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Ratings

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Basler Kantonalbank

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Basler Kantonalbank

SACP	a

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

\+

Support	+3
ALAC Support	0
GRE Support	+3
Group Support	0
Sovereign Support	0

\+

Additional Factors	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 stable outlook on Basler Kantonalbank (BKB) reflects S&P Global Ratings' view that the bank benefits from being a government-related entity (GRE). We consider that there is an extremely high likelihood that the Canton of Basel-City would provide timely and sufficient extraordinary support to BKB in the event of financial distress. Moreover, 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.

We consider the potential for a downgrade to be 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 GRE. However, we currently consider this scenario unlikely and would expect BKB's existing obligations to be grandfathered.

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. The SACP is 'a'.

We continue to consider BKB to be a 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 three-notch uplift to our assessment of BKB's SACP.

In our view, the Swiss bank resolution regime coming that came into effect on Jan. 1, 2016, does not impede cantonal owners' ability to provide extraordinary support to banks, like BKB, that we consider as being GREs.

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

Our criteria use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor SACP, 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.

Our economic risk score of '2' for Switzerland is supported by the country's highly diversified and competitive economy, very high household income levels, and banks' prudent loan underwriting standards. However, it also reflects that risks have increased, owing to the cumulative rise in Swiss house prices and domestic lending over past several years. Although these imbalances are still low in a global context, they have also led the regulator to enact macroprudential measures to rein in robust growth in mortgage indebtedness. We recognize that house price and lending growth have cooled since the beginning of 2014. However, in our view, house prices and household indebtedness remain historically high, in particular when considering the low rate of home ownership in Switzerland. The very high mortgage debt level is mitigated by the large amount of financial assets, including pensions, held by households in Switzerland.

Our industry risk score of '2' primarily reflects the banking sector stability and a high share of deposit funding. Banks' net interest margins continue to decline gradually, given the pressure on deposit margins from the negative yield environment. This is partly offset, however, by higher margins on lending products, fee income from investment advisory-related activities, and cost management. As a result, banks are still able to generate returns on core banking products that are adequate to meet their cost of capital. Moreover, in our view, the Swiss regulator's regulatory initiatives are more stringent than those in other European banking industries.

Table 1

Basler Kantonalbank Key Figures					
		--Year-ended Dec. 31--			
(Mil. CHF)	**2016***	**2015**	**2014**	**2013**	**2012**
Adjusted assets	38,864.7	38,513.6	38,062.2	39,192.5	39,127.7
Customer loans (gross)	27,540.0	27,187.0	27,089.9	27,037.0	26,442.6
Adjusted common equity	3,609.2	3,556.1	3,398.5	3,102.6	3,042.0
Operating revenues	280.3	575.5	577.6	620.9	698.9
Noninterest expenses	176.7	350.0	334.2	359.6	340.9
Core earnings	98.0	180.6	204.0	221.1	323.8

*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) 38.9 billion as of June 30, 2016, 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 61.3%-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 continue 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 will continue to contribute a modest proportion of up to one-third of operating revenues. Trading revenues--which we expect will represent about 12% 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 will stabilize at about 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, since the parent's lending growth potential is constrained by the saturated banking market of Basel-City. We expect Bank Coop's profitability (representing about a quarter of the group's half-year 2016 operating revenues) will 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--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Total revenues from business line (mil. CHF)	294.4	642.6	593.7	636.4	728.1
Commercial & retail banking/total revenues from business line	84.0	82.9	78.7	79.0	79.5
Asset management/total revenues from business line	16.0	17.1	21.3	21.0	20.5
Return on equity	3.0	3.5	3.2	3.4	8.3

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

Capital and earnings: Very strong capitalization

The bank's risk-adjusted capital ratio was 16.7% at year-end 2015, and we expect it to increase to about 17.0% over the next 24 months from ongoing retention of earnings. We also foresee the bank's risk-weighted assets increasing to a limited extent. BKB's capital position is among the very strongest globally, although it is below the average of highly rated cantonal banks in Switzerland. 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 those 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 will maintain a three-year average earnings buffer at about 30 basis points, since we anticipate that interest rates in Switzerland will remain low. This means that, in our view, BKB will be able to cover 0.3% of its risk-weighted assets in a credit stress with its annual earnings. We note, however, that BKB's average real credit losses in the last five years were only a fraction (12%) of our normalized loss assumptions. We also note, however, that 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--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Tier 1 capital ratio	N/A	17.6	15.3	15.4	15.3
S&P RAC ratio before diversification	N.M.	16.7	16.1	16.4	17.5
S&P RAC ratio after diversification	N.M.	14.1	14.1	14.6	14.8

Table 3

Basler Kantonalbank Capital And Earnings (cont.)

		--Year-ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Adjusted common equity/total adjusted capital	97.3	97.3	100.0	100.0	100.0
Net interest income/operating revenues	62.0	60.1	60.1	56.5	52.8
Fee income/operating revenues	22.4	23.6	26.7	27.6	26.1
Market-sensitive income/operating revenues	13.9	13.2	11.1	13.5	18.0
Noninterest expenses/operating revenues	63.0	60.8	57.9	57.9	48.8
Preprovision operating income/average assets	0.5	0.6	0.6	0.7	0.9
Core earnings/average managed assets	0.5	0.5	0.5	0.6	0.8

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

Table 4

S&P Global Ratings' Risk-Adjusted Capital Framework Detailed Results Publication Table

	--Dec. 31, 2015--				
	EAD (1)	**Basel II RWA (2)**	**Average Basel II RW (%)**	**S&P Global Ratings' RWA**	**Average S&P Global Ratings' RW (%)**
Government and central banks	2,625,194	467,967	18	87,293	3
Institutions	3,569,797	598,774	17	413,877	12
Corporate	7,157,767	5,513,279	77	4,866,306	68
Retail	21,528,486	9,807,144	46	6,722,510	31
Of which mortgage	17,460,045	6,380,870	37	4,184,216	24
Securitization (3)	0	0	0	0	0
Other assets	5,191,203	62,684	1	5,140,150	99
Total credit risk	40,072,447	16,449,848	41	17,230,136	43
Equity in the banking book (4)	77,563	60,138	150	744,020	959
Trading book market risk	--	1,867,450	--	2,801,175	--
Total market risk	--	1,927,588	--	3,545,195	--
Total insurance risk	--	--	--	0	--
Total operational risk	--	1,097,425	--	1,164,122	--
RWA before diversification	--	20,599,336	--	21,939,453	100
Total Diversification/Concentration Adjustments	--	--	--	4,008,153	18
RWA after diversification	--	20,599,336	--	25,947,606	118
		Tier 1 capital	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings' RAC ratio (%)**
Capital ratio before adjustments		3,665,460	17.8	3,656,062	16.7
Capital ratio after adjustments (5)		3,665,460	17.6	3,656,062	14.1

Footnotes: (1) EAD: Exposure at default. (2) RWA: Risk-weighted assets. (3) Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework (4) Equity Exposure includes the minority equity holdings in financial institutions. (5) For Tier 1 ratio, adjustments are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons).

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 higher engagement in trading activities. We positively recognize that BKB made tangible progress in improving its risk management systems, but note that these have not been tested through a full business cycle and that its risk-management track record as slightly weaker than peers', as shown 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 CHF65 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 take comfort from BKB improvements in its risk-management capabilities and its overall risk profile including 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 will remain slightly below the average of the Swiss banking industry due to the bank's cautious approach to mortgage lending, prudent risk management, and the 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, which we generally view as riskier than residential real estate lending, represents about one-third of BKB's loan portfolio. 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 will 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--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Growth in customer loans	2.6	0.4	0.2	2.2	1.2
Total diversification adjustment / S&P RWA before diversification	N.M.	18.3	14.0	11.9	18.1
Total managed assets/adjusted common equity (x)	10.8	10.8	11.2	12.6	12.9
New loan loss provisions/average customer loans	(0.0)	0.1	0.1	0.0	0.0
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	0.3	1.0	1.0	1.0

Table 5

Basler Kantonalbank Risk Position (cont.)					
		--Year-ended Dec. 31--			
(%)	2016*	2015	2014	2013	2012
Loan loss reserves/gross nonperforming assets	N/A	51.4	19.3	189.0	187.3

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

Funding and liquidity: Favorable assessment supported by cantonal guarantee

We assess BKB's funding as average and its liquidity position as strong because of its strong base of customer deposits. BKB's funding is in line with Switzerland's BICRA score of '2' for systemwide funding. The bank's core customer deposits account for 69% of its funding base and for 85% of its loan portfolio mid-year 2016. 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 110% as of mid-year 2016. In addition we continue to consider the core customer deposit base as very stable due to the cantonal guarantee, which we expect will 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 will 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 1.7x as of mid-year 2016. 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--			
(%)	2016*	2015	2014	2013	2012
Core deposits/funding base	68.8	69.0	71.3	72.0	75.0
Customer loans (net)/customer deposits	117.3	115.7	112.7	112.8	108.2
Long term funding ratio	87.8	87.6	87.5	90.2	89.6
Stable funding ratio	108.3	105.7	109.5	112.9	108.6
Short-term wholesale funding/funding base	13.5	13.8	13.8	10.7	11.5
Broad liquid assets/short-term wholesale funding (x)	1.6	1.4	1.7	2.3	1.9
Net broad liquid assets/short-term customer deposits	13.0	8.9	13.2	31.4	14.1
Short-term wholesale funding/total wholesale funding	43.0	44.0	48.2	38.2	45.9
Narrow liquid assets/3-month wholesale funding (x)	2.7	2.4	2.0	2.9	2.4

*Data as of June 30.

External support: Extremely high likelihood of extraordinary government support

We regard BKB as a GRE and assess the likelihood that BKB's owner, the canton of Canton of Basel-City, would provide timely and sufficient support to BKB as extremely high. We base our assessment on our view of the bank's:

- Integral link with the canton. We expect the Canton of Basel-City to provide considerable and timely credit support to BKB in all circumstances, due to the canton's full ownership of GKB and possession of 100% of the voting rights, as well as its provision of a statutory guarantee for GKB; and

- Very important role in the canton, owing to the large impact of BKB's activities on the local economy.

Because of these factors, we incorporate a three-notch uplift into the long-term rating on BKB. We do not envisage that the bank's GRE status or our view of an extremely high likelihood of extraordinary government support will change in the foreseeable future.

BKB benefits from Basel's statutory guarantee, which ultimately covers all of its liabilities as stipulated by law. We note, however, that the guarantee does not ensure timely repayment, as defined by our criteria, but we believe that the canton has strong incentives to help BKB 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.

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 09, 2011
- Banks: Banks: Rating Methodology And Assumptions, Nov. 09, 2011
- Banks: Bank Capital Methodology And Assumptions, Dec. 06, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Banks: Commercial Paper I: Banks, March 23, 2004

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 16, 2016)	
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+

*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.

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