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Luzerner Kantonalbank

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Luzerner Kantonalbank

SACP	a+

Anchor	a-	
Business Position	Adequate	0
Capital and Earnings	Very Strong	+2
Risk Position	Adequate	0
Funding	Average	0
Liquidity	Strong	

+

Support	+2

GRE Support	+2
Group Support	0
Sovereign Support	0

+

Additional Factors	0

Issuer Credit Rating
AA/Stable/A-1+

Major Rating Factors

Strengths:	Weaknesses:
• Strong retail franchise in the Canton of Lucerne. • Sound financial profile, characterized by very strong capitalization, a low risk appetite, and sustainable earnings. • Close ties with the Canton of Lucerne, facilitated by the bank's majority ownership and a statutory guarantee.	• Limited regional, business, and earnings diversity. • Concentration risk due to the focus on real estate lending in the home region. • Lack of growth potential.

Outlook: Stable

Standard & Poor's Ratings Services' stable outlook on Switzerland-based Luzerner Kantonalbank (LUKB) reflects the outlook on its majority owner and guarantor, the Canton of Lucerne. The stable outlook also incorporates our expectation that the bank's status as government-related entity (GRE) and the "extremely high" likelihood will not change in the foreseeable future. Moreover, we expect that LUKB will be able to maintain its sound financial profile in the near term.

We could take a negative rating action if LUKB's ties with the Canton of Lucerne loosened or the canton's statutory guarantee underwent changes. This could lead us to review LUKB's role for or link with the canton, which may lead to a weaker assessment of LUKB's status as a GRE. However, we currently consider this scenario unlikely and would expect LUKB's existing obligations to be grandfathered.

A positive rating action is remote at this stage, in our view, as we do not expect the comparatively concentrated business model to be adjusted. However, a positive rating action on Canton of Lucerne would prompt an upgrade of LUKB.

Rationale

Our ratings on LUKB reflect the 'a-' anchor for banks operating in Switzerland, as well as our assessments of its "adequate" business position, "very strong" capital and earnings, "adequate" risk position, "average" funding, and "strong" liquidity, as our criteria define these terms. We assess the stand-alone credit profile (SACP) at 'a+'.

We continue to consider LUKB to be a GRE with an "extremely high" likelihood of receiving timely and sufficient extraordinary government support in the event of financial stress. We base our view on LUKB's "very important" role for and "integral" link with its home canton, Lucerne. We consequently apply a two-notch uplift to the SACP to derive our long-term rating on the bank.

Anchor: 'a' for banks operating solely in the Swiss Confederation

Our bank 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 commercial bank operating only in Switzerland is 'a-'.

The BICRA score includes our evaluation of economic risk. In this respect, we view Switzerland as a highly diversified and competitive economy, benefiting from one of the highest GDPs per capita in the world and very robust government finances. We believe that large parts of the Swiss banking market demonstrate a conservative risk and lending culture, which has accompanied moderate growth of house prices and loan portfolios.

The Swiss banking industry is supported by its sizable and very stable customer deposit base. Pure domestic Swiss banks have not loosened credit standards in recent years, thanks to sound earnings potential from core products. We consider regulatory standards to be more stringent than in other developed countries.

Table 1

Luzerner Kantonalbank Key Figures					
		--Year-ended Dec. 31--			
(Mil. CHF)	**2015***	**2014**	**2013**	**2012**	**2011**
Adjusted assets	32,519.3	29,363.8	28,443.7	28,043.8	26,856.2
Customer loans (gross)	25,135.6	24,405.8	23,424.1	22,785.7	21,870.1
Adjusted common equity	2,351.4	2,191.5	2,090.8	2,037.6	1,910.8
Operating revenues	214.4	451.6	446.6	442.0	446.4
Noninterest expenses	111.2	221.8	221.1	228.8	224.1
Core earnings	89.9	181.5	179.3	175.2	173.1

*Data as of June 30. CHF--Swiss franc.

Business position: A strong retail banking franchise in its small home region

We assess LUKB's business position as "adequate," owing to its strong retail franchise in the Canton of Lucerne and its conservative management. We expect these factors to provide stability to LUKB's business model and to partly offset its high regional and product concentration.

LUKB is a midsize cantonal bank, and its assets totaled Swiss franc (CHF) 32.5 billion (about €30.2 billion) as of June 30, 2015. It is the leading commercial bank in the region of Lucerne, with a large market share of about 30% in retail and corporate banking, especially in business with 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. This continues to expose the bank to a significant concentration risk and therefore to volatility within the small local economy. We don't expect the bank's narrow business focus and operating region to change in the near future.

On the positive side, thanks to LUKB's outstanding brand and a statutory guarantee from the canton, we expect it to continue to enjoy strong customer confidence, reflected in its sustainable revenues dominated by net interest income and its stable deposit base. Its total income breaks down into 70%-75% from net interest income, 20% from fee income and 5%-10% from market-sensitive income, a revenue split we expect it to maintain.

Furthermore, LUKB is active in private banking; we estimate its assets under management at CHF15 billion. LUKB targets mainly affluent clients in its home region. We expect LUKB's private banking business to expand organically and to steadily contribute about a quarter of its revenues. While this will result in revenue diversification--that 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.

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. However, LUKB's legal and ownership structure means that it experiences slightly more pressure to report reasonable returns on equity to satisfy its owners. Given that we expect the current low interest rate environment to prevail and to continue straining earnings, we will closely monitor how LUKB will operate over the next few years to achieve satisfactory dividends to its shareholders. Nevertheless, we generally believe that the management will maintain its prudent and conservative underwriting standards, despite rising competition in its home region. These factors will, in our view, enable LUKB to preserve its sound financial position.

Table 2

Luzerner Kantonalbank Business Position					
		--Year-ended Dec. 31--			
(%)	**2015***	**2014**	**2013**	**2012**	**2011**
Loan market share in country of domicile	N/A	2.2	2.2	2.3	2.3
Deposit market share in country of domicile	N/A	1.8	1.9	2.0	2.0
Total revenues from business line (mil. CHF)	228.8	451.7	446.6	445.5	447.1
Commercial & retail banking/total revenues from business line	100.0	88.2	87.3	89.9	87.3
Other revenues/total revenues from business line	N/A	11.8	12.7	10.1	12.7
Return on equity	7.8	8.1	8.1	8.2	8.1

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

Capital and earnings: Robust capitalization is a key rating strength

In our opinion LUKB's capital and earnings are "very strong," compared with the banks we rate globally.

We expect that LUKB's earnings retention will enable the bank to maintain our risk-adjusted capital (RAC) ratio in the 16.0%-16.5% range over the next 18-24 months, assuming moderate loan growth of roughly 4%, relatively stable noninterest income, and continuously low cost of risk. The RAC ratio equaled 15.3% as of Dec. 31, 2014, which is, however, at the lower end of our range among the rated Swiss cantonal banks. In February 2015 LUKB issued a CHF130 million Additonal Tier 1 (AT1) hybrid, leading to an increase of 90 basis points (bps) in its RAC ratio, given we fully include this instrument in total adjusted capital, our measure of loss-absorbing capital.

We view LUKB's earnings capacity as strong and stable, supporting the bank's very strong capital position over the near to medium-term. 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 95 bps. Still, this figure is lower than the average for rated cantonal banks.

LUKB's regulatory Tier 1 ratio stood at 15.2% and its total capital ratio at 16.0% at end-June 2015. We understand that robust capitalization remains one of LUKB's strategic targets, and we believe that the majority owner, the Canton of Lucerne, remains supportive of keeping LUKB's capital at the current level. We expect LUKB to maintain its 50% dividend payout ratio and to preserve sufficient internal capital generation to finance loan growth. We understand, however, that unlike other cantonal banks, LUKB faces constraints in its ongoing build-up of capital, because it needs to provide its owners with reasonable returns on equity.

Table 3

Luzerner Kantonalbank Capital And Earnings					
		--Year-ended Dec. 31--			
(%)	**2015***	**2014**	**2013**	**2012**	**2011**
Tier 1 capital ratio	15.2	13.8	14.1	14.1	13.7
S&P RAC ratio before diversification	N.M.	15.3	18.2	16.6	18.4
S&P RAC ratio after diversification	N.M.	13.5	15.4	14.5	15.8

Table 3

Luzerner Kantonalbank Capital And Earnings (cont.)					
Adjusted common equity/total adjusted capital	94.8	100.0	100.0	100.0	100.0
Net interest income/operating revenues	69.2	73.7	72.4	74.9	73.0
Fee income/operating revenues	20.0	18.6	18.1	17.3	18.3
Market-sensitive income/operating revenues	9.9	6.7	8.2	6.9	7.6
Noninterest expenses/operating revenues	51.9	49.1	49.5	51.8	50.2
Preprovision operating income/average assets	0.7	0.8	0.8	0.8	0.8
Core earnings/average managed assets	0.6	0.6	0.6	0.6	0.7

*Data as of June 30. RAC--Risk-adjusted capital. N.M.--Not meaningful.

Table 4

Luzerner Kantonalbank Risk-Adjusted Capital Framework Data

(Mil. CHF)	Exposure*	Basel III RWA	Average Basel III RW (%)	Standard & Poor's RWA	Average Standard & Poor's RW (%)
Credit risk					
Government and central banks	60	0	0	2	3
Institutions	3,667	1,128	31	743	20
Corporate	7,632	4,369	57	5,033	66
Retail	18,066	8,209	45	4,937	27
Of which mortgage	16,634	7,558	45	3,992	24
Securitization§	0	0	0	0	0
Other assets	1,116	186	17	1,104	99
Total credit risk	30,541	13,892	45	11,819	39
Market risk					
Equity in the banking book†	179	220	123	1,228	688
Trading book market risk	--	308	--	462	--
Total market risk	--	528	--	1,690	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	827	--	847	--
(Mil. CHF)		**Basel III RWA**		**Standard & Poor's RWA**	**% of Standard & Poor's RWA**
Diversification adjustments					
RWA before diversification	--	15,831	--	14,356	100
Total Diversification/Concentration Adjustments	--	--	--	1,929	13
RWA after diversification	--	15,831	--	16,285	113
(Mil. CHF)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**Standard & Poor's RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments	--	2,187	13.8	2,192	15.3
Capital ratio after adjustments‡	--	2,187	13.8	2,192	13.5

Table 4

Luzerner Kantonalbank Risk-Adjusted Capital Framework Data (cont.)

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and Standard & Poor's 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, 2014, Standard & Poor's.

Risk position: Focus on mortgage lending exposes the bank to real estate market trends

In our view, LUKB's overall risk position is "adequate." The concentration risks in LUKB's lending book to regional economy and especially residential real estate market are mitigated by LUKB's prudent risk management and low risk appetite. These factors are reflected in the high asset quality of its loan portfolio.

The loan book is dominated by residential real estate loans, which accounted for about 70% as of June 30, 2015, of the loan portfolio and exposes the bank to material concentration risk. We see, however, that the mortgage portfolio is granular and highly collateralized, with an estimated average loan-to-value ratio of about 60% for mortgage loans, partly mitigating the concentration risk. Like its domestic peers, LUKB is exposed to risks related to the steady increase in residential real estate prices. Although we understand that LUKB finances real estate in so-called "hot spots" in the area along Lake Lucerne, we expect it to maintain its conservative underwriting practices in mortgage lending.

Consequently, we project LUKB's cost of risk to remain low at about 5 bps-10 bps, given our expectation of a prolonged low interest rate environment in Switzerland (8 bps in 2014). The share of nonperforming loans to total loan portfolio has slightly increased, but we expect it to remain at its current low levels of about 30 bps-35 bps points in the next 18-24 months.

LUKB's limited participation in syndicated corporate loans (about 5% of its loan book) exposes it to elevated credit risk. This is partly mitigated by borrowers' generally sound creditworthiness, LUKB's selective participation in this type of lending, and its adherence to conservative underwriting standards. Therefore, we believe that this activity does not provide any significant diversification benefit for LUKB but it won't either lead to a lower risk assessment if it stays at the current magnitude.

LUKB caters to private banking clients in its home canton and neighboring regions following its decision back in 2007-2008 to withdraw from international business. However, like many Swiss domestic banks active in private banking, LUKB has applied as a financial institution in category 2 of the current U.S. investigation program, because it could not rule out that some of its clients might have broken U.S. tax laws in the past. We understand that LUKB has provisioned certain amounts on its balance sheet to account for potential fines and related costs associated with the current investigations of U.S. tax authorities. Consequently, in our base case, we assume that any potential fine would be offset by these provisions and LUKB's annual earnings.

Table 5

Luzerner Kantonalbank Risk Position					
		--Year-ended Dec. 31--			
(%)	**2015***	**2014**	**2013**	**2012**	**2011**
Growth in customer loans	5.6	4.2	2.8	4.2	5.7
Total diversification adjustment / S&P RWA before diversification	N.M.	13.4	18.2	14.5	16.8

Table 5

Luzerner Kantonalbank Risk Position (cont.)					
Total managed assets/adjusted common equity (x)	13.8	13.4	13.6	13.8	14.1
New loan loss provisions/average customer loans	0	0.1	0.1	0	0.1
Net charge-offs/average customer loans	N.M.	0	0	0.1	0
Gross nonperforming assets/customer loans + other real estate owned	0.4	0.3	0.3	0.3	0.2
Loan loss reserves/gross nonperforming assets	N/A	384.8	456.5	415.0	522.9

*Data as of June 30. RWA--Risk-weighted assets. N.M.--Not meaningful. N/A--Not applicable.

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 anticipate that the bank's funding profile will continue to benefit from its large share of core customer deposits (72% of total funding as of June 30, 2015), which we consider very stable owing to LUKB's business strength and the statutory guarantee for its liabilities. The core deposit funds are complemented by wholesale funding, mainly issuance of covered bonds (roughly 10% of the funding base) and unsecured bonds . We expect LUKB's stable funding ratio according to our internal specifications to remain at a comfortable level around 110%-115% over 2015-2016 (against 113% as of June 30, 2015) and believe that its funding profile would withstand a possible economic downturn, as shown by the "flight to quality" during the most recent crises.

Our assessment of LUKB's liquidity as "strong" mirrors our view of its outstanding liquidity ratio of close to 4.0x as of June 30, 2015 (broad liquid assets to short-term wholesale funding). Our assessment compares favorably with the Swiss average and the liquidity position of universal banks globally. Moreover, we believe that owing to LUKB's close ties with the Lucerne canton and its statutory guarantee, the bank would not be exposed to large withdrawals of customer deposits in times of stress. 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--			
(%)	**2015***	**2014**	**2013**	**2012**	**2011**
Core deposits/funding base	71.8	78.3	81.3	77.9	74.5
Customer loans (net)/customer deposits	120.0	118.0	112.1	115.9	121.4
Long term funding ratio	95.7	97.8	97.5	95.4	94.2
Stable funding ratio	113.3	106.9	108.4	107.3	105.6
Short-term wholesale funding/funding base	4.7	2.4	2.7	4.9	6.3
Broad liquid assets/short-term wholesale funding (x)	3.8	4.6	4.8	2.8	2.1
Net broad liquid assets/short-term customer deposits	19.4	11.7	13.0	12.1	10.2
Short-term wholesale funding/total wholesale funding	16.4	11.2	14.3	22.4	24.8
Narrow liquid assets/3-month wholesale funding (x)	4.6	6.0	5.9	3.7	3.2

*Data as of June 30.

External support: Two notches of uplift owing to strong ties with the Canton of Lucerne

We regard LUKB as a GRE and assess the likelihood that LUKB's owner, the Canton of Lucerne, would provide timely and sufficient support to LUKB as "extremely high." We base our assessment on the bank's "integral" link with the canton, which we expect to provide considerable and timely credit support in all circumstances to LUKB due to the canton's majority ownership and provision of a statutory guarantee for LUKB. In addition, LUKB has a "very important" role to the canton, in our view, owing to the significant impact of its activities on the local economy. Because of this, we apply a two-notch uplift to the 'a+' SACP, leading us to derive the 'AA' long-term rating on the bank.

LUKB benefits from Lucerne's statutory guarantee, which ultimately covers all of LUKB's liabilities, excluding those of its subsidiaries. We note, however, that the guarantee does not 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, due to the bank's importance to the regional economy.

Additional rating factors: None

No additional factors affect this rating.

Hybrid Issue Rating

Our 'A-' rating on LUKB's Tier 2 subordinated bond issuance reflect 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 by removing 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).

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks, May 4, 2010

Related Research

- Banking Industry Country Risk Assessment: Switzerland, Sept. 9, 2015
- Banking Industry Country Risk Assessment Update: August 2015, Aug. 20, 2015
- Swiss Canton of Lucerne 'AA+/A-1+' Ratings Affirmed; Outlook Stable, Feb. 20, 2015
- Switzerland Ratings And BICRA Unaffected By Swiss National Bank's Change In Exchange Rate Policy, Jan. 15,

2015

- Various Ratings Actions On Swiss Banking Groups On Rising Economic Imbalances, Dec. 1, 2014
- Outlook On Nine Swiss Banks To Negative On Exposure To Rising Property Prices; Ratings On All Swiss Banks Affirmed, Jul. 3, 2012

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 September 10, 2015)

Luzerner Kantonalbank	
Counterparty Credit Rating	AA/Stable/A-1+
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+
Related Entities	
Lucerne (Canton of)	
Issuer Credit Rating	AA+/Stable/A-1+
Senior Unsecured	AA
Subordinated	A-

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's 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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