FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Zuercher Kantonalbank at 'AAA'; Outlook Stable

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Fitch Ratings - London - 19 Jul 2023: Fitch Ratings has affirmed Zuercher Kantonalbank's (ZKB) Long-Term Issuer Default Rating (IDR) at 'AAA' with a Stable Outlook and Viability Rating (VR) at 'a+'.

KEY RATING DRIVERS

ZKB's IDRs are driven by support from its guarantor and sole owner, the Canton of Zurich (AAA/Stable/F1+). ZKB's Shareholder Support Rating (SSR) is equalised with the canton's Long-Term IDR. ZKB's VR reflects the bank's stable and resilient business model, conservative risk appetite, strong asset quality, funding and capitalisation and adequate and improving profitability.

Cantonal Guarantee: The canton guarantees all of ZKB's non-subordinated liabilities according to a specific cantonal law (ZKB Law). ZKB's balance sheet is large relative to the canton's budgetary resources, but we believe the bank's stable and resilient business model, funding, and capital buffers mean that recapitalisation or liquidity support needs would be manageable in a realistic stress scenario.

Timely Support Expected: The canton's guarantee does not explicitly address the timeliness of support, but Fitch believes that support would be provided in a timely fashion if necessary, given ZKB's high importance for the canton and the potential repercussions of systemically important bank's failure for the Swiss financial sector. The canton's constitution also requires it to have a cantonal bank, making the institutional owner more likely to support the bank in financial distress.

Strong Regional Franchise: ZKB's leading franchise in deposit-taking and residential mortgage lending in the Canton of Zurich, where the bank's operations are concentrated, supports the VR. Geographic concentration is mitigated by Zurich's economic strength and the bank's diversified business activities covering retail and commercial banking. ZKB is also the third-largest fund provider and one of the largest asset managers in Switzerland through its wholly-owned subsidiary Swisscanto.

Material Real Estate Exposure: ZKB's impaired loans ratio is very low compared with international peers. ZKB's main risk stems from a large real estate exposure in Zurich, with 74% of end-2022 gross customer loans in residential property financing. Fitch believes loan quality would be resilient to a significant decline in property values due to the bank's strict underwriting standards and moderate loan-to-value ratios.

Improving Earnings: Our assessment of ZKB's profitability reflects its long record of adequate, stable and fairly diversified earnings, despite a material share of trading income in the bank's revenue. Operating profitability (1.4% of risk-weighted assets in 2022) benefits from rising interest rates and we expect it to improve further in 2H23 and 2024.

Strong Capitalisation: ZKB's common equity Tier 1 (CET1) ratio remained strong at 16.8% at end-2022, despite strong loan growth. The canton's guarantee covers half of ZKB's gone-concern capital requirement, which will be fully phased in at 7.86% in 2026. The remaining gap will be covered with bail-in debt that the bank started issuing this year.

Stable Funding: ZKB's funding is underpinned by a large and mostly granular deposit base, despite some more concentrated corporate and institutional deposits. Customer deposits account for over half of non-equity funding and almost cover the full volume of loans. Wholesale funding needs are moderate and benefit from the bank's cantonal guarantee, due to which investors perceive ZKB as a safe haven in times of increased market uncertainty.

Recovery and Resolution Plan: As a domestic systemically important bank, ZKB has a recovery and resolution plan to be approved by the Swiss banking supervisor (FINMA). According to this plan, to recapitalise ZKB, the canton could be required to provide CHF3 billion of capital, which is large relative to its own resources. We believe the provision of this capital would be manageable for the canton given its strong financial position, and would not on its own drive negative action on the canton's ratings, or trigger a reassessment of our support assumptions.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

A downgrade of the Canton of Zurich's IDRs would result in a downgrade of ZKB's IDRs and SSR. A material increase in the canton's contingent liabilities, which are dominated by ZKB, could put pressure on ZKB's IDRs and SSR. Contingent liabilities could increase, for instance, because of sustained growth in the bank's balance sheet in excess of the canton's GDP growth, or due to a material delay by the canton in promptly addressing a potential capital shortfall at ZKB.

ZKB's IDRs and SSR are also sensitive to changes to the bank's relationship with the canton, especially if the ZKB Law was amended in a way that would weaken the guarantee's effectiveness or cast doubt on the timeliness of support. However, we view this scenario as unlikely.

The VR would likely be downgraded if large real estate-related losses, which could arise from a sharp drop in residential property prices in Zurich, led to a CET1 ratio materially below 16%, or an impaired loans ratio durably above 2%. The rating would also come under pressure if profitability deteriorated durably, or if the bank increased its risk appetite, which could be indicated by higher loan growth or by greater exposure to interest-rate risk in the loan book.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

The Long-Term IDR is at the highest level on Fitch's scale and cannot be upgraded.

An upgrade of the VR is unlikely given the concentration of ZKB's business model on the Canton of Zurich, resulting in a large exposure to the local property market. An upgrade would also require an improvement in the bank's profitability.

VR ADJUSTMENTS

The earnings and profitability score of 'a-' has been assigned above the 'bbb' category implied score, due to the following adjustment reason: revenue diversification (positive).

The capitalisation and leverage score of 'a+' has been assigned below the 'aa' category implied score, due to the following adjustment reason: capital flexibility and ordinary support (negative).

The funding and liquidity score of 'aa-' has been assigned above the 'a' category implied score, due to the following adjustment reason: liquidity access and ordinary support (positive).

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

ZKB's IDRs are aligned with those of the Canton of Zurich.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT	RATING	PRIOR
Zuercher Kantonalbank	LT IDR AAA Rating Outlook Stable Affirmed	AAA Rating Outlook Stable
	ST IDR F1+ Affirmed	F1+
	Viability a+ Affirmed	a+
	Shareholder Support aaa Affirmed	aaa

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Maria Shishkina
Director
Primary Rating Analyst
+44 20 3530 1379
maria.shishkina@fitchratings.com
Fitch Ratings Ltd
30 North Colonnade, Canary Wharf London E14 5GN

Marco Diamantini
Director
Secondary Rating Analyst
+49 69 768076 114
marco.diamantini@fitchratings.com

Christian Kuendig
Managing Director
Committee Chairperson
+44 20 3530 1399
christian.kuendig@fitchratings.com

MEDIA CONTACTS

Peter Fitzpatrick
London
+44 20 3530 1103
peter.fitzpatrick@thefitchgroup.com

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 07 Sep 2022) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Zuercher Kantonalbank	UK Issued, EU Endorsed

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