

Research Update:

Luzerner Kantonalbank 'AA' Ratings Affirmed Despite Weaker Stand-Alone Creditworthiness; Outlook Positive

September 21, 2022

Overview

- Luzerner Kantonalbank (LUKB) has been among Switzerland's fastest growing lenders for several years and has moved to new customer activities outside of its traditional area of expertise.
- While this adds to diversification, we think it highlights the bank's somewhat higher risk appetite and results in a lower risk-return profile and higher reliance on wholesale funding compared to domestic peers.
- As such, we apply now a negative comparable ratings analysis (CRA) adjustment when assessing the bank's stand-alone creditworthiness, which results in our downward revision of its stand-alone credit profile (SACP) to 'a' from 'a+'.
- Nevertheless, we affirmed our 'AA/A-1+' long-term and short-term on LUKB, since we base our ratings predominantly on our expectation of an extremely high likelihood of extraordinary support from the Canton of Lucerne.
- The positive outlook reflects LUKB's importance to the canton and that the canton's continued improved fiscal performance may strengthen its ability to provide extraordinary support to the bank, in case of need.

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Rating Action

On Sept. 21, 2022, S&P Global Ratings affirmed its 'AA/A-1+' long- and short-term issuer credit ratings on Luzerner Kantonalbank (LUKB). The outlook remains positive.

At the same time, we lowered our issue rating on the bank's subordinated bond to 'BBB+' from 'A-', and our issue rating on the bank's junior subordinated bond to 'BBB-' from 'BBB'.

Rationale

We think that the bank's SACP has weakened because of its recent transition. Mainly due to bank's increased risk appetite and higher reliance on hybrids and wholesale funding compared to domestic peers, we now apply a negative one-notch adjustment to the SACP, in line with our criteria on CRA, to capture a more holistic view of LUKB's creditworthiness. This results in our downward revision of the bank's SACP to 'a' from 'a+'. While the relative weaknesses individually are not material enough to impact any other SACP factors, they collectively contribute to a weaker overall assessment than peers with an SACP of 'a+'.

Relatively high lending growth and expansion in activities outside of LUKB's traditional area of expertise have, in our view, changed the bank's financial profile. The bank's pace of lending growth has been above that of its cantonal bank peers for many years. While this adds to the diversification of its portfolio, in our view, it also indicates a somewhat higher risk appetite than peers and may lead to accumulation of higher risks in the long run. We believe that the investments outside LUKB's home turf may result in more fierce competition with strong banks in those markets. Also, increasing involvement in short-term real estate fund financing and real estate development are adding to the risks, in our view. The bank also intends to substantially increase its customer offerings related to structured products. This might positively contribute to earnings but could become a source of additional operational and litigation risk.

LUKB's reliance on volatile income sources has increased over recent years, reflecting a higher share of banking activities, which are sensitive to market developments. LUKB's risk-adjusted core earnings, measured by core earnings to S&P Global Ratings' risk-weighted assets were at 1.07% as of year-end 2021 and the lowest of all Swiss cantonal banks, reflecting its dependence on market-sensitive income. LUKB's three-year average S&P Global Ratings' earnings buffer of 0.77% as of the same date is among the lowest of its peer group, indicating, among other things, a lower capacity for earnings to cover normalized losses.

We believe the bank plans to expand further into more risky and more market sensitive business. This includes material investments, as the bank targets becoming a leading provider in structured products in Switzerland and material growth in commercial real estate lending outside the Canton of Lucerne. This may eventually put more volatility to the bottom-line performance and result in higher risk costs over the economic cycle, than for local peers.

While an upcoming capital injection of Swiss franc (CHF) 500 million from shareholders will support growth, LUKB has become increasingly reliant on hybrid capital instruments. We view the planned capital injection from the Canton of Lucerne as supportive for the bank's risk-adjusted capital (RAC) ratio, which was at 16.28% in December 2021. LUKB's projected ratio of 19.04%-19.50% over the next 18-24 months is very strong, and we view the capitalization as the main strength in our analyses. However, the bank's buffer above the 15% threshold for our very strong capital and earnings assessment is smaller than for most local peers. Together with the high share of hybrids (22% of total adjusted capital), this makes the bank an outlier among its peers. To facilitate lending growth, LUKB has been supporting its capitalization with the issuance of additional Tier 1 (AT1) capital. In our view, hybrid instruments typically have a lower ability to absorb losses than common equity.

Due to LUKB's integral link with and very important role for Lucerne, the likelihood of parental support continues to be the main driver supporting our issuer credit rating (ICR) on the bank.

We consider LUKB to be a government-related entity. LUKB has an important role in contributing to the development of the canton's economy and an integral link to the canton, including benefitting from a guarantee. In the event of financial stress at LUKB, we believe 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. We think that extraordinary support from canton compensates for the increased risks in the bank's SACP. As a result, we affirmed our ICR on the bank at 'AA'.

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. We expect that, over the coming two years, LUKB will continue to benefit from an extremely high likelihood of support from Lucerne.

Upside scenario

We could consider an upgrade of LUKB over the next two years if we were to consider a continued improved fiscal performance to materially strengthening 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.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	AA/Positive/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	Adequate and	Adequate and

	To	From
Liquidity	Adequate (0)	Adequate (0)
Comparable rating analysis	(-1)	0
Support	(+3)	(+2)
ALAC Support	(0)	(0)
GRE Support	(+3)	(+2)
Group Support	(0)	(0)
Sovereign Support	(0)	(0)
Additional Factors	(0)	(0)

ESG credit indicators: E-2, S-2, G-2

Issue Ratings--Subordination Risk Analysis

The rating on LUKB's Tier 2 subordinated bond is 'BBB+'. This reflects 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 AT1 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 revised 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 were provided to LUKB.

Related Criteria

- 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

- 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

- 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
- Luzerner Kantonalbank, March 2, 2022
- Swiss and Liechtenstein Bank Ratings Affirmed Under Revised FI Criteria, Feb. 8, 2022

Ratings List

Downgraded

	To	From
Luzerner Kantonalbank		
Subordinated	BBB+	A-
Junior Subordinated	BBB-	BBB

Ratings Affirmed

Luzerner Kantonalbank

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

Senior Unsecured	AA
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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceld/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914

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