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Basler Kantonalbank

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Basler Kantonalbank

SACP	a+		+	Support	+2	+	Additional Factors	0

Anchor	a	
Business Position	Adequate	0
Capital and Earnings	Very Strong	+2
Risk Position	Moderate	-1
Funding	Average	0
Liquidity	Strong	

GRE Support	+2
Group Support	0
Sovereign Support	0

Issuer Credit Rating
AA/Stable/A-1+

Major Rating Factors

Strengths:	Weaknesses:
• Strong financial profile and sound asset quality. • Very strong customer franchise in home region. • Extremely high likelihood of support from the Canton of Basel-City, facilitated by full ownership and a statutory guarantee.	• Reputational risk relating to risk of prosecution from U.S. tax authorities. • Limited growth prospects in the saturated Basel-City banking market. • Comparably low profitability of majority-owned subsidiary, Bank Coop.

Outlook: Stable

The outlook on BKB is stable, reflecting our view that that it benefits from being a government-related entity (GRE). We consider that there is an "extremely high" likelihood that the Canton of Basel-City (AA+/Stable/A-1+) would provide future timely and sufficient extraordinary support to BKB in the event of financial distress. Morever, we believe BKB's capital and earnings will sufficiently buffer potential fines stemming from possible legal prosecution by the U.S. tax authorities due to acceptance of undeclared funds from U.S. clients. The stable outlook also reflects that the bank is continuing to improve its risk management systems.

The potential for a downgrade is very low, as long as the bank's stand-alone credit profile (SACP) is at or above our threshold of 'bb+'. In the event of a small deterioration in the SACP, the ratings would be cushioned by potential extraordinary support from the canton. In addition, a downgrade could occur if we were to lower our ratings on Basel-City by at least two notches. We consider this highly unlikely within our two-year outlook horizon.

Further negative rating actions may be triggered by a change in BKB's role for or link with the Canton of Basel-City or changes in the statutory guarantee, which may lead to a weaker assessment of BKB's status as a government-related entity (GRE). However, we currently consider this scenario unlikely and would expect BKB's existing obligations to be grandfathered.

We are unlikely to raise the ratings on BKB in the next 12-24 months. We would consider revising its SACP upward if we observed sustainable improvements in BKB's risk management and a capital- and franchise-neutral resolution of pending legal and reputational risk. However, all else remaining equal, we could raise the ratings on BKB if we raised our ratings on Basel-City.

Rationale

Our ratings on BKB reflect its anchor of 'a-', its "adequate" business position, "very strong" capital and earnings, "moderate" risk position, "average" funding, and "strong" liquidity, as our criteria define these terms. The SACP is 'a'.

We continue to consider BKB to be a government-related entity (GRE) with an "extremely high" likelihood of receiving extraordinary government support in times of stress. We base this view on BKB's "very important" role for and "integral" link with the Canton of Basel-City. This enables a two-notch uplift to our assessment of BKB's SACP.

Anchor:'a-' for a commercial bank operating in Switzerland

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

Basler Kantonalbank Key Figures					
		--Year-ended Dec. 31--			
(Mil. CHF)	**2015***	**2014**	**2013**	**2012**	**2011**
Adjusted assets	38,229.4	42,911.2	39,192.5	39,127.7	38,757.8
Customer loans (gross)	26,894.3	27,643.9	26,542.1	25,951.3	25,636.2
Adjusted common equity	3,469.1	3,398.5	3,102.6	3,042.0	2,973.4
Operating revenues	288.2	577.6	620.9	698.9	638.8
Noninterest expenses	173.6	334.2	359.6	340.9	364.7
Core earnings	67.9	204.3	221.1	323.8	227.8

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

Business position: One of the top 10 banks in Switzerland in terms of total assets

We consider BKB's business profile to be "adequate" on the basis of the bank's strong and sustainable, but also regionally focused, market position.

BKB is the eighth-largest bank in Switzerland with total assets of Swiss franc (CHF) 38.0 billion as of June 30, 2015, consolidating its subsidiary Bank Coop (not rated), which had total assets of CHF16.6 billion at the same date. While BKB focuses on its retail and corporate lending business in the wealthy Basel region, its 57.6%-owned subsidiary Bank Coop engages mainly in countrywide residential mortgage lending and lending to small and midsize companies. We do not expect BKB to materially alter its geographic and business diversity. However, we expect it will continue its strategic refocus of its core competencies and products in the next two years because of heightened legal and reputational risk since year-end 2012. Rather than pursuing its historic expansionary strategy, we expect BKB will consolidate and work-out legacy risk over the medium term, which would be positive for the ratings.

Ancillary private banking and trading business lines provide some diversity but we expect these to continue to contribute a modest proportion of up to one-third of operating revenues. Trading revenues--expected to represent 10%-15% of operating revenues in the next two years--are mainly client-initiated foreign exchange and precious metals trading operations. The bank has shut down its certificate business. We expect noninterest income to decline slightly to less than 40% of operating revenues in the next two years.

In addition, we anticipate that Bank Coop will experience slightly higher loan growth than the wider group over the medium term, as the parent's lending growth potential is constrained by the saturated banking market of Basel-City. We expect Bank Coop's profitability (representing 42% of the group's half-year 2015 operating revenues) to remain subdued compared with that of the wider group, but we think the gap will narrow over the next two years. We also anticipate that Bank Coop's status as a second bank for large sections of its clientele to continue to weigh on our assessment of BKB's business stability.

Table 2

Basler Kantonalbank Business Position					
		--Year-ended Dec. 31--			
(%)	**2015***	**2014**	**2013**	**2012**	**2011**
Total revenues from business line (currency in millions)	323.7	593.7	636.4	728.1	643.0

Table 2

Basler Kantonalbank Business Position (cont.)					
Commercial & retail banking/total revenues from business line	81.8	78.7	79.0	79.5	75.8
Return on equity	3.1	5.7	3.4	8.3	6.8

*Data as of June 30.

Capital and earnings: BKB's capital position remains the key rating strength

The bank's risk-adjusted capital (RAC) ratio was 16.1% at year-end 2014 and we expect it to increase to about 17.0%-18.0% over the next 18 months, mainly due to a CHF200 million capital increase in first half of 2015 (of which CHF100 million is AT1 hybrids) and ongoing retention of earnings. We also foresee the bank's risk-weighted assets growing to a limited extent. Although BKB's capital is below the average of rated cantonal banks in Switzerland, its capital position is among the strongest compared globally. Furthermore, we regard the bank's owner as supportive of BKB's very strong capital position and would expect timely additional support in times of need.

Elevated reputational and legal risk stemming from pending legal actions by the U.S. Department of Justice against Swiss banks could weigh negatively on our assessment of BKB's capital and earnings. The size and timing of any fine that BKB might need to pay as legal compensation are uncertain. In our base case, we have factored in an amount slightly above the amounts already reserved by BKB for legal risk, but believe that such a cost would be offset by BKB's provisions and annual earnings.

In terms of earnings capacity, we expect BKB to maintain a three-year average earnings buffer at about 53 basis points as we anticipate that interest rates in Switzerland will remain low. This means that, in our view, BKB will be able to cover 0.53% of its risk-weighted assets in a credit stress with its annual earnings. However, we consider other cantonal banks to have greater ability to absorb losses by internal capital generation.

Table 3

Basler Kantonalbank Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2015***	**2014**	**2013**	**2012**	**2011**
Tier 1 capital ratio	N/A	15.3	15.4	15.3	13.4
S&P RAC ratio before diversification	N.M.	16.1	16.4	17.5	16.2
S&P RAC ratio after diversification	N.M.	14.1	14.6	14.8	12.6
Adjusted common equity/total adjusted capital	97.2	100.0	100.0	100.0	100.0
Net interest income/operating revenues	58.7	60.1	56.5	52.8	58.3
Fee income/operating revenues	24.7	26.7	27.6	26.1	28.7
Market-sensitive income/operating revenues	14.9	11.1	13.5	18.0	10.6
Noninterest expenses/operating revenues	60.3	57.9	57.9	48.8	57.1
Preprovision operating income/average assets	0.6	0.6	0.7	0.9	0.7
Core earnings/average managed assets	0.3	0.5	0.6	0.8	0.6

*Data as of June 30. N/A--Not applicable. N.M.--Not meaningful.

Table 4

Basler Kantonalbank RACF [Risk-Adjusted Capital Framework] Data

(CHF 000s)	Exposure*	Basel II RWA	Average Basel II RW (%)	Standard & Poor's RWA	Average Standard & Poor's RW (%)
Credit risk					
Government and central banks	5,486,038	384,063	7	164,622	3
Institutions	3,345,044	872,738	26	1,015,732	30
Corporate	12,939,730	8,881,725	69	9,660,716	75
Retail	14,631,324	10,583,575	72	4,474,525	31
Of which mortgage	13,373,792	10,583,575	79	3,645,152	27
Securitization§	0	0	0	0	0
Other assets	68,810	72,825	106	68,073	99
Total credit risk	36,470,946	20,794,925	57	15,383,667	42
Market risk					
Equity in the banking book†	113,072	89,900	150	1,001,340	886
Trading book market risk	--	2,197,400	--	3,296,100	--
Total market risk	--	2,287,300	--	4,297,440	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	1,172,863	--	1,420,516	--
(CHF 000s)		**Basel II RWA**		**Standard & Poor's RWA**	**% of Standard & Poor's RWA**
Diversification adjustments					
RWA before diversification		25,659,388		21,101,624	100
Total Diversification/Concentration Adjustments		--		2,964,612	14
RWA after diversification		25,659,388		24,066,235	114
(CHF 000s)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**Standard & Poor's RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		3,361,832	13.1	3,398,472	16.1
Capital ratio after adjustments‡		3,361,832	15.3	3,398,472	14.1

*Exposure at default. §Securitisation Exposure includes the securitisation 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: Sound asset quality, but reputational risk remains

While we view BKB's loan portfolio as having generally sound asset quality, we assess its risk exposure as being higher than that of rated peers in Switzerland due to its above-average exposure to commercial real estate lending and its stronger engagement in trading activities. Furthermore, we view its risk management track record as slightly weaker than peers', as evidenced by a bank-specific fraud case involving Swiss investment boutique ASE Investment AG in 2012 and legal and reputational risk due to potential prosecution by the U.S. tax authorities.

While the financial risk arising from the ASE-related fraud case has been offset by the provision of CHF50 million to indemnify affected clients, we understand that BKB has already provisioned CHF109 million to meet potential fines from the U.S. Department of Justice relating to acceptances of transfers of undeclared funds from U.S. clients. In our base case, we assume that any such fine would be offset by these provisions and by BKB's annual earnings. Nevertheless, associated reputational risk weighs on our assessment of BKB's overall risk position.

At the same time, we understand that BKB continues to improve its risk management capabilities and its overall risk profile, with changes to its trading operations such as closing its certificates business and introducing tighter controls over its trading department.

We expect BKB's loan growth to remain slightly below the average of the Swiss banking industry due to the bank's cautious approach to mortgage lending, prudent risk management, and saturated home market. Domestic housing price increases in recent years are likely to lead to an increased risk of correction and higher loan losses; we already largely reflect this in our Swiss BICRA assessment.

Moreover, commercial lending represents about one-third of BKB's loan portfolio, which is higher than that of the bank's peers and which we generally view as riskier than residential real estate lending. In addition, we observe single-name concentration in BKB's corporate portfolio that is higher than peers' concentrations; we estimate that its top-10 corporate loans account for about 10% of its total commercial loan portfolio. Nevertheless, risk arising from BKB's corporate loan portfolio partly reflects the narrowness of Basel-City's economic structure. In addition, we understand that BKB focuses only on high quality names and therefore we expect tail-risk to be relatively remote. At the same time, we regard the asset quality of the bank's sizable securities portfolio, which is mainly used for liquidity purposes, as very sound.

Table 5

Basler Kantonalbank Risk Position

		--Year-ended Dec. 31--			
(%)	**2015***	**2014**	**2013**	**2012**	**2011**
Growth in customer loans	(5.4)	4.2	2.3	1.2	6.0
Total diversification adjustment / S&P RWA before diversification	N.M.	14.0	11.9	18.1	29.2
Total managed assets/adjusted common equity (x)	11.0	12.6	12.6	12.9	13.0
New loan loss provisions/average customer loans	0.3	0.1	0.0	0.0	0.1
Net charge-offs/average customer loans	N.M.	0.0	0.0	0.0	0.0
Gross nonperforming assets/customer loans + other real estate owned	N/A	1.0	1.0	1.0	1.1
Loan loss reserves/gross nonperforming assets	N/A	111.9	189.0	187.3	171.9

*Data as of June 30. N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Funding and liquidity: Favorable assessment supported by cantonal guarantee

BKB's funding is "average" and its liquidity position is "strong," in our opinion.

BKB's funding is in line with Switzerland's BICRA score of '2' for systemwide funding. The bank's core customer deposits account for 71% of its funding base and for 90% of its loan portfolio. This excludes the comparably large equity position on BKB's balance sheet. Our calculation of the bank's stable funding ratio has remained clearly above

100% throughout the past five years, and was 113% as of year-end 2014. We still regard the core customer deposit base as very stable due to the cantonal guarantee, which we expect to remain in place. The remainder of BKB's funding mix is made up of interbank funding and capital market funding via secured and unsecured instruments. Due to the bank's status as a GRE, we expect both funding sources to remain stable, even in more challenging economic conditions than at present.

The "strong" liquidity assessment reflects BKB's very favorable liquidity position, which would allow it to endure more than 12 months with no access to market funding. This is facilitated by broad liquid assets to short-term wholesale funding being significantly above 1.0x for the past five years. The ratio was 2.0x as of year-end 2014. This supports our view that BKB's liquid assets comfortably cover its short-term wholesale funding needs.

Table 6

Basler Kantonalbank Funding And Liquidity

		--Year-ended Dec. 31--			
(%)	**2015***	**2014**	**2013**	**2012**	**2011**
Core deposits/funding base	71.0	69.8	72.0	75.0	75.7
Customer loans (net)/customer deposits	110.9	113.6	110.7	106.2	105.4
Long term funding ratio	89.6	88.0	90.2	89.6	89.0
Stable funding ratio	113.5	110.8	116.3	111.9	108.8
Short-term wholesale funding/funding base	11.5	13.2	10.7	11.5	12.0
Broad liquid assets/short-term wholesale funding (x)	2.0	1.8	2.4	2.0	1.8
Net broad liquid assets/short-term customer deposits	16.8	15.2	33.8	15.6	12.3
Short-term wholesale funding/total wholesale funding	39.2	43.7	38.2	45.9	49.5
Narrow liquid assets/3-month wholesale funding (x)	2.5	2.1	3.0	2.6	2.0

*Data as of June 30.

External support: "Extremely high" likelihood of extraordinary government support

We factor into the final ratings three notches of uplift above the SACP, reflecting our unchanged view of BKB as a GRE. We consider that there is an "extremely high" likelihood that the Canton of Basel-City, BKB's full owner, would provide timely and sufficient extraordinary support to the bank in the event of financial distress. We base this assumption on the cantonal guarantee in place, as stipulated by law, as well as BKB's ownership setup and its importance for Basel's regional economy.

Additional rating factors: None

No additional factors affect this rating.

Related Criteria And Research

Related Criteria

- Basler Kantonalbank Long-Term Ratings Lowered To 'AA' Due To Remaining Legal And Reputational Risks; Outlook Stable, Aug. 6, 2013
- Outlook On Nine Swiss Banks To Negative On Exposure To Rising Property Prices; Ratings On All Swiss Banks Affirmed, July 3, 2012

- Banking Industry Country Risk Assessment: Switzerland, April 11 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

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 August 25, 2015)

Basler Kantonalbank	
Counterparty Credit Rating	AA/Stable/A-1+
Junior Subordinated	BBB-
Counterparty Credit Ratings History	
06-Aug-2013	AA/Stable/A-1+
03-Jul-2012	AA+/Negative/A-1+
16-Jun-2009	AA+/Stable/A-1+
Sovereign Rating	
Swiss Confederation	AAA/Stable/A-1+
Related Entities	
Basel-City (Canton of)	
Issuer Credit Rating	AA+/Stable/A-1+
Senior Unsecured	AA
Senior Unsecured	AA+

*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.