MOODY'S
INVESTORS SERVICE

Rating Action: Moody's confirms St. Galler Kantonalbank's deposit ratings at Aa1, downgrades senior unsecured debt rating to Aa2

30 Apr 2020

Frankfurt am Main, April 30, 2020 -- Moody's Investors Service (Moody's) has today confirmed the long-term deposit ratings of St. Galler Kantonalbank (SGKB) at Aa1 and downgraded the bank's senior unsecured debt rating to Aa2 from Aa1; the outlook was changed to stable from ratings under review.

At the same time, the rating agency affirmed SGKB's a2 Baseline Credit Assessment (BCA) and upgraded the bank's Adjusted BCA to a1 from a2. Moody's also upgraded SGKB's preferred stock non-cumulative rating (assigned to the bank's high-trigger AT1 instrument) to Baa1(hyb) from Baa2(hyb), its junior subordinate debt rating to A2(hyb) from A3(hyb), and its subordinate debt rating to A2 from A3.

Today's rating action concludes Moody's review for downgrade initiated on 22 January 2020, which was linked to a re-assessment of the implications for the credit profile of the bank's guarantor, the Canton of St. Gallen, of the very sizeable contingent liability arising from a deficiency guarantee provided by the canton on SGKB's senior obligations. It reflects the comprehensive application of Moody's Support and Structural Analysis, which comprises Affiliate Support, an Advanced Loss Given Failure (LGF) analysis, and Government Support, compared with its previous approach to solely incorporate the creditworthiness of the Canton of St. Gallen in the rating agency's assumption of government support for all instruments that benefit from the canton's guarantee.

For a full list of all affected ratings, please refer to the end of this press release.

RATINGS RATIONALE

RATIONALE FOR THE AFFIRMATION OF THE BCA

Moody's affirmation of SGKB's a2 BCA reflects the resilience of the bank's intrinsic financial strength, despite the rapid and widening spread of the coronavirus outbreak and the deteriorating global economic outlook, which are creating a severe and extensive credit shock across many sectors, regions and markets and will weigh on the bank's solvency. Moody's regards the coronavirus outbreak as a social risk under its environment, social and governance (ESG) framework, given the substantial implications for public health and safety.

While the rating agency expects problem loans to rise and profitability to be under pressure in 2020, the bank benefits from a solid capital base, with a tangible common equity (TCE) to risk-weighted-assets (RWA) ratio of 17.5% as of 31 December 2019, and adequate, high-quality liquid resources. Furthermore, SGKB is exposed to confidence-sensitive market funding, but it benefits from the deficiency guarantee provided by the Canton of St. Gallen, which results in low funding costs and strong market access even in a more stressed environment.

RATIONALE FOR THE UPGRADE OF THE ADJUSTED BCA

The Canton of St. Gallen owns 51% of the share capital of SGKB, which, combined with the bank's economic and social role as a cantonal bank in the region, provides an incentive for the canton to inject capital into SGKB, in case of need, to prevent the failure of the bank. The support provided by the canton prior to failure benefits all debt-holders, which prompted Moody's to incorporate such support within affiliate support, resulting in an upgrade of the Adjusted BCA to a1 from a2.

RATIONALE FOR THE CONFIRMATION OF THE DEPOSIT AND COUNTERPARTY RISK RATINGS

SGKB is subject to Swiss banking regulations, which Moody's considers an operational resolution regime. The rating agency therefore applies its Advanced LGF analysis, which takes into consideration the risks faced by the different debt and deposit classes across the liability structure at failure. Because of significant volume of instruments outstanding that rank below deposits and counterparty risk liabilities in insolvency, Moody's expects an extremely low loss-given-failure for these instrument classes, resulting in three notches of rating uplift for SGKB's deposits and counterparty risk liabilities from the bank's a1 Adjusted BCA, and the confirmation of SGKB's Aa1 deposit, Counterparty Risk Ratings, and the Aa1(cr) Counterparty Risk Assessment.

RATIONALE FOR THE DOWNGRADE OF THE SENIOR UNSECURED RATING

In contrast to the outcome for deposits and counterparty risk liabilities, Moody's Advanced LGF analysis results in only one notch of rating uplift for senior unsecured debt from SGKB's a1 Adjusted BCA, mostly because of more limited volume of instruments designated to be loss-absorbing prior to senior unsecured bonds. However, since the Canton of St. Gallen guarantees all senior obligations of the bank, SGKB's senior unsecured debt ratings benefits from one further notch of rating uplift from this commitment, which Moody's incorporates in government support. Overall, though, this results in a downgrade of the senior unsecured debt rating to Aa2 from Aa1.

RATIONALE FOR THE UPGRADE OF THE SUBORDINATE AND JUNIOR SUBORDINATE INSTRUMENTS

The upgrade of SGKB's subordinated and junior subordinated instruments to A2 from A3, and to A2(hyb) from A3(hyb), respectively, follows the upgrade of the Adjusted BCA. For these rating classes, which are not covered by the deficiency guarantee, Moody's already applied its Advanced LGF analysis, which continues to result in a high loss-given-failure.

RATIONALE FOR THE UPGRADE OF THE HIGH-TRIGGER AT1 INSTRUMENT

The upgrade of SGKB's high-trigger AT1 instrument (a non-cumulative preferred stock instrument) to Baa1(hyb) from Baa2(hyb) follows the upgrade of the bank's Adjusted BCA to a1.

The Baa1(hyb) rating incorporates several considerations: the output of its model-based outcome; the determination of the rating level of a non-viability security for SGKB (because the high-trigger AT1 securities incorporate a pre-failure trigger breach risk and cannot be rated above a non-viability security) and a preferred security (for the same reason); as well as possible actions by Swiss Financial Market Supervisory Authority (FINMA) prior to any defined trigger breach. As such, the Baa1(hyb) rating reflects that FINMA can force the write-down of the high-trigger securities, once SGKB receives extraordinary support from the Canton of St. Gallen to avoid insolvency, which could happen prior to a contractual trigger breach.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Although unlikely given the already high level, SGKB's ratings could be upgraded if the bank's standalone creditworthiness improves significantly, resulting from a combination of materially reduced concentrations risks, significantly higher profitability and an improved combined liquidity profile.

The bank's senior unsecured debt rating could be upgraded if the creditworthiness of the Canton of St. Gallen improves. The bank's subordinated, junior subordinated, and senior unsecured debt ratings could also benefit from higher rating uplift from Moody's Advanced LGF analysis, if material volumes of additional subordinated instruments were to be issued. SGKB's high-trigger AT1 instrument cannot be upgraded, since the rating agency caps such instrument ratings at the Baa1(hyb) level.

Downward pressure on the bank's ratings could result from a downgrade of the bank's BCA, or from a material deterioration of the canton's creditworthiness. The bank's Aa1 long-term ratings could also be downgraded as result of a change in the bank's liability structure, which could lead to a lower result from Moody's Advanced LGF analysis.

The bank's BCA could be downgraded if its asset risk, predominantly from its real estate lending book, would increase as reflected in sustainably higher problem loans, combined with lower cushions from its capital ratios and depressed profitability. Furthermore, a deteriorating liquidity profile could exert downwards rating pressure.

LIST OF AFFECTED RATINGS

Issuer: St. Galler Kantonalbank

..Downgrades:

....Senior Unsecured Regular Bond/Debenture, downgraded to Aa2 from Aa1, outlook changed to Stable from Rating under Review

..Upgrades:

....Adjusted Baseline Credit Assessment, upgraded to a1 from a2

....Subordinate Regular Bond/Debenture, upgraded to A2 from A3

....Junior Subordinated Regular Bond/Debenture, upgraded to A2(hyb) from A3(hyb)

....Preferred Stock Non-cumulative, upgraded to Baa1(hyb) from Baa2(hyb)

..Confirmations:

....Long-term Counterparty Risk Ratings, confirmed at Aa1

....Long-term Bank Deposits, confirmed at Aa1, outlook changed to Stable from Rating under Review

....Long-term Counterparty Risk Assessment, confirmed at Aa1(cr)

..Affirmations:

....Short-term Counterparty Risk Ratings, affirmed P-1

....Short-term Bank Deposits, affirmed P-1

....Short-term Counterparty Risk Assessment, affirmed P-1(cr)

....Baseline Credit Assessment, affirmed a2

..Outlook Action:

....Outlook changed to Stable from Rating under Review

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1147865 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

For ratings issued on a program, series, category/class of debt or security this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series, category/class of debt, security or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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The ratings have been disclosed to the rated entity or its designated agent(s) and issued with no amendment resulting from that disclosure.

These ratings are solicited. Please refer to Moody's Policy for Designating and Assigning Unsolicited Credit Ratings available on its website www.moodys.com.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1133569 .

At least one ESG consideration was material to the credit rating action(s) announced and described above.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

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