S&P Global
Ratings

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Luzerner Kantonalbank

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Luzerner Kantonalbank

SACP	a+		+	Support	+2	+	Additional Factors	0

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

Support	
ALAC Support	0
GRE Support	+2
Group Support	0
Sovereign Support	0

Issuer Credit Rating
AA/Stable/A-1+

Major Rating Factors

Strengths:	Weaknesses:
• Close ties with the Canton of Lucerne, facilitated by its majority ownership of the bank and a state guarantee. • Very strong capitalization accompanied by low risk costs and negligible nonperforming assets. • Strong retail franchise in the Canton of Lucerne.	• Lending growth significantly higher than that of cantonal bank peers, which might lead to additional risk taking. • Concentration risk owing to the focus on real estate lending in its home region. • Reliance on additional Tier 1 (AT1) instruments to support regulatory and S&P Global Ratings' capital ratio buffers.

Outlook: Stable

S&P Global Rating's stable outlook on Swiss Luzerner Kantonalbank (LUKB) reflect our expectation that the bank 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.

We could lower our issuer credit rating (ICR) if LUKB's ties with the Canton of Lucerne weaken or if there were changes to the canton's state guarantee, both scenarios that could lead us to reassess the bank's status as a government-related entity (GRE) and potentially result in a multi-notch downgrade. However, we currently consider this unlikely and, if it happens, we expect LUKB's existing obligations would be grandfathered. At present, the sensitivity of the rating on the bank to a potential downward revision of its standalone credit profile (SACP) remains very limited.

However, if we concluded that lending growth has become aggressive, leading to an increased risk profile compared with that of the bank's peers, we could revise downward the SACP and consequently lower our issue ratings on Luzerner Kantonalbank's subordinated debt.

We could also lower the SACP, leading to a revision of our hybrid ratings, if the bank's compliance with regulatory capital ratio minimums became increasingly dependant on issuance of those instruments. We could also lower the SACP if we saw a risk that our risk-adjusted capital (RAC) ratio could decrease below 15% in the next 24 months on the back of increased growth.

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

Rationale

Our rating on LUKB reflects its dominant cantonal franchise and operations in favorable conditions of low banking and industry risk for Swiss banks. In our view, the bank will remain resilient amid the ongoing COVID-19 pandemic and related recession. The rating also reflects our view of the bank's solid capitalization in a global comparison, even though LUKB's capital buffer remains lower than that of most of its cantonal bank peers in Switzerland. We see LUKB's customer deposit base as loyal and we expect the bank would benefit from customers' search for safe havens during a stress scenario.

The ratings on LUKB continue to markedly benefit from our assessment of LUKB as a GRE with an extremely high likelihood of receiving timely and sufficient extraordinary government support from its home Canton Lucerne, if necessary. We base this on LUKB's very important role for and integral link with Lucerne. We think the canton has enough resources to support the bank in the case of need.

Anchor: 'a-' for banks operating only in Switzerland

Our criteria use our Banking Industry Country Risk Assessment (BICRA) to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for a bank operating mainly in Switzerland is 'a-'. We view the trends for both economic and industry risk as stable.

We expect Switzerland's economy will contract materially in 2020 due to the COVID-19 pandemic but will fully recover over the coming two years. Under this scenario, we think the Swiss banking sector will remain resilient, supported by the country's diversified and competitive economy, very high household income levels, and a proven stress-resilient corporate sector. We think Swiss authorities' material support measures for domestic firms and households should cushion the short-term effect on Swiss banks' loan books. Additionally, we view positively banks' prudent loan underwriting standards and high collateralization of residential mortgage loans, which dominate most banks' customer portfolios. Considering these factors, we expect only a limited increase in credit losses, from historical low levels. We also expect affordability risk in the housing market might slightly reduce over the coming years given price growth in the owner-occupied segment is likely to remain muted in the wake of the pandemic. However, we note that a particular, ongoing risk is the investment property segment (estimated 30% of the market), where we already observed signs of a price correction before the pandemic.

Our view of industry risk in Switzerland encompasses the stability of the domestic banking sector and our expectation that damage from the COVID-19 pandemic will remain contained. We view positively the limited presence of foreign players, the banks' high capital levels in an international comparison, and their low reliance on capital markets for funding. In our view, the Swiss regulator's initiatives remain more stringent than those in other European banking sectors. We expect that banks' net interest margins will further decline gradually in a permanent low-interest-rate environment, as higher-yield assets mature and retail deposit rates remain floored at zero. However, we expect that repricing of lending products, additional income from investment advisory-related activities, and ongoing cost management will offset some of the pressure. We consider risk for Swiss banks from tech disruption as limited as of today, given the population's preference for cash payments, the small size of the market, which has high barriers of entry, and technologically well-equipped banks.

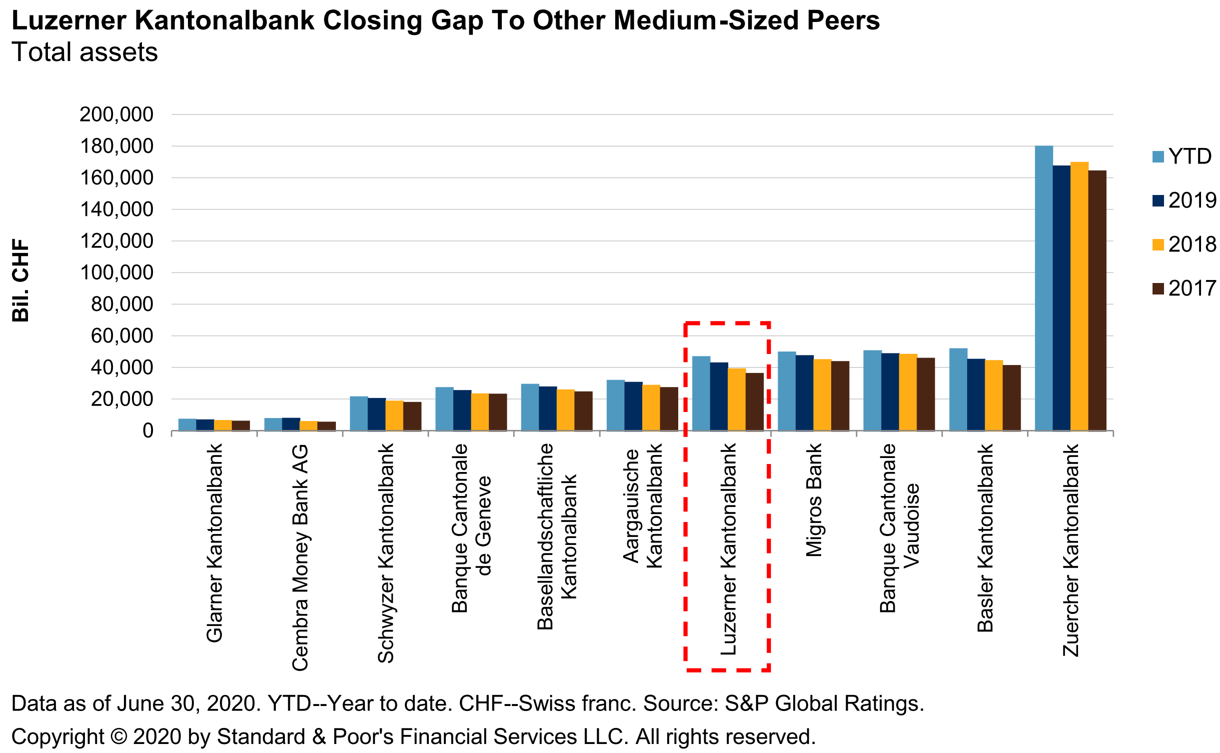
Table 1

Luzerner Kantonalbank--Key Figures

	--Year ended Dec. 31--				
(Mil. CHF)	**2020***	**2019**	**2018**	**2017**	**2016**
Adjusted assets	47,900.4	42,493.1	38,761.0	35,881.6	34,854.9
Customer loans (gross)	34,482.4	32,684.0	30,687.6	28,157.8	26,820.2
Adjusted common equity	2,842.8	2,759.3	2,663.6	2,568.3	2,481.5
Operating revenues	397.6	504.4	491.0	475.1	448.4
Noninterest expenses	213.6	260.7	261.1	258.4	235.7
Core earnings	154.9	204.9	194.1	183.2	180.0

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

Chart 1



Business position: A strong retail banking franchise with geographic concentration

Based on LUKB's stable but predominantly regionally focused market position, we consider its business profile on par with that of its domestically focused Swiss peers.

LUKB is a midsize cantonal bank. Its assets totaled Swiss franc (CHF) 46.4 billion (about €43 billion) as of June 30, 2020. It is the leading commercial bank in the region of Lucerne, with a high market share of about 30% in retail and corporate banking, especially small and midsize enterprises.

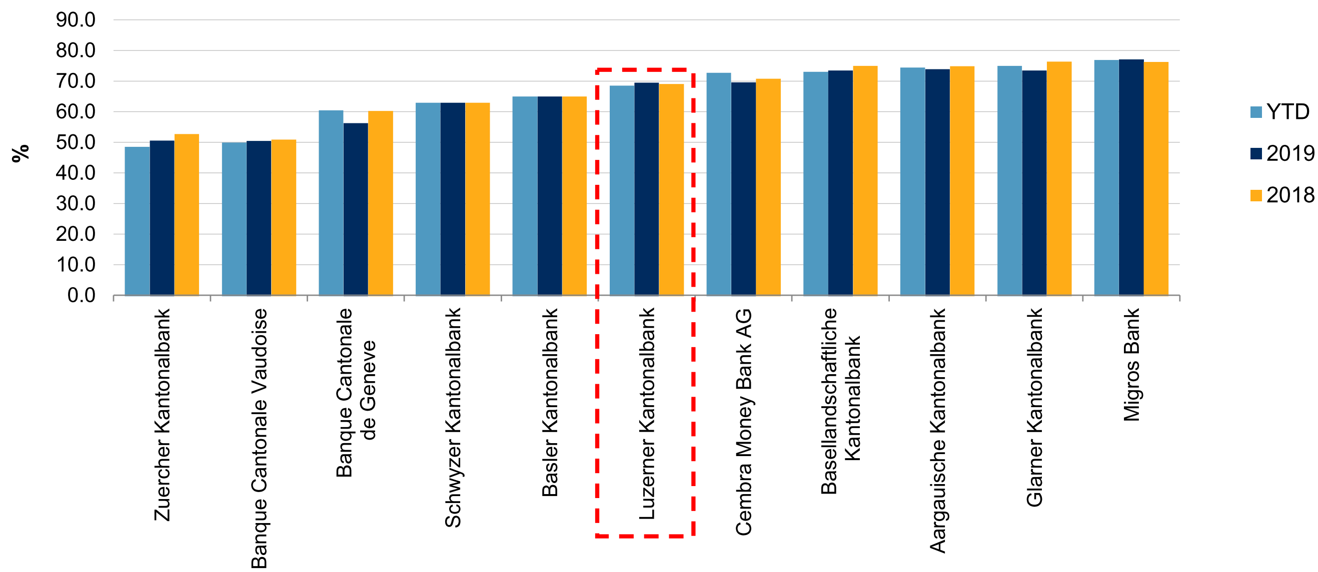
We expect the bank will expand further outside its home canton, focusing on residential mortgage lending. While we view credit quality as comparable, we believe that customer relationships outside the home canton tend to be less stable. In addition, the bank has been increasingly involved in short-term mortgage financing to real estate funds. This contributes to the balance sheet growth above the average of its peers, closing the gap to other medium-sized cantonal banks in terms of total assets.

Thanks to LUKB's reputable brand and a state guarantee from the canton, we expect the bank will continue to enjoy strong customer confidence, reflected in its sustainable revenue. The revenue base is dominated by net interest income of about 70% of total revenue in 2020, while about 19% is from fees and commissions. While increased customer trading activity in 2020 led to higher fee and commission income, we expect this split will remain over the medium term.

Chart 2

Luzerner Kantonalbank's High Dependence On Net Interest Income Is Comparable With Most Cantonal Banks

Net interest income/operating revenues



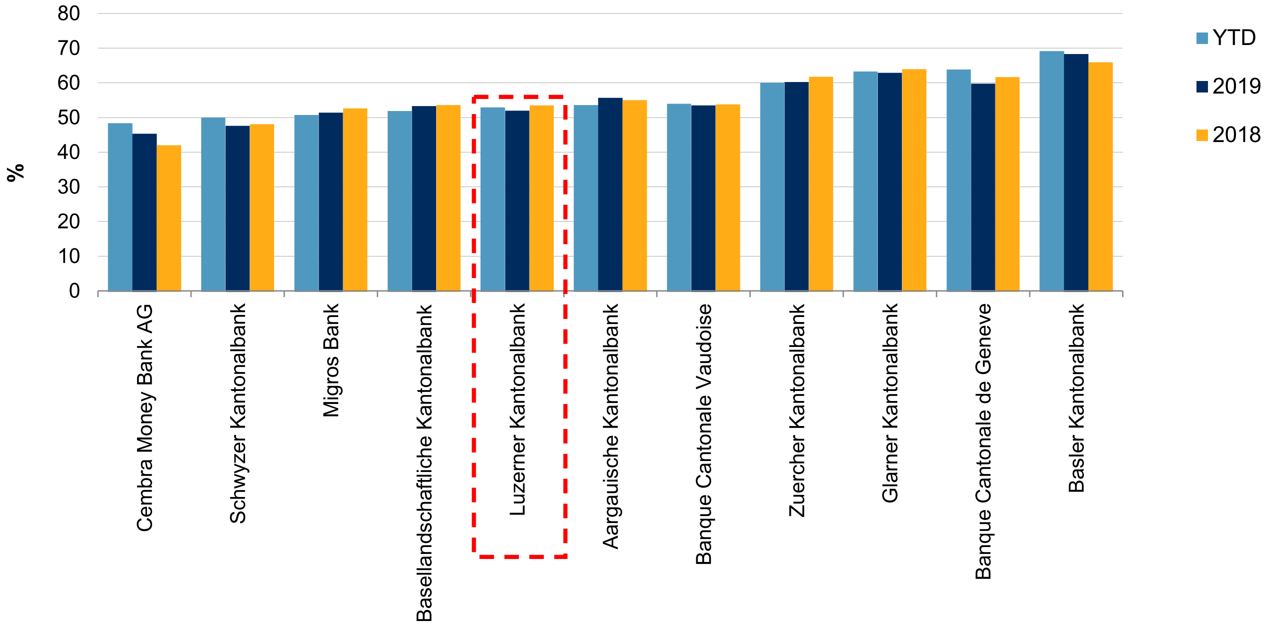
Data as of June 30, 2020. YTD--Year to date. Source: S&P Global Ratings.

LUKB is also active in private banking, with its assets under management increasing to almost Swiss franc (CHF)24 billion as of June 2020. LUKB mainly targets affluent clients in the Canton of Lucerne. We expect LUKB's private banking business will further expand, contributing about a quarter of total revenue going forward. While this will result in greater revenue diversification, the benefits, in our view, will not offset risks steaming from regional and business concentration.

LUKB's latest strategy confirms the bank's proactive stance in tackling efficiency and digitalization challenges and in meeting an increased demand for sustainable products from customers. The bank's main focus will stay on real estate lending and asset management in order to further diversify its revenue base. In November 2020, LUKB acquired a 30% stake in the Swiss real estate servicer Fundamenta Holding Group, broadening the bank's product portfolio. With a cost-income ratio of 50%, the bank is placed on average with its cantonal bank peers.

Chart 3

Luzerner Kantonalbank's RAC Ratio Is Average Compared With Swiss Peers' But Very High Globally
Cost-to-income ratio



Data as of June 30, 2020. YTD--Year to date. RAC--RAC--Risk-adjusted capital. Source: S&P Global Ratings.

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 ownership strategy. At the same time, LUKB's legal and ownership structure means, in our view, that it is under more pressure to report reasonable returns on equity to satisfy its owners.

Table 2

Luzerner Kantonalbank--Business Position

	--Year ended Dec. 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Loan market share in country of domicile	N/A	2.7	2.6	2.4	2.4
Deposit market share in country of domicile	N/A	1.7	1.8	1.8	1.9
Total revenues from business line (currency in millions)	402.0	504.5	498.6	478.9	452.1
Commercial & retail banking/total revenues from business line	100.0	100.0	100.0	100.0	100.0
Return on average common equity	7.3	7.3	7.4	7.6	7.4

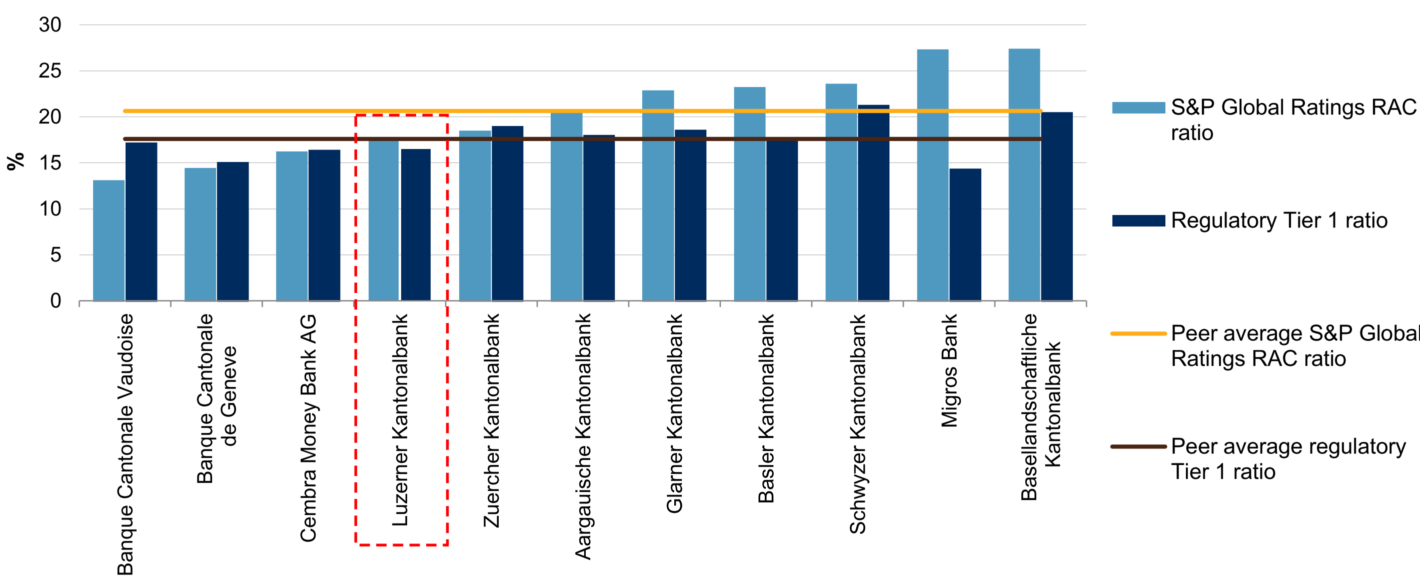
*Data as of Sept. 30. N/A--Not applicable.

Capital and earnings: Very strong capital remains a rating strength, but safe buffers seem to increasingly rely on AT1 issuance

Chart 4

Luzerner Kantonalbank's Capital Ratios Are Among The Highest Globally But Lower Than The Domestic Peer Average

S&P Global Ratings' RAC ratio before diversification



Data as of Dec. 31, 2019. RAC--Risk-adjusted capital. Source: S&P Global Ratings.

We assess LUKB's capital and earnings as very strong compared with that of other banks we rate globally. This is mainly based on our expectation that the bank's RAC ratio will remain at 17.0%-18.0% in the next 18-24 months, compared with 17.4% at year-end 2019. We also expect an increase in the bank's risk-weighted assets (RWAs) resulting from the above-average pace of customer loan growth.

LUKB has been supporting its capitalization buffer with the issuance of AT1 capital instruments, most recently CHF360million in March 2020. We fully recognize that amount in the total adjusted capital, our base for the calculation of our RAC ratio.

We understand that there might be the need for similar issuances in the near-to-medium term, given the bank's high balance sheet growth.

LUKB's strategy expects the regulatory total capital ratio will remain in the target range of 14%-18%. The bank's regulatory Tier 1 ratio equaled 15.8% as of Sept. 30, 2020, and we think it will remain similar over time given our expectation of moderating lending growth. We expect LUKB will stabilize its profits despite the adverse environment and maintain its 50%-60% dividend pay-out ratio over the next two years (51% in 2019).

We project LUKB's three-year average earnings buffer, which measures the capacity for a bank's earnings to cover normalized losses, will drop slightly to 0.6%-0.9% (an earnings buffer of about 1.0% indicates adequate earnings capacity). Still, this figure is only slightly below the average for the cantonal banks we rate and does not change our assessment of the bank's capital and earnings as very strong.

Table 3

Luzerner Kantonalbank--Capital And Earnings					
	--Year ended Dec. 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Tier 1 capital ratio	N/A	16.5	15.7	16.1	16.5
S&P Global Ratings' RAC ratio before diversification	N/A	17.4	16.9	18.3	18.8
S&P Global Ratings' RAC ratio after diversification	N/A	13.4	13.2	14.3	14.2
Adjusted common equity/total adjusted capital	79.3	84.4	91.1	90.8	90.5
Net interest income/operating revenues	68.4	69.1	68.7	70.4	71.1
Fee income/operating revenues	19.4	19.7	19.0	18.8	18.4
Market-sensitive income/operating revenues	10.9	10.0	10.8	9.4	9.6
Cost to income ratio	53.7	51.7	53.2	54.4	52.6
Preprovision operating income/average assets	0.5	0.6	0.6	0.6	0.6
Core earnings/average managed assets	0.5	0.5	0.5	0.5	0.5

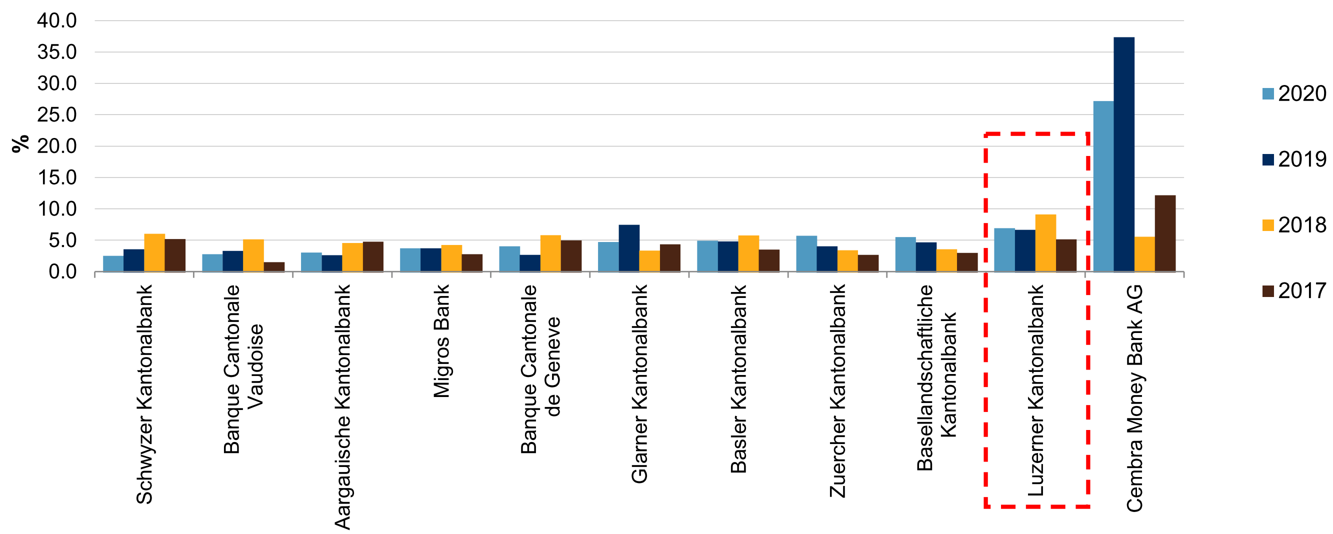
*Data as of Sept. 30. N/A--Not applicable. RAC--Risk-adjusted capital.

Risk position: Accelerated mortgage lending but with maintained strong risk metrics

We estimate that LUKB's customer lending will increase by about 5%-6% in 2020, more than doubling the market's average pace. This continues the trend of the recent years. The bank reported one of the quickest increases in its loan book among Swiss banks in 2019, at about 9%, predominantly driven by mortgage-secured products granted both inside and outside the canton. Nevertheless, we believe LUKB's underwriting standards have not yet been compromised by the attraction of new business.

Chart 5

Luzerner Kantonalbank Has Highest Growth Rates Among Cantonal Bank Peers
Growth in customer loans



Data as of Dec. 31, 2019. Source: S&P Global Ratings.

Assuming only limited negative impact from the COVID-19 pandemic on the Swiss real estate sector, we project LUKB's cost of risk will remain low at or slightly below 5 basis points in the next 18-24 months. The share of nonperforming loans in the total loan portfolio remained at a stable 0.2% as of June 30, 2020, compared with similarly low 2018-2019 levels.

The concentration risks in LUKB's lending book to the regional economy and especially to the residential real estate market are mitigated by its prudent risk management, in our view. This is reflected in the high asset quality of its loan portfolio. The loan book is dominated by residential real estate loans, which, as of June 30, 2020, accounted for over 70% of the loan portfolio and expose 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 about 57% as of first-half 2020, partly mitigating the concentration risk. Also, we note that the number of loans for residential properties originating outside the canton now exceed 25% of the total residential financing portfolio, which might counterbalance the bank's regional concentration.

Like its other Swiss banks, LUKB remains exposed to risks related to a potential correction in Swiss residential real estate markets, which we do not consider as imminent.

LUKB's participation in syndicated corporate loans, representing less than 5% of total loans as of June 30, 2020, exposes it to somewhat higher credit risk. This is partly mitigated by borrowers' generally sound creditworthiness, LUKB's selective participation in this type of lending, and its adherence to sound underwriting standards.

That said, we do not believe this activity provides any significant diversification benefit for LUKB. We expect the bank will continue its efforts to further accelerate its structured products business, potentially broadening its earnings base. While LUKB aims to target predominantly institutional clients, it might also become a source of additional litigation risk in the future.

Table 4

Luzerner Kantonalbank--Risk Position					
	--Year ended Dec. 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Growth in customer loans	7.3	6.5	9.0	5.0	5.2
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	29.8	28.3	28.2	33.0
Total managed assets/adjusted common equity (x)	16.8	15.4	14.6	14.0	14.0
New loan loss provisions/average customer loans	0.0	0.0	0.0	0.0	0.0
Net charge-offs/average customer loans	N.M.	0.1	0.0	0.0	0.1
Gross nonperforming assets/customer loans + other real estate owned	0.2	0.2	0.2	0.2	0.2
Loan loss reserves/gross nonperforming assets	268.7	268.7	307.3	354.2	305.3

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

Funding and liquidity: A strong retail deposits franchise, but an increased reliance on wholesale funding

We view LUKB's customer deposit base as stable given the bank's strong franchise, supported by the state guarantee for its senior liabilities.

Customer deposits' share of LUKB's overall funding base has been declining over the last few years and amounted to 58% at end-June 2020. To defend the return on its equity, LUKB has expanded its use of short-term funding. This now constitutes more than 15% of its funding base, versus 10%-11% previously. We expect the funding structure will remain similar in the next 24 months.

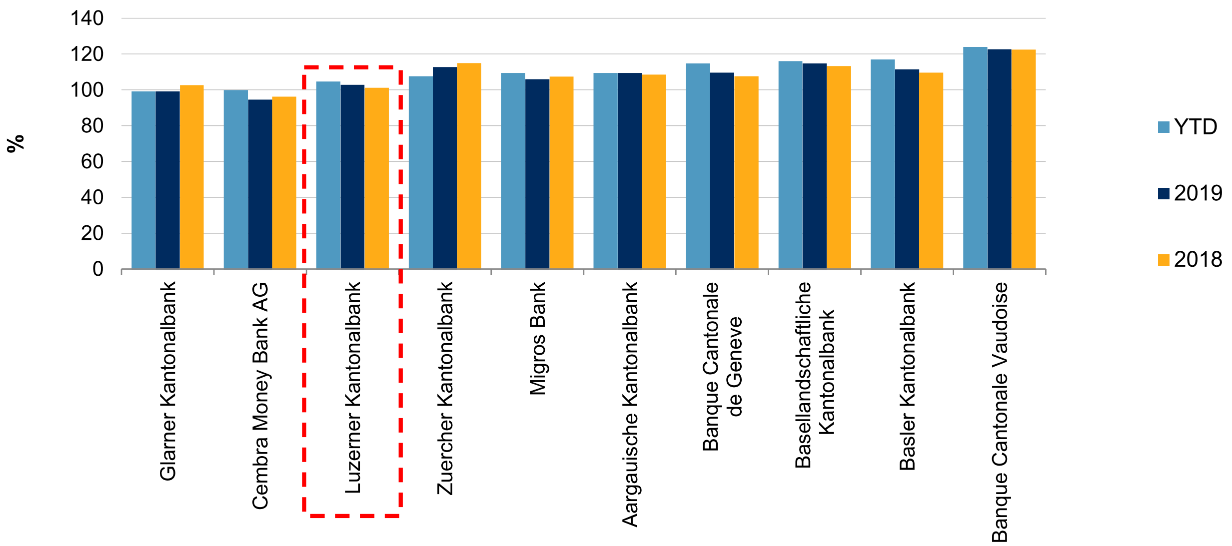
Our stable funding ratio for LUKB dropped to about 102% in 2019, which is in line with the peer average.

Our liquidity ratio was 1.2x for the same period, indicating a buffer to cover short-term wholesale funding by broad liquid assets. We expect LUKB will tightly manage its liquidity by placing excess liquidity (repurchase transactions with securities lending) at the Swiss National Bank within their maximum threshold, at a zero-percent rate, which is profitable given ongoing negative interest rates. Therefore, we don't expect ratios will increase materially going forward. 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. The stability of LUKB's depositor base was recently demonstrated by the continuous increase in the bank's customer deposits in first-half 2020, despite the increased market stress and low interest rates offered by the bank.

The regulatory liquidity coverage ratio was 150.6% as of year-end 2019 (against the 100% regulatory minimum from 2019), and remains between 110%-170%.

Chart 6

Luzerner Kantonalbank's Customer Deposits Are Stable in Times Of Crisis
Stable funding ratio



Data as of June 30, 2020. YTD--Year to date. Source: S&P Global Ratings.

Table 5

Luzerner Kantonalbank--Funding And Liquidity

	--Year ended Dec. 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Core deposits/funding base	57.5	58.9	63.3	68.1	69.2
Customer loans (net)/customer deposits	137.3	143.7	137.3	127.3	123.1
Long-term funding ratio	84.3	85.4	85.9	90.0	90.1
Stable funding ratio	105.7	102.3	100.5	105.2	107.1
Short-term wholesale funding/funding base	17.0	15.8	15.4	10.9	10.8
Broad liquid assets/short-term wholesale funding (x)	1.3	1.2	1.1	1.5	1.7
Net broad liquid assets/short-term customer deposits	10.0	5.3	2.0	8.7	10.9
Short-term wholesale funding/total wholesale funding	38.5	37.3	41.0	33.3	34.3
Narrow liquid assets/3-month wholesale funding (x)	2.0	1.4	1.2	1.8	1.8

*Data as of Sept. 30.

Support: Extremely high likelihood of extraordinary government support

We consider LUKB a GRE. The long-term rating on LUKB is two 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, if needed. We base this on our view of the bank's integral link with and very important role for the canton. 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 think a default by LUKB would have a significant systemic impact on the local economy. We do not anticipate any change to the bank's current integral link with and very important role for the canton in the medium term.

LUKB benefits from the Canton of Lucerne's state guarantee, which ultimately covers all of LUKB's liabilities apart from subordinated debt. However, we note that the guarantee does not explicitly ensure timely repayment, as defined by our criteria. While being outside our outlook horizon, we consider the potential risk that future agreements between Switzerland and the EU regarding preferential market access for Switzerland might include the removal of remaining state guarantees for all banks. Nevertheless, we believe that the canton has strong incentives to help LUKB meet its obligations on time given the bank's importance to the regional economy, and to prevent reputational damage.

We believe that the prospect of extraordinary government support for Swiss banks is uncertain because Switzerland has implemented several legislative measures in recent years to address the "too big to fail" issue and has established a functioning resolution regime. However, we generally believe that resolution frameworks are less likely to impede the cantonal owners' willingness to provide extraordinary support to cantonal banks, including LUKB.

Environmental, social and governance: ESG factors are influencing decision-making

ESG factors have a neutral impact on our assessment of LUKB's creditworthiness. Social and environmental credit factors are in line with those of peer cantonal banks in Switzerland. LUKB takes into account ESG standards for its investment business, based on the United Nation's Principles for Sustainable Investment.

Given LUKB is a government-owned bank, we remain mindful of political influence. We note that its supervisory board consists mostly of non-politicians, often with a banking background. We believe that political influence is therefore relatively contained, beyond the rolling strategy setting.

Issue ratings

Our 'A-' 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 because of the notes' contractual subordination;
- Two notches reflecting the notes' discretionary coupon payments and regulatory Tier 1 capital status; and
- One notch because the notes contain a contractual write-down clause, which would be triggered if the Swiss government, the Swiss central bank, or the Canton of Lucerne were to provide extraordinary support to LUKB to prevent it from becoming nonviable.

Related Criteria

- General Criteria: Principles Of Credit Ratings, Feb 16, 2011
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, Apr 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, Mar 25, 2015
- Criteria -Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov 9, 2011
- Criteria -Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, Jul 20, 2017
- Criteria -Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, Jul 17, 2013
- Criteria -Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov 9, 2011

Related Research

- COVID-19: Swiss Banking Sector To Remain Resilient, June 17, 2020
- Tech Disruption In Retail Banking: Swiss Banks Are In No Rush To Become Digital Frontrunners, Feb. 13, 2020
- Banking Industry Country Risk Assessment: Switzerland, Nov. 20, 2019

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 December 9, 2020)*	
Luzerner Kantonalbank	
Issuer Credit Rating	AA/Stable/A-1+
Junior Subordinated	BBB
Senior Unsecured	AA
Subordinated	A-

Ratings Detail (As Of December 9, 2020)*(cont.)	
Issuer 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	
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.