MOODY'S
INVESTORS SERVICE

Rating Action: Moody's places on review for downgrade Swiss cantonal bank ZKB's Aaa ratings and SGKB's Aa1 ratings

22 Jan 2020

Frankfurt am Main, January 22, 2020 -- Moody's Investors Service (Moody's), has today placed on review for downgrade the Aaa long-term deposit and issuer ratings of Zuercher Kantonalbank (ZKB) and the Aa1 long-term deposit and senior unsecured ratings of St. Galler Kantonalbank (SGKB). The rating action is linked to a re-assessment of the implications for the credit profiles of the banks' respective guarantors, the Canton of Zurich and the Canton of St. Gallen, of the very sizeable contingent liabilities arising from deficiency guarantees provided to each institution; the banks' ratings partly reflect the strength of those guarantees and therefore, indirectly, the creditworthiness of the respective canton.

Moody's expects to have finalized its evaluation of the contingent liability risks within three months and that the magnitude of a potential downgrade will likely be limited, perhaps to one notch.

At the same time, Moody's upgraded ZKB's Baseline Credit Assessment (BCA) and Adjusted BCA to a1 from a2 and its high-trigger AT1 securities to Baa1(hyb) from Baa2(hyb), while it affirmed the bank's P-1 short-term ratings.

Furthermore, the rating agency affirmed SGKB's a2 BCA and Adjusted BCA and upgraded SGKB's high-trigger AT1 instrument to Baa2(hyb) from Baa3(hyb); Moody's also affirmed SKGB's A3 subordinated and A3(hyb) junior subordinated ratings and its P-1 short-term ratings.

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

RATINGS RATIONALE

RATIONALE FOR THE REVIEW FOR DOWNGRADE ON THE GUARANTEED RATINGS

Moody's currently bases ZKB's Aaa long-term deposit and issuer ratings on a deficiency guarantee provided by the Canton of Zurich and SGKB's Aa1 long-term deposit and senior unsecured ratings on a deficiency guarantee provided by the Canton of St. Gallen, and the creditworthiness of the two Swiss regional governments. The latter includes an assessment of the regional governments' economic fundamentals, institutional frameworks, governance and management, financial performance and debt profile, and potential support being provided by the sovereign, in case of need. Part of the assessment of the financial performance and debt profile is an evaluation of the risks related to contingent liabilities.

The review for downgrade on ZKB's Aaa ratings and SGKB's Aa1 ratings reflect a review initiated by Moody's of the implications for the cantons' creditworthiness of their sizeable contingent liabilities arising from those guarantees. That review will factor in the financial implications for each canton of its guarantee being called as well as the likelihood of that happening, among others.

FOCUS OF THE REVIEW

The review will examine the various forms of support each canton might be required to provide to the respective institution, through ongoing supervision and early intervention ahead of a default scenario up to and including the triggering of each guarantee. Moody's will consider whether -- and may well conclude that -- the size of each guarantee relative to the respective canton's financial revenue-raising capacity materially undermines the canton's credit profile notwithstanding the potential for earlier forms of intervention to lower the risk of the guarantee being triggered.

Were Moody's to conclude that the respective canton's credit profile were indeed weaker than previously estimated, there would be corresponding implications for the credit profiles of each bank. However, the rating agency will also re-assess how the government guarantees in place impact the risk position of either banks' depositors and senior unsecured investors. The introduction of Moody's Advanced Loss Given Failure analysis and the position of ZKB as a systemic institution within the Swiss banking universe are factors to be considered and could offset part of the consequent downward rating pressure on the banks. Partly as a consequence, it is likely that the extent of any downgrade will be limited, perhaps to one notch.

RATIONALE FOR THE UPGRADE OF ZKB'S BCA

The upgrade of the BCA to a1 from a2 reflects Moody's expectation of a sustained increase in the bank's capital buffers, providing an even higher cushion for potential adverse developments, for instance a severe housing crisis. The expectation is based on growing regulatory requirements, which are likely to be met via a combination of core capital and Tier 2 instruments.

The upgrade further takes into account the bank's proven and very sound access to confidence-sensitive funding sources, while the standalone creditworthiness of the bank continues to be supported by its extremely liquid balance sheet, its strong asset quality, as reflected in the bank's low non-performing loans and declining market risks, as well as solid and well diversified earnings. In addition, Moody's has not identified particular corporate governance concerns that could undermine ZKB's strong creditworthiness. The BCA reflects the assessment of the implications due to a change in the Macro Profile Switzerland to Strong (+) from Very Strong (-).

RATIONALE FOR THE AFFIRMATION OF SGKB'S BCA

SGKB a2 BCA reflects the bank's generally sound solvency profile, stemming from its sound asset quality and adequate capitalization. Its liquidity and funding profile is relatively balanced with limited recourse to interbank liabilities in exchange of a higher share of covered bonds in the funding mix, a more moderate need to access confidence-sensitive market funding while also benefitting from a guarantee provided by its majority owner.

SGKB's BCA continues to reflect its still significant geographical concentrations and moderate, but stable risk-adjusted profitability. The rating agency has not identified specific corporate governance risks for SGKB. The BCA reflects the assessment of the implications due to a change in the Macro Profile Switzerland to Strong (+) from Very Strong (-).

RATIONALE FOR THE UPGRADE OF ZKB'S HIGH-TRIGGER AT1 INSTRUMENT

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

Moody's applies a model to assess the probability of ZKB's CET1 ratio reaching the write-down trigger. The model is based on ZKB's Adjusted BCA of a1 and the single entity-level CET1 capital ratio of 16.5% as of third quarter 2019. The model provides an outcome of Baa1(hyb). According to Moody's methodology for rating high-trigger AT1 securities, the rating agency rates to the lower of a model-based outcome and a non-viability security rating.

RATIONALE FOR THE UPGRADE OF SGKB'S HIGH-TRIGGER AT1 INSTRUMENT

The upgrade of SGKB's high-trigger AT1 instrument (a non-cumulative preferred stock instrument) to Baa2(hyb) from Baa3(hyb) is driven by the sustained improvement of the bank's regulatory CET1 ratios.

Moody's applies a model to assess the probability of SGKB's CET1 ratio reaching the write-down trigger. The model is based on SGKB's Adjusted BCA of a2 and the bank's improved CET1 capital ratio of 15.7% as of June 2019. The model provides an outcome of Baa2(hyb). According to Moody's methodology for rating high-trigger AT1 securities, the rating agency rates to the lower of a model-based outcome of Baa2(hyb) and a non-viability security rating.

RATIONALE FOR THE AFFIRMATION OF SGKB's SUBORDINATED BONDS

The affirmation for SGKB's A3 subordinated and A3(hyb) junior subordinated instruments follows the affirmation of the Adjusted BCA, which itself mirrors the affirmation of the BCA, and unchanged results from Moody's Advanced Loss Given Failure analysis for these instruments.

WHAT COULD CHANGE THE RATINGS UP / DOWN

ZKB's deposit and issuer ratings, as well as its high-trigger AT1 securities are already positioned at the highest possible level. For SGKB, there is no upward ratings pressure on the deposit and senior unsecured ratings as signaled by the review for downgrade.

While upward pressure on the banks' standalone creditworthiness is unlikely given the high BCAs in place, a

BCA upgrade could result from a combination of materially reduced concentrations risks, significantly higher profitability and an improved combined liquidity profile.

SGKB's subordinated, junior subordinated and high-trigger AT1 ratings could face rating upward pressure in the case of an upgrade of the bank's BCA. The subordinated and junior subordinated debt ratings could also benefit from higher rating uplift from the rating agency's Advanced LGF analysis, if material volumes of additional subordinated instruments were to be issued.

Downward pressure on the banks' ratings could result from a downgrade of their BCAs or from a material deterioration of the respective canton's creditworthiness.

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

LIST OF AFFECTED RATINGS

Issuer: Zuercher Kantonalbank

..Upgrades:

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

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

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

..Placed on Review for Downgrade:

....Long-term Counterparty Risk Ratings, currently Aaa

....Long-term Bank Deposits, currently Aaa, outlook changed to Rating under Review from Stable

....Long-term Counterparty Risk Assessment, currently Aaa(cr)

....Long-term Issuer Ratings, currently Aaa, outlook changed to Rating under Review from Stable

..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)

..Outlook Action:

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

Issuer: St. Galler Kantonalbank

..Upgrades:

....Preferred Stock Non-cumulative, upgraded to Baa2(hyb) from Baa3(hyb)

..Placed on Review for Downgrade:

....Long-term Counterparty Risk Ratings, currently Aa1

....Long-term Bank Deposits, currently Aa1, outlook changed to Ratings under Review from Stable

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

....Senior Unsecured Regular Bond/Debenture, currently Aa1, outlook changed to Ratings under Review from Stable

..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

....Adjusted Baseline Credit Assessment, affirmed a2

....Subordinate Regular Bond/Debenture, affirmed A3

....Junior Subordinated Regular Bond/Debenture, affirmed A3(hyb)

..Outlook Action:

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

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks Methodology published in November 2019. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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