

Research Update:

Zuger Kantonalbank Assigned 'AA+/A-1+' Ratings; Outlook Stable

November 8, 2022

Overview

- We consider Zuger Kantonalbank (ZGKB), a well-established midsize bank in North-western Switzerland, to have very strong capitalization and adequate funding and liquidity.
- In addition, we consider ZGKB a government-related entity (GRE) benefiting from an extremely high likelihood of support. The bank has an important role in contributing to the development of the canton's economy and an integral link to the canton, including benefiting from a guarantee.
- We assigned our 'AA+/A-1+' long- and short-term issuer credit ratings to ZGKB, which includes four notches of GRE support to the bank's stand-alone credit profile (SACP).
- The stable outlook reflects our expectation that ZGKB will maintain its market position in its home canton and link to and role for the canton over the next 24 months.

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Rating Action

On Oct. 20, 2022, S&P Global Ratings assigned its 'AA+/A-1+' long- and short-term issuer credit ratings to Switzerland-based Zuger Kantonalbank (ZGKB). The outlook is stable.

Rationale

Our rating factors in our expectation that ZGKB will uphold its long-standing franchise in its home canton of Zug and, to a lesser extent, also in its surrounding cantons. Similar to its Swiss cantonal peers, ZGKB has a solid franchise in mortgage and small and midsize enterprise (SME) lending in Zug and, to a smaller extent, in its neighboring cantons in German-speaking, North-western Switzerland. Consequently, our anchor, the starting point in our assessment of a bank's creditworthiness, is 'a-', in line with that of other banks solely operating in Switzerland.

Our business position assessment reflects ZGKB's solid franchise in its home turf, but concentrated business model and significant competition from neighboring cantonal and cooperative banks. In our view, its focus on retail mortgage lending in the small canton of Zug,

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one of Switzerland's wealthiest cantons, provides the bank with a stable and long-standing customer base but offers only limited growth potential in the medium-to-long term. ZGKB also has well established and profitable asset management operations (assets under management of Swiss franc [CHF] 15 billion), which present upside potential for the bank's net fee and commission income in the coming years.

The bank exhibits one of the lowest cost-to-income ratios of its cantonal bank peer group, at only 48% as of mid-2022, reflecting ZGKB's cost discipline and solid margins. The bank's average return on equity was at about 5.5% in recent years, and we expect similar returns in the future, in line with most other cantonal banks.

We view ZGKB's robust capitalization and sound asset quality as a rating strength. We expect ZGKB's risk-adjusted capital (RAC) ratio of 23.6% at year-end 2021 will increase and stabilize at about 24.0%-24.5% by 2024, which is very strong in a global comparison. We currently do not consider hybrid instruments in our calculation, since ZGKB's capital base solely consists of common equity. Our RAC forecast is underpinned by the expectation of increasing retained earnings on the back of a stable payout per share of CHF220 and only modest credit growth. We acknowledge that our RAC for ZGKB is significantly higher than its regulatory Tier 1 capital of 17.2% at June 30, 2022, given S&P Global Ratings' lower risk weight for Swiss mortgages. We project ZGKB's three-year average earnings buffer, which measures the capacity for a bank's earnings to cover normalized losses, will be comfortable at about 1.5% over the medium term, which acts as a first line of defense against potential future losses in a deteriorating economic environment. Similar to other cantonal bank peers, ZGKB's nonperforming assets were lower than the system average of 0.72% in 2021 at less than 0.01% of customer loans. We do not expect the bank will deviate from its underwriting criteria, which supports asset quality through 2024.

We expect ZGKB's loan growth to moderate to about 4.0%-4.5% over the next 24 months, reflecting sound underwriting standards and asset quality continuing to benefit from the bank's high share in granular, lower-risk residential real estate loans, which represent roughly 60% of ZGKB's CHF18.3 billion credit risk portfolio. ZGKB engages in very limited trading activities, generating only marginal market risk, comprising mainly interest rate risk from mismatches in asset-liability management activities, which are adequately hedged, in our view.

ZGKB demonstrates a strong retail deposit franchise, with low reliance on wholesale funding and holds adequate liquidity buffers. Due to its strong market position in Zug, we view ZGKB's customer deposit base as stable, also supported by its cantonal guarantee. Core customer deposits accounted for 62.8% of its funding base as of June 30, 2022, which we view as in line with that of other domestic banks. Backed by only limited amounts of unsecured and interbank funding, we expect ZGKB's stable funding ratio to remain at favorable levels of about 105% over the medium term, following 103% as of mid-2022. Our liquidity ratio, broad liquid assets to total assets, was 18.3x for the same period, indicating a good buffer to cover an extended period without access to market funding in an adverse scenario. Broad liquid assets to short-term wholesale funding equals 1.27x. These ratios are in line with most domestic peers', but do not exceed superior ratios of other banks where we assign a stronger score. Importantly, we also factor in some intrinsic advantages from the cantonal ownership and guarantee into the bank's SACP. We note that the cantonal backbone improves availability and lowers the cost of market funding for the bank.

We consider the bank's creditworthiness to be constrained by its concentrated business model and somewhat higher risk appetite than peers' due to its exposure to the property sector.

We view ZGKB as more exposed to the economic cycle due to its substantial commercial real estate portfolio (24.5% of loan portfolio as of year-end 2021) as well as exposures to real estate developers, which are more material than that of peers. Although the bank demonstrates strong asset quality, we believe the real estate portfolio exposes the bank to elevated sector and single-name concentrations compared with low-risk peers with higher SACP. Although these relative weaknesses are not individually material enough to affect any other SACP factors, they collectively contribute to a weaker overall assessment than peers with our assessment of 'a+'. We therefore see ZGKB's stand-alone creditworthiness as more in line with that of other Swiss peers at the 'a' level, such as Luzerner Kantonalbank, Banque Cantonale de Geneve, Banque Cantonale Vaudoise, or Bank J. Safra Sarasin AG. In turn, we apply a negative comparable ratings analysis (CRA) adjustment to ZGKB.

We expect ZGKB will maintain its integral link with and very important role for the canton of Zug.

With the canton's long-term commitment, we consider ZGKB to be a GRE. ZGKB has a very important role in contributing to the development of the canton's economy due to its market share of 50% and its default would cause significant financial stress. In our view, ZGKB also has an integral link with Zug due to its cantonal guarantee, also stipulated by law. In times of stress, we believe there is an extremely high likelihood that the canton would provide sufficient and timely support to the bank, since a default could severely damage the canton's reputation.

Outlook

The stable outlook on ZGKB reflects our expectation that the bank's GRE-status, entailing an extremely high likelihood of support from the Canton of Zug, will remain unchanged over the next 24 months. Our ratings on ZGKB are sensitive to our assessment of the owner's ability and willingness to support the bank.

Downside scenario

If we perceived a weakening in ZGKB's role for or link with the canton, or material changes in the statutory guarantee, this could lead us to revise our assessment of the bank's GRE support. However, we do not envisage such a scenario in the next two years. Also, if this were to happen, we would expect that ZGKB's existing obligations would be grandfathered. The sensitivity of the rating to a potential downward revision of its SACP remains very limited.

Upside scenario

We consider rating upside to be remote. We could consider revising ZGKB's SACP upward if the bank demonstrates sustained and stable operations over the cycle without signs of weakening asset quality or earnings. However, a one-notch improvement of the SACP would not translate into a higher issuer credit rating.

Environmental, Social and Governance

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

ESG factors have no material influence on our credit rating analysis for ZGKB. As stipulated by law, the cantonal bank's mandate is focused on providing basic financial services to the canton's population, also supporting economic development in the region. We view the bank's offering of transformation advice to clients as well as its sustainability in asset management as positive. However, environmental and social factors are only marginally supportive of our credit rating analysis.

Ratings Score Snapshot

Issuer Credit Rating	AA+/Stable/A-1+
SACP	a
Anchor	a-
Business Position	Adequate (0)
Capital and Earnings	Very Strong (+2)
Risk Position	Adequate (0)
Funding and Liquidity	Adequate and Adequate (0)
Comparable Ratings Analysis	-1
Support	+4
ALAC Support	0
GRE Support	+4
Group Support	0
Sovereign Support	0
Additional factors	0

Related Criteria

- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017

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- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Banking Industry Country Risk Assessment: Switzerland, May 30, 2022

Ratings List

New Ratings

Zuger Kantonalbank

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

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