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Aargauische Kantonalbank

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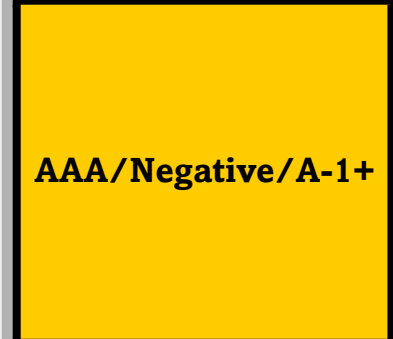
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Aargauische Kantonalbank

SACP	aa-		+	Support	+3	+	Additional Factors	0
Anchor	a			GRE Support	+3		Issuer Credit Rating 	
Business Position	Adequate	0		Group Support	0			
Capital and Earnings	Very Strong	+2		Sovereign Support	0			
Risk Position	Adequate	0						
Funding	Average	0						
Liquidity	Strong	0						

Major Rating Factors

Strengths:	Weaknesses:
<ul style="list-style-type: none"> • A sound financial profile, underpinned by very strong capitalization and strong earnings capacity. • Sound asset quality and prudent risk management. • Ownership and expected support if needed from the financially strong Canton of Aargau, including a statutory guarantee. 	<ul style="list-style-type: none"> • 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, even 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 and lead us to review our ratings on these banks, including AKB. Such review could result in a downward revision of the AKB's stand-alone credit profile (SACP) and a one-notch downgrade of the bank.

An improvement in AKB's SACP is unlikely at this stage, given 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 consider AKB to be a government-related entity (GRE) with an extremely high likelihood of receiving timely and sufficient extraordinary government support in times of financial distress. 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+). We therefore apply a three-notch uplift to our assessment of AKB's SACP.

Anchor: 'a' for domestic Banks operating in Switzerland

The anchor reflects AKB's Swiss headquarters and its credit exposures, which are almost exclusively to Swiss-domiciled counterparties.

Our bank criteria use our BICRA economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The BICRA score of '1' for Switzerland includes our evaluation of "very low" economic risk and "low" industry risk. Consequently, the anchor for a commercial bank operating only in Switzerland is 'a'.

We view the Swiss economy as highly diversified and competitive, benefiting from one of the highest GDP 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 in housing prices and loan portfolios.

Economic risk in Switzerland is growing, owing to the recent acceleration of residential real estate price increases and real estate loan growth during the past few years, which has led to increasing economic imbalances.

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

Table 1

Aargauische Kantonalbank Key Figures					
	--Year-ended Dec. 31--				
(Mil. CHF)	2014*	2013	2012	2011	2010
Adjusted assets	22,186.3	22,217.1	21,593.9	19,906.5	19,164.8
Customer loans (gross)	18,579.4	18,307.4	17,698.8	17,092.3	16,216.5
Adjusted common equity	1,703.5	1,617.4	1,543.2	1,455.9	1,349.0
Operating revenues	187.2	370.3	380.4	391.4	376.8
Noninterest expenses	88.8	181.2	190.5	197.5	210.6
Core earnings	88.4	165.3	165.3	168.4	141.9

*Data as of June 30. CHF--Swiss franc.

Business position: Geographic and product concentration mitigated by a stable business profile

We base our assessment of AKB's "adequate" business profile on the bank's strong business stability, which offsets concentration risks arising from its focus on real estate lending and on Aargau. AKB's history of sound and sustainable profitability, prudent risk management, and cautious lending standards are fundamental elements of our business profile assessment, further boosted by the bank's stable performance, despite its comparatively highly concentrated business focus.

AKB is a midsize cantonal bank with total assets of Swiss franc (CHF) 22.2 billion (€18.3 billion) as of June 30, 2014. 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. Unlike many other rated cantonal banks, we understand that the competitive environment in AKB's core market is more difficult. But we expect AKB to maintain its market shares of about 30% in 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 solid client base.

In November 2013, AKB's sold its subsidiary AKB Privatbank Zürich AG, which generated about 7%-8% of the bank's revenues during past years, mainly stemming from private banking activities. We don't expect the sale of the subsidiary to hinder AKB's overall earnings profile, as AKB will be able to compensate the sale through organic growth. In addition, we positively acknowledge the reduction in potential reputational risk exposure via this subsidiary, which somewhat focused on off-shore private banking business.

We currently don't expect that the retirement of AKB's longstanding CEO, planned for April 2015, will cause major disruptions in AKB's business model or operations, particularly given that the bank has already announced a successor.

Table 2

Aargauische Kantonbank Business Position					
	--Year-ended Dec. 31--				
(%)	2014*	2013	2012	2011	2010
Loan market share in country of domicile	N/A	1.7	1.8	1.8	1.7
Deposit market share in country of domicile	N/A	1.4	1.5	1.5	1.5
Total revenues from business line (mil. CHF)	188.1	396.3	380.7	392.4	379.5
Return on equity	6.7	6.3	6.3	6.7	6.7

*Data as of June 30. CHF--Swiss franc. N/A--Not applicable.

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

At year-end 2013, our risk-adjusted capital (RAC) ratio for AKB stood at 19.3%, and we expect it will gradually increase over the next 18 months to about 20%-21%, due to our assumption of stable results and the bank's ongoing retention of earnings and accumulation of general banking risk reserves. We continue to 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 our RAC ratio for AKB, 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 weaken 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, incorporating 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. That said, in our view, AKB will be able to cover 1.5% of its risk weighted assets in a credit stress by its annual earnings, which would in this context be able to act as a first line of defense and compares quite favorably with the Swiss average.

Table 3

Aargauische Kantonalbank Capital And Earnings					
	--Year-ended Dec. 31--				
(%)	2014*	2013	2012	2011	2010
Tier 1 capital ratio	N/A	16.1	15.4	14.7	13.9
S&P RAC ratio before diversification	N.M.	19.3	17.8	17.5	16.7
S&P RAC ratio after diversification	N.M.	17.3	16.1	16.3	15.4
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	68.4	71.7	71.0	70.2	70.8
Fee income/operating revenues	19.1	17.6	18.5	18.4	19.6
Market-sensitive income/operating revenues	11.0	8.1	9.1	10.1	8.2
Noninterest expenses/operating revenues	47.4	48.9	50.1	50.5	55.9
Provision operating income/average assets	0.9	0.9	0.9	1.0	0.9
Core earnings/average managed assets	0.8	0.8	0.8	0.9	0.8

*Data as of June 30. RAC--Risk-adjusted capital. N/A--Not applicable. N.M.--Not meaningful.

Table 4

Aargauische Kantonalbank Risk-Adjusted Capital Framework Data						
(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	1,689	0	0	51	3	
Institutions	1,569	375	24	251	16	
Corporate	5,653	3,225	57	3,743	66	
Retail	13,173	6,538	50	3,131	24	
Of which mortgage	11,647	5,238	45	2,213	19	
Securitization	0	0	0	0	0	
Other assets	448	213	47	242	54	
Total credit risk	22,532	10,350	46	7,418	33	
Market risk						
Equity in the banking book§	23	25	109	164	715	

Table 4

Aargauische Kantonalbank Risk-Adjusted Capital Framework Data (cont.)					
Trading book market risk	--	63	--	94	--
Total market risk	--	88	--	258	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	700	--	721	--
(Mil. CHF)	Basel II RWA		Standard & Poor's RWA		% of Standard & Poor's RWA
Diversification adjustments					
RWA before diversification	--	11,138	--	8,397	100
Total adjustments to RWA	--	--	--	971	12
RWA after diversification	--	11,138	--	9,368	112
(Mil. CHF)	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	Standard & Poor's RAC ratio (%)	
Capital ratio					
Capital ratio before adjustments	--	1,794	16.1	1,617	19.3
Capital ratio after adjustments†	--	1,794	16.1	1,617	17.3

*Exposure at default. Securitization exposure includes the securitization 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, 2013, Standard & Poor's.

Risk position: Large concentration in residential mortgage lending, but strong risk metrics

We think that the asset quality of AKB's loan portfolio is high. We base our view on AKB's prudent risk management and lending standards, which we consider to be more stringent than that of competitors in the Swiss market. We expect loan growth to continue at approximately 3%-4% per year, broadly in line with that of other cantonal banks, following the implementation of additional more stringent self-regulatory measures in issuing real estate loans in the Swiss markets in 2014. 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 hamper 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 Aargau have been lower than the Swiss average and have recently receded. 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 24% 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.

Furthermore, we expect current tax investigations by U.S. authorities to have a rather small financial impact on AKB's earnings, given the fact that AKB already provisioned certain related amounts on its balance sheet and that the number of its clients subject to U.S. tax laws have been historically very low. We also view associated reputational risks as modest. However, we acknowledge that AKB, in line with many other Swiss banks, decided to apply for category 2 of the associated U.S. investigation program, as it could not rule out, that a few of its clients might have broken U.S. tax laws in the past.

Table 5

Aargauische Kantonalbank Risk Position					
	--Year-ended Dec. 31--				
(%)	2014*	2013	2012	2011	2010
Growth in customer loans	3.0	3.4	3.5	5.4	4.2
Total diversification adjustment / S&P RWA before diversification	N.M.	11.6	10.9	7.2	8.3
Total managed assets/adjusted common equity (x)	13.0	13.7	14.0	13.7	14.2
New loan loss provisions/average customer loans	0.0	0.1	0.1	0.1	0.1
Net charge-offs/average customer loans	N.M.	0.1	(0.1)	(0.1)	(0.0)
Gross nonperforming assets/customer loans + other real estate owned	N/A	0.3	0.4	0.6	0.8
Loan loss reserves/gross nonperforming assets	N/A	294.7	222.9	182.6	125.2

*Data as of June 30. RWA--Risk-weighted assets. N/A--Not applicable. N.M.--Not meaningful.

Funding and liquidity: A loyal customer base and strong liquidity

AKB's funding is "average" and in line with our BICRA score of '2' for systemwide funding in Switzerland. The bank's liquidity 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 75% of its funding base and 83% of its loan portfolio, and it has a comparably large equity position on its balance sheet at about 7% of total assets. Due to the cantonal guarantee, which we expect to remain in place, we expect AKB's customer deposits to remain very stable, as we assess AKB's customer base as very loyal. The remainder of AKB's funding mix is divided equally between interbank funding and capital market funding via secured and unsecured instruments. We expect AKB's stable funding ratio calculated according to Standard & Poor's internal specifications to remain between 100% and 105% over the next years, broadly comparable with metrics of other rated cantonal banks.

Our "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 in line with our criteria. 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. AKB's broad liquid assets cover its short-term wholesale funding on average at about 150% within a one-year horizon, which is comfortable but lower as the average of rated domestic-oriented Swiss banks, stemming mainly from a comparably stronger dependence on interbank funding. Nevertheless, 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, which supports our strong liquidity assessment for AKB.

Table 6

Aargauische Kantonalbank Funding And Liquidity					
	--Year-ended Dec. 31--				
(%)	2014*	2013	2012	2011	2010
Core deposits/funding base	74.8	75.6	75.6	77.6	74.2
Customer loans (net)/customer deposits	125.6	120.0	119.7	123.2	128.0
Long term funding ratio	90.8	90.9	92.2	94.1	91.5
Stable funding ratio	99.2	102.5	104.2	100.9	98.3
Short-term wholesale funding/funding base	10.0	9.8	8.5	6.4	9.2
Broad liquid assets/short-term wholesale funding (x)	1.3	1.4	1.6	1.4	1.1
Net broad liquid assets/short-term customer deposits	3.7	5.4	7.8	3.4	0.9
Short-term wholesale funding/total wholesale funding	39.5	40.3	34.9	28.6	35.6
Narrow liquid assets/3-month wholesale funding (x)	1.6	1.7	2.0	2.5	1.4

*Data as of June 30.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

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.

We view AKB as having an integral link with and a very important role for Aargau, which is primarily facilitated by the cantonal guarantee in place. We also think a potential default of AKB would have a significant systemic impact for the local economy, which further incentivizes support mechanisms for the bank in case of financial distress at the bank level.

Recent political discussions to use the bank's strong earnings capacity and equity base to reduce the canton's debt burden via extraordinary dividends have not led to tangible changes. However, we will closely monitor the relationship between the canton and the bank, as certain political measures could point to a weakening relationship, such as proposed changes in the legal form of the bank or the proposal to limit compensation for the bank's executives.

Additional rating factors: None

No additional factors affect this rating.

Related Criteria And Research**Related Criteria**

- 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

Related 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 Kantonbank To Negative On Risk From Rising Property Prices; 'AAA/A-1+' Affirmed, July 3, 2012
- Banking Industry Country Risk Assessment: Switzerland, December 6, 2013

Anchor Matrix										
Industry Risk	Economic 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	-	-	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 21, 2014)**Aargauische Kantonbank**

Counterparty Credit Rating

AAA/Negative/A-1+

Counterparty Credit Ratings History

03-Jul-2012	<i>Foreign Currency</i>	AAA/Negative/A-1+
20-Dec-2007		AAA/Stable/A-1+
19-Dec-2007		AA+/Stable/A-1+
03-Jul-2012	<i>Local Currency</i>	AAA/Negative/A-1+
19-Dec-2007		AAA/Stable/A-1+
18-Aug-2006		AA+/Positive/A-1+

Sovereign Rating

Swiss Confederation (Unsolicited Ratings)

AAA/Stable/A-1+

Ratings Detail (As Of August 21, 2014) (cont.)

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.

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