB to be a government-related entity (GRE). LUKB has a very important role in contributing to the development of the canton's economy and an integral link to the canton, including benefitting from a cantonal guarantee. We think that, in the event of financial stress at LUKB, there is an extremely high likelihood that the canton would provide sufficient and timely support to the bank, since a default could severely damage the canton's reputation.

Our view of LUKB's intrinsic creditworthiness is unchanged. We expect LUKB's SACP to reflect the bank's strong regional franchise in the canton and the surrounding area, where it enjoys a market share of about 30% in retail and corporate banking. Furthermore, it is underpinned by the bank's high capitalization, its key rating strength. We forecast LUKB's risk-adjusted capital (RAC) ratio will hover at 18.5%-19.5% over the next 18-24 months, compared with 19.1% at end-2023, supported by the bank's sound earnings retention and its owner's capital injection of Swiss franc (CHF) 488 million in 2023. Our projection is underpinned by LUKB's stable profitability; we project a 6.0%-7.5% return on equity (ROE) until 2025, from 7.5% at end-2023. That appears relatively low in an international comparison, mainly due to the bank's high capitalization. Although LUKB's sound underwriting focused on low-risk collateralized lending translates into sound asset quality metrics on par with peers', we continue to apply a negative comparable adjustment notch in our SACP to capture the bank's somewhat higher-risk appetite towards commercial real estate and its more aggressive financial policy in terms of reliance on hybrid capital and wholesale funding.

Outlook

Our stable outlook reflects our expectation that LUKB will continue to benefit from an extremely high likelihood of support from the Canton of Lucerne over the next two years. Our ratings on LUKB are sensitive to our assessment of the canton'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. We currently consider both these scenarios very unlikely. If either were to occur, we assume LUKB's existing obligations would be grandfathered. Also we could lower the rating if the canton's financial prospects and ability to support LUKB were to wane.

We now consider the ratings on LUKB and on the bank's senior unsecured debt to be less sensitive to a downgrade, considering that such an action would hinge on a multi-notch downward revision of its SACP, all other things equal. We view this as unlikely.

However, if we concluded that the bank's lending growth had become overly aggressive, leading to a weaker risk profile than peers', or to a deterioration of our RAC to below 15% in the next 24 months, we could revise down the SACP and consequently lower our ratings on LUKB's hybrid issuances.

Upside scenario

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

Ratings Score Snapshot

	To	From
Issuer Credit Rating	AA+/Stable/A-1+	AA/Positive/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 and liquidity	Adequate and adequate (0)	Adequate and adequate (0)
Comparable ratings analysis	-1	-1
Support	+4	+3
ALAC support	0	0
GRE support	+4	+3
Group support	0	0
Sovereign support	0	0
Additional factors	0	0

SACP--Stand-alone credit profile.

Related Criteria

- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, April 30, 2024
- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- 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: 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

- Luzerner Kantonalbank, March 26, 2024
- Subnational Debt 2024: Switzerland, Resilient Budget Surpluses Should Enable Further Deleveraging, Feb. 29, 2024
- Full Analysis: Switzerland, Feb. 12, 2024
- Banking Industry Country Risk Assessment: Switzerland, Aug. 18, 2023
- LUKB's Capital Increase Supports Capital Buffers And Quality Of Capital, May 26, 2023
- European Housing Prices: A Sticky, Gradual Decline, Jan. 11, 2023
- Luzerner Kantonalbank 'AA' Ratings Affirmed Despite Weaker Stand-Alone Creditworthiness; Outlook Positive, Sept. 21, 2022

Ratings List

Ratings Affirmed

Luzerner Kantonalbank

Subordinated	BBB+
Junior Subordinated	BBB-

Upgraded

	To	From
Luzerner Kantonalbank		
Senior Unsecured	AA+	AA

Upgraded; Outlook Action; Ratings Affirmed

	To	From
Luzerner Kantonalbank		
Issuer Credit Rating	AA+/Stable/A-1+	AA/Positive/A-1+

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