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Aargauische Kantonalbank

Primary Credit Analyst:

Dirk Heise, Frankfurt (49) 69-33-999-163; dirk.heise@standardandpoors.com

Secondary Contact:

Nicolas W Hengstebeck, Frankfurt (49) 69-33-999-167; nicolas.hengstebeck@standardandpoors.com

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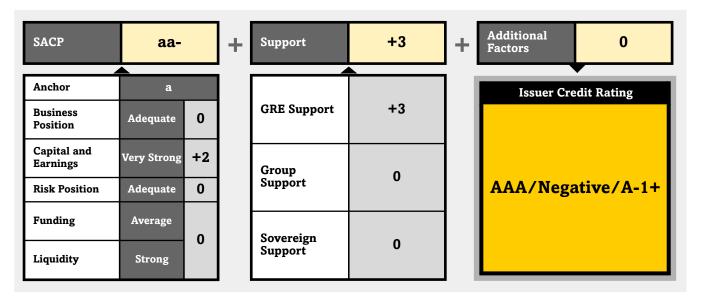
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Aargauische Kantonalbank



Major Rating Factors

Strengths:

- A sound financial profile, underpinned by very strong capitalization and strong earnings capacity.
- Sound asset quality and prudent risk management.
- "Integral" link with and "very important" role for the Canton of Aargau, its owner, and a statutory guarantee.

Weaknesses:

- Concentration risks from limited geographic diversity and focus on residential mortgage lending.
- Subdued growth prospects in the saturated and competitive home market.
- Limited earnings diversification.

Outlook: Negative

Standard & Poor's Ratings Services' outlook on Switzerland-based Aargauische Kantonalbank (AKB) is negative. This reflects our view on the growing economic imbalances in the Swiss Confederation, stemming from residential real estate price increases we have observed over past years and associated risks for the high asset quality of AKB's mortgage loan book.

If we were to lower our Banking Industry Country Risk Assessment (BICRA) on the Swiss Confederation based on these growing economic imbalances, it would affect the anchor for domestically-oriented Swiss banks, leading us to review our ratings on these banks, including AKB. Such review could result in a downward revision of the stand-alone credit profile (SACP) and a downgrade of AKB by one notch.

An improvement in AKB's SACP is unlikely at this stage, in view of the bank's comparatively concentrated business. We could revise the outlook to stable, if we concluded that risks from the current developments in residential real estate prices would not affect AKB's creditworthiness at all or would affect it only to a minor extent.

Rationale

Our ratings on AKB reflect its anchor of 'a', its "adequate" business position, "very strong" capital and earnings, "adequate" risk position, "average" funding, and "strong" liquidity, as our criteria define these terms. The SACP is 'aa-'.

We continue to consider AKB a government-related entity (GRE) with an "extremely high" likelihood of receiving extraordinary government support in times of stress. We base this on our view of AKB's "very important" role for and "integral" link with its home canton, the Canton of Aargau (AAA/Stable/A-1+). This provides a three-notch uplift to our assessment of AKB's SACP.

Anchor: 'a' for banks operating in Switzerland

Our bank criteria use the BICRA economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The anchor for a commercial bank operating only in Switzerland is 'a'.

The BICRA score includes our evaluation of economic risk. In this respect, we view Switzerland as a highly diversified and competitive economy, benefiting from one of the highest GDPs per capita in the world and very robust government finances. We believe Switzerland demonstrates a conservative risk and lending culture, which has accompanied recent moderate growth of house prices and loan portfolios.

The Swiss banking industry is supported by its sizable and very stable customer deposit base. Pure domestic Swiss banks have not loosened credit standards in recent years, thanks to sound earnings potential from core products. We consider regulatory standards to be more stringent than in other developed countries.

Table 1

Aargauische Kantonalbank Key Figures								
			l 					
(Mil. CHF)	2013*	2012	2011	2010	2009			
Adjusted assets	21,426.1	21,593.9	19,906.5	19,164.8	18,555.2			
Customer loans (gross)	18,066.4	17,698.8	17,092.3	16,216.5	15,569.6			
Adjusted common equity	1,620.6	1,543.2	1,455.9	1,349.0	1,324.3			
Operating revenues	189.2	380.4	391.4	376.8	373.5			
Noninterest expenses	96.5	190.5	197.5	210.6	189.0			
Core earnings	80.3	165.3	168.4	141.9	149.8			

^{*}Data as of June 30. CHF--Swiss Franc.

Business position: Geographic and product concentration mitigated by a stable business profile AKB's "adequate" business profile stems from its strong business stability, which offsets concentration risks arising from its focus on real estate lending and on the Canton of Aargau.

AKB is a midsize cantonal bank with total assets of Swiss franc (CHF) 21.4 billion (€17.4 billion) as of June 30, 2013. Like most cantonal banks, AKB focuses mainly on residential mortgage lending and lending to small and midsize enterprises in its home canton and to a lesser extent in neighboring cantons. In contrast to many other rated cantonal banks, we understand that the competitive environment in AKB's core market is more difficult because we expect AKB

to maintain its market shares of about 30% in the Canton of Aargau, which is lower than the market share of other cantonal banks in their respective home cantons.

The bank's geographic concentration in Aargau and neighboring regions exposes it to economic swings in a rather small economy. Although we see risks arising from AKB's concentrated business profile, we expect the bank to continue to post very sound and stable earnings in the coming years by continuing its focus on low-margin, but stable and less-risky, business, with an exceptionally stable client base. AKB's engagement in private banking business, particularly through its subsidiary AKB Privatbank Zürich AG, provides it with a limited diversification benefit as the subsidiary accounts for only about 7% of AKB's overall operating revenues.

AKB's history of strong and sustainable profitability, prudent risk management, and cautious lending standards are fundamental in our assumption of why we consider the bank's business position and performance as stable, despite its comparatively highly concentrated business focus.

Table 2

Aargauische Kantonalbank Business Position								
		Y	ear-ende	d Dec. 31-	<u>-</u>			
(%)	2013*	2012	2011	2010	2009			
Total revenues from business line (Mil. CHF)	191.9	380.7	392.4	379.5	376.5			
Other revenues/total revenues from business line	100.0	100.0	100.0	100.0	100.0			
Return on equity	6.8	6.3	6.7	6.7	6.4			

^{*}Data as of June 30. CHF-Swiss franc.

Capital and earnings: Very strong compared with that of global peers

At year-end 2012, our risk-adjusted capital (RAC) ratio for AKB stood at 17.8%, and we expect it to gradually increase over the next 18 months to about 18.5%-19.5%, due to our anticipation of stable results and the bank's ongoing retention of earnings. Although our assessment of AKB's capital is lower than the average for the cantonal banks we rate, we still view AKB's capital position as very strong from a global perspective.

A potential downward revision of the BICRA on Switzerland, based on growing economic imbalances, would have negative implications for AKB's RAC ratio, because economic risks associated with Swiss exposures would increase within our capital framework. We do not expect, however, that our overall assessment of AKB's very strong capital position would be negatively impacted in such a scenario.

Our assessment of AKB's earnings rests on our perception of its strong earnings capacity, even compared with that of other cantonal banks, adding to our view of AKB's "very strong" capital position. Due to our expectation of a prolonged period of low interest rates, we estimate the three-year average earnings buffer will remain at about 150 basis points, which we believe AKB can maintain over the medium term.

Table 3

Aargauische Kantonalbank Capital And Earnings						
	-	Y	ear-ended	l Dec. 31		
(%)	2013*	2012	2011	2010	2009	
Tier 1 capital ratio	N/A	15.4	14.7	13.9	13.2	

Table 3

Aargauische Kantonalbank Capital And Earnings (cont.)								
S&P RAC ratio before diversification	N.M.	17.8	17.5	16.7	17.1			
S&P RAC ratio after diversification	N.M.	16.1	16.3	15.4	14.8			
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0			
Net interest income/operating revenues	70.5	71.0	70.2	70.8	69.5			
Fee income/operating revenues	18.9	18.5	18.4	19.6	19.1			
Market-sensitive income/operating revenues	9.1	9.1	10.1	8.2	8.4			
Noninterest expenses/operating revenues	51.0	50.1	50.5	55.9	50.6			
Preprovision operating income/average assets	0.9	0.9	1.0	0.9	1.0			
Core earnings/average managed assets	0.7	0.8	0.9	0.8	0.8			

^{*}Data as of June 30. N/A--Not applicable. N.M.--Not meaningful.

Risk position: Increasing residential housing prices pose a potential risk

The asset quality of AKB's loan portfolio is high in our view, based on AKB's prudent risk management and lending standards, which we consider to be more stringent than that of competitors in the Swiss Market. Loan growth has been broadly in line with the Swiss average and we expect that to continue at a growth rate of approximately 4%-5% per year in line with that of other cantonal banks. AKB's real estate loan portfolio represents more than 90% of the loan book, where the majority consists of residential real estate loans. It is very granular and highly collateralized, with an estimated sound average loan-to-value ratio of 65%.

Due to AKB's focus on mortgage lending, we perceive that the housing price increases we have observed in Switzerland over the past several years will likely increase the risks of correction and subsequently could negatively impact AKB's current sound asset quality. This could become an area of concern for the rating, as shown by our negative outlook. At the same time, we acknowledge that residential real estate price increases in the Canton of Aargau have been lower than the Swiss average. However, the housing market in Aargau may not be able to fully decouple itself from the developments in the national housing market.

We generally view commercial lending as riskier than residential real estate loan business. Nevertheless, we believe the quality of AKB's commercial loan portfolio, including commercial real estate, which accounts for about 19% of its loan book, to be very sound because exposure to cyclical and riskier sectors, such as tourism or real estate development, is modest. Overall credit losses remained low for the past three years, at about 10 basis points of the total loan portfolio each year.

AKB makes negligible use of complex products because it strives to operate only in markets and with products it fully understands. Market risk mainly comprises interest rate risk from mismatches in asset-liability management activities, which are adequately hedged in our view. AKB engages in very limited trading activities, which are generally client initiated.

Table 4

Aargauische Kantonalbank Risk Position					
		Y	ear-ende	d Dec. 3	1
(%)	2013*	2012	2011	2010	2009
Growth in customer loans	4.2	3.5	5.4	4.2	6.7

Table 4

Aargauische Kantonalbank Risk Position (cont.)					
Total diversification adjustment / S&P RWA before diversification	N.M.	10.9	7.2	8.3	15.6
Total managed assets/adjusted common equity (x)	13.2	14.0	13.7	14.2	14.0
New loan loss provisions/average customer loans	0.1	0.1	0.1	0.1	0.2
Net charge-offs/average customer loans	N.M.	(0.1)	(0.1)	(0.0)	0.0
Gross nonperforming assets/customer loans + other real estate owned	N/A	0.4	0.6	8.0	0.8
Loan loss reserves/gross nonperforming assets	N/A	428.0	342.4	235.8	241.9

^{*}Data as of June 30. N/A--Not applicable. N.M.--Not meaningful.

Table 5

(Mil. CHF)	Exposure*	Basel II RWA	Average Basel II RW (%)	Standard & Poor's RWA	Average Standard & Poor's RW (%)
Credit risk					
Government and central banks	24	1	3	1	3
Institutions	1,002	375	37	191	19
Corporate	6,758	3,713	55	4,481	66
Retail	11,931	5,775	48	2,664	22
Of which mortgage	11,010	4,963	45	2,092	19
Securitization	0	0	0	0	0
Other assets	421	338	80	331	79
Total credit risk	20,136	10,201	51	7,668	38
Market risk					
Equity in the banking book¶	15	25	167	111	740
Trading book market risk		88		131	
Total market risk		113		242	
Insurance risk					
Total insurance risk				0	
Operational risk					
Total operational risk		713		741	
(Mil. CHF)		Basel II RWA		Standard & Poor's RWA	% of Standard & Poor's RWA
Diversification adjustments					
RWA before diversification		11,026		8,652	100
Total adjustments to RWA				940	11
RWA after diversification		11,026		9,592	111
(Mil. CHF)	_	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	Standard & Poor's RAC ratio (%)
Capital ratio					
Capital ratio before adjustments		1,707	15.5	1,543	17.8

Table 5

Aargauische Kantonalbank Ri	sk-Adjusted Capital Framew	vork Data (cont.)		
Capital ratio after	1,707	15.4	1,543	16.1
adjustments§				

^{*}Exposure at default. Securitisation Exposure includes the securitisation tranches deducted from capital in the regulatory framework. ¶Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. §Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. CHF--Swiss Franc. Sources: Company data as of Dec. 31, 2012, Standard & Poor's.

Funding and liquidity: A loyal customer base and strong liquidity

AKB's funding is "average" and in line with our BICRA score of '1' for systemwide funding in Switzerland. The bank's liquidity position is "strong", in our opinion. Both assessments reflect the stability we consider AKB enjoys based on the guarantee provided by the canton.

The bank's core customer deposits account for 74% of its funding base and 83% of its loan portfolio, and it has a comparably large equity position on its balance sheet. Due to the cantonal guarantee, which we expect to remain in place, we regard AKB's customer deposits as very stable and its customer base as loyal. The remainder of AKB's funding mix is divided equally between interbank funding and capital market funding via secured and unsecured instruments.

The "strong" liquidity assessment reflects AKB's very favorable liquidity position, which enables it to operate for more than 12 months with no access to market funding. Its liquid assets comfortably cover its short-term wholesale funding needs, minimizing the risk of a liquidity gap. AKB's stable customer base is likely to help it weather potential capital market distress. Moreover, based on their close ties to and its guarantee by the canton, we would expect AKB to profit from any potential eroding confidence in other Swiss financial institutions, not benefiting from the same close ties and guarantee.

Table 6

Aargauische Kantonalbank Funding And Liquidity								
			Year-ended	d Dec. 31				
(%)	2013*	2012	2011	2010	2009			
Core deposits/funding base	76.6	74.3	74.7	72.0	72.5			
Customer loans (net)/customer deposits	123.5	120.7	126.8	130.5	127.7			
Long term funding ratio	92.2	91.6	94.1	90.7	85.0			
Stable funding ratio	100.0	104.6	101.9	98.4	N/A			
Short-term wholesale funding/funding base	8.4	9.1	6.4	10.0	16.3			
Broad liquid assets/short-term wholesale funding (x)	1.4	1.5	1.4	1.0	N/A			
Net broad liquid assets/short-term customer deposits	4.6	7.1	3.7	(0.2)	N/A			
Short-term wholesale funding/total wholesale funding	36.1	35.6	25.3	35.9	59.0			
Narrow liquid assets/3-month wholesale funding (x)	1.8	2.0	2.5	1.3	N/A			

^{*}Data as of June 30. N/A--Not applicable.

External support: "Extremely high" likelihood of extraordinary support

We consider AKB to be a GRE, given its full ownership by the Canton of Aargau. The long-term rating on AKB is three notches higher than its SACP, reflecting our opinion of an "extremely high" likelihood of timely and sufficient

extraordinary support for AKB from its owner in the event of financial distress, in accordance with our GRE methodology. This is based on AKB's "integral" link with and "very important" role for the Canton of Aargau, which is primarily facilitated by the cantonal guarantee in place. We think a potential default of AKB would have a significant systemic impact for the local economy. We do not expect these views to change in the medium term.

Additional rating factors: None

No additional factors affect this rating.

Related Criteria And Research

- Outlook On Nine Swiss Banks To Negative On Exposure To Rising Property Prices; Ratings On All Swiss Banks Affirmed, July 3, 2012
- Outlook On Aargauische Kantonalbank To Negative On Risk From Rising Property Prices; 'AAA/A-1+' Affirmed, July 3, 2012
- Banking Industry Country Risk Assessment: Switzerland, April 11, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

Anchor	Matrix									
Industry					Econon	nic Risk				
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	1	-	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 August 30, 2013)								
Aargauische Ka	Aargauische Kantonalbank							
Counterparty Cro	edit Rating	AAA/Negative/A-1+						
Counterparty C	Counterparty Credit Ratings History							
03-Jul-2012	Foreign Currency	AAA/Negative/A-1+						
20-Dec-2007		AAA/Stable/A-1+						
19-Dec-2007		AA+/Stable/A-1+						
03-Jul-2012	Local Currency	AAA/Negative/A-1+						
19-Dec-2007		AAA/Stable/A-1+						

Ratings Detail (As Of August 30, 2013) (cont.)						
18-Aug-2006	AA+/Positive/A-1+					
Sovereign Rating						
Swiss Confederation (Unsolicited Ratings)	AAA/Stable/A-1+					
Related Entities						
Aargau (Canton of)						
Issuer Credit Rating	AAA/Stable/A-1+					
Senior Unsecured	AAA					

^{*}Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

Additional Contact:

Financial Institutions Ratings Europe; FIG_Europe@standardandpoors.com

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