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Aargauische Kantonalbank

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Aargauische Kantonalbank

SACP	a+

Anchor	a-	
Business Position	Adequate	0
Capital and Earnings	Very Strong	+2
Risk Position	Adequate	0
Funding	Average	0
Liquidity	Strong	

\+

Support	+3
GRE Support	+3
Group Support	0
Sovereign Support	0

\+

Additional Factors	0

Issuer Credit Rating
AA+/Stable/A-1+

Major Rating Factors

Strengths:	Weaknesses:
• A sound financial profile, underpinned by very strong capitalization and strong earnings capacity. • Ownership and statutory guarantee by and expected support from the financially strong Canton of Aargau, if needed. • High-quality loan book, dominated by granular and well-collateralized residential mortgages.	• 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 due to focus on real estate lending.

Outlook: Stable

Standard & Poor's Ratings Services' stable outlook on Switzerland-based Aargauische Kantonalbank (AKB) reflects that on its majority owner and guarantor, the Canton of Aargau. The stable outlook also reflects our expectation that the bank's status as government-related entity (GRE) and our view that there's an "extremely high" likelihood that the canton would provide support to AKB, if needed, will not change in the next few years. Moreover, we expect that AKB will maintain its sound financial profile, underpinned by its very strong capitalization and sound earnings capacity in the over the next 18 to 24 months.

We could take a negative rating action if AKB's ties with the Canton of Aargau were to loosen or changes to the canton's statutory guarantee were applied. This could lead us to review AKB's role for or link with the canton, which might lead to a weaker assessment of the bank's status as a GRE. However, we currently consider this scenario unlikely and expect AKB's existing obligations will be grandfathered.

A positive rating action on AKB is remote at this stage because we do not expect the bank will revise its concentrated business model.

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. We assess AKB's stand-alone credit profile (SACP) at 'a+'.

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

We use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating to bank under our bank criteria. Our BICRA score of '2' for Switzerland includes our '2' economic risk and '2' industry risk scores. Consequently, our anchor for a commercial bank operating only in Switzerland is 'a-'.

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

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 that large parts of the Swiss banking market demonstrate a conservative risk and lending culture.

That said, economic risk has increased, due to an 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. 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						
		--Year ended Dec. 31--				
(Mil. CHF)	**2015***	**2014**	**2013**	**2012**	**2011**	**2010**
Adjusted assets	24,113.2	22,932.9	22,217.1	21,593.9	19,906.5	19,164.8
Customer loans (gross)	19,338.1	19,067.3	18,307.4	17,698.8	17,092.3	16,216.5
Adjusted common equity	1,999.8	1,702.9	1,617.4	1,543.2	1,455.9	1,349.0
Operating revenues	191.4	366.8	370.3	380.4	391.4	376.8
Noninterest expenses	87.5	175.6	181.2	190.5	197.5	210.6
Core earnings	73.8	170.9	165.3	165.3	168.4	141.9

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

Business position: Geographic and product concentration mitigated by stable business activity

We base our assessment of AKB's "adequate" business position on the bank's strong business stability, which offsets concentration risks arising from its focus on real estate lending and on the canton of Aargau. AKB's history of sound and sustainable profitability, prudent risk management, and cautious lending standards are fundamental in our business position assessment, further boosted by the bank's stable performance, despite its highly concentrated regional and business focus compared with most other European banks.

AKB is a midsize cantonal bank and ranks No. 5 out of a total of 24 cantonal banks in Switzerland (by size of balance sheet) and operates in Northwest Switzerland, which is characterized by its strong small and midsize industrial sector.

Like most cantonal banks, AKB is expected to focus mainly on its home canton and its neighboring regions and is active primarily in residential mortgage lending (about 74% of the current loan book) and lending to small and midsize enterprises (around 15%) as well as lending activities to public bodies. AKB's business activity also includes private-banking services to wealthy clientele in the canton.

Unlike many other cantonal banks we rate, AKB faces a more difficult competitive environment in its core market. Still, we expect AKB will maintain its market leading position in Aargau over the next few years, building on its status as the cantonal bank.

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 position, we expect the bank will continue to post very sound and stable earnings in the coming years by keeping its focus on achieving appropriate risk-adjusted margins, rather than business volumes, with an exceptionally solid client base.

We currently don't expect that the retirement of AKB's longstanding CEO, planned for mid-2016, will cause major disruptions in the bank's business model or operations.

Table 2

Aargauische Kantonalbank Business Position						
		--Year ended Dec. 31--				
(%)	**2015***	**2014**	**2013**	**2012**	**2011**	**2010**
Loan market share in country of domicile	N/A	1.8	1.7	1.8	1.8	1.7
Deposit market share in country of domicile	N/A	1.4	1.4	1.5	1.5	1.5
Total revenues from business line (mil. CHF)	208.5	370.7	396.3	380.7	392.4	379.5
Return on equity	9.0	6.1	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 2014, our risk-adjusted capital (RAC) ratio for AKB had declined to 17.7% from 19.3% at year-end 2013, due to increased capital requirements under our Standard & Poor's capital framework. This is because we associate higher economic risks with exposures to Swiss counterparties following our revision of the economic risk score to "2" from "1" for Switzerland in December 2014.

However, we project the RAC ratio for AKB will gradually recover over the next 18 months to above 19%, based on our expectation that earnings retention into capital will gradually surpass growth in risk weighted assets, owing to reduced growth in the loan book.

We continue to view AKB's capital position as "very strong," based on our projected RAC ratio. This is further supported by the bank's capital target of a 16% common equity tier 1 ratio, which has been agreed with the canton.

Our assessment of AKB's earnings relies 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. Despite our expectation of a prolonged period of low interest rates, we estimate the three-year average earnings buffer will remain at about 135 basis points, due to slightly improved interest rate margins on issued loans, which partly offsets the pressure on deposit margins.

That said, we think AKB would likely cover 1.35% of its risk-weighted assets, in a credit stress scenario, with its annual earnings. Such coverage would represent a first line of defense and compares favorably with the Swiss banking sector average.

Our main assumption behind this projected coverage is profit before tax in the CHF95 million-CHF105 million range in 2015, and slightly below CHF95 million over 2016 and 2017 owing to declining net interest margins and loan portfolio growth of about 3% annually. Also, we expect the bank's dividend policy will remain in line with previous years (payout ratio of 65%-55% in relation to reported net income after allocation to general banking reserves)

Table 3

Aargauische Kantonalbank Capital And Earnings						
		--Year ended Dec. 31--				
(%)	**2015***	**2014**	**2013**	**2012**	**2011**	**2010**
Tier 1 capital ratio	N/A	16.5	16.1	15.4	14.7	13.9
S&P RAC ratio before diversification	N.M.	17.7	19.3	17.8	17.5	16.7

Table 3

Aargauische Kantonalbank Capital And Earnings (cont.)						
S&P RAC ratio after diversification	N.M.	15.6	17.3	16.1	16.3	15.4
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	69.1	69.1	71.7	71.0	70.2	70.8
Fee income/operating revenues	15.9	19.8	17.6	18.5	18.4	19.6
Market-sensitive income/operating revenues	14.1	9.7	8.1	9.1	10.1	8.2
Noninterest expenses/operating revenues	45.7	47.9	48.9	50.1	50.5	55.9
Preprovision operating income/average assets	0.9	0.8	0.9	0.9	1.0	0.9
Core earnings/average managed assets	0.6	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	2,000	0	0	60	3
Institutions	1,320	338	26	257	20
Corporate	5,920	3,376	57	4,296	73
Retail	13,575	6,694	49	3,899	29
Of which mortgage	12,047	5,416	45	2,891	24
Securitization§	0	0	0	0	0
Other assets	214	179	84	89	42
Total credit risk	23,029	10,587	46	8,601	37
Market risk					
Equity in the banking book†	25	35	138	179	718
Trading book market risk	--	104	--	156	--
Total market risk	--	138	--	335	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	686	--	700	--
(Mil. CHF)		**Basel II RWA**		**Standard & Poor's RWA**	**% of Standard & Poor's RWA**
Diversification adjustments					
RWA before diversification	--	11,411	--	9,637	100
Total adjustments to RWA	--	--	--	36	1
RWA after diversification	--	--	--	(52)	(1)

Table 4

Aargauische Kantonalbank Risk-Adjusted Capital Framework Data (cont.)

(Mil. CHF)	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	Standard & Poor's RAC ratio (%)
Capital ratio				
Capital ratio before adjustments	1,888	16.5	1,703	17.7
Capital ratio after adjustments‡	1,888	16.5	1,703	15.6

*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 regard AKB's risk position as "adequate." 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 book growth will slow somewhat, because senior management is putting more emphasis on risk-adjusted-margins rather than volume growth (average growth of 4.1% per year between 2010 and 2014). AKB's real estate loan portfolio--consisting mostly of residential real estate loans--represents more than 89% of the loan book. It is very granular and highly collateralized, and its new business displays a sound average loan-to-value ratio of 66%.

Due to AKB's focus on mortgage lending, we think that the housing price increases in Switzerland over the past several years will likely heighten the risks of correction and subsequently could hamper AKB's current sound asset quality. At the same time, we acknowledge that residential real estate price increases in Aargau have been lower than the Swiss average and have recently decreased. However, the Aargau housing market may not be able to fully delink 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 15% of its loan book, to be very sound because exposure to cyclical and riskier sectors, such as tourism or real estate development, is modest.

Positively, we believe that the bank will maintain its conservative underwriting standards in new mortgage lending, helping it to keep a marginal level of nonperforming loans in its loan book. This supports our estimate that credit losses will be less than 10 basis points on customer loans over the next two years. We therefore expect that AKB's pre-provision operating income will full cover loan provisioning.

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. The current interest rate environment, characterized by negative yields across many term buckets, poses many challenges for managing this risk type. It makes exposure hedging by way of interest rate swaps fairly expensive. Also, it is more difficult to make robust assumptions about client behavior and repricing related to deposit or loan products that do not have predetermined interest rate reset dates. This is an important feature for AKB's balance sheet since funding is largely through savings deposits, whereas the loan book consists mainly of longer-term fixed rate loans. However, we understand that AKB is actively addressing this issue and has adjusted its strategy and risk parameters accordingly. AKB engages in very limited trading activities, which are generally client initiated.

Furthermore, we expect current tax investigations by U.S. authorities will have a rather small financial impact on AKB's earnings, given that AKB has already provisioned certain related amounts on its balance sheet and that the number of its clients subject to U.S. tax laws has 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, because 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--				
(%)	**2015***	**2014**	**2013**	**2012**	**2011**	**2010**
Growth in customer loans	2.8	4.2	3.4	3.5	5.4	4.2
Total diversification adjustment/S&P RWA before diversification	N.M.	13.0	11.6	10.9	7.2	8.3
Total managed assets/adjusted common equity (x)	12.1	13.5	13.7	14.0	13.7	14.2
New loan loss provisions/average customer loans	0.3	0.1	0.1	0.1	0.1	0.1
Net charge-offs/average customer loans	N.M.	0.0	0.1	(0.1)	(0.1)	(0.0)
Gross nonperforming assets/customer loans + other real estate owned	N/A	0.0	0.3	0.4	0.6	0.8
Loan loss reserves/gross nonperforming assets	N/A	N.M.	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. In addition, it has a comparably large equity position on its balance sheet at about 8.3% of total assets. Due to the cantonal guarantee, which we expect will stay in place, we expect AKB's customer deposits will remain very stable, because we view AKB's customer base as very loyal. That said, we expect loans will continue to exceed deposits, with the ratio staying between 125% and 120%, which indicates AKB dependency on other means for funding. These additional sources of AKB's funding mix are divided equally between interbank funding and capital market funding, via secured and unsecured instruments. AKB's comparably large equity position on its balance sheet (8.3% of total assets) caters for the remainder of the long-term funding source. We expect AKB's stable funding ratio, calculated according to Standard & Poor's internal specifications, will remain between 100% and 105% over the next few years, broadly comparable with metrics of other rated cantonal banks.

We believe that AKB's funding profile would remain robust during an economic downturn. This is because the "flight to quality" during the most recent financial crises has strengthened AKB's funding profile and its customer deposits have increased steadily over 2012-2015, despite the low interest rates the bank has offered on its funding tools. We believe that in a stress scenario, customers' perception of AKB would continue to benefit from its close ties to and its guarantee by the canton.

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 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 1.2x within a one-year horizon, which is relatively low compared with the average of rated domestic-oriented Swiss banks. As a mitigating factor, short-term whole-sale funding represents only about 2.4% of the total funding base.

Table 6

Aargauische Kantonalbank Funding And Liquidity

		--Year ended Dec. 31--				
(%)	**2015***	**2014**	**2013**	**2012**	**2011**	**2010**
Core deposits/funding base	71.8	75.0	75.6	75.6	77.6	74.2
Customer loans (net)/customer deposits	123.6	122.3	120.0	119.7	123.2	128.0
Long-term funding ratio	88.9	89.8	90.9	92.2	94.1	91.5
Stable funding ratio	N/A	99.4	101.7	103.3	99.9	97.4
Short-term wholesale funding/funding base	12.1	11.1	9.8	8.5	6.4	9.2
Broad liquid assets/short-term wholesale funding (x)	N/A	1.1	1.4	1.6	1.4	1.1
Net broad liquid assets/short-term customer deposits	N/A	2.4	5.4	7.8	3.4	0.9
Short-term wholesale funding/total wholesale funding	42.8	44.4	40.3	34.9	28.6	35.6
Narrow liquid assets/3-month wholesale funding (x)	N/A	1.6	1.7	2.0	2.5	1.4

*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.

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 it encounters financial distress.

Additional rating factors: None

No additional factors affect our rating on AKB.

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

- Banking Industry Country Risk Assessment Update: August, Aug. 20, 2015
- Switzerland Ratings And BICRA Unaffected By Swiss National Bank's Change In Exchange Rate Policy, Jan. 15, 2015
- Banking Industry Country Risk Assessment: Switzerland, Jan. 7, 2015
- Various Ratings Actions On Swiss Banking Groups On Rising Economic Imbalances, Dec. 1, 2014

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 September 8, 2015)

Aargauische Kantonalbank		
Counterparty Credit Rating		AA+/Stable/A-1+
Counterparty Credit Ratings History		
01-Dec-2014	*Foreign Currency*	AA+/Stable/A-1+
03-Jul-2012		AAA/Negative/A-1+
20-Dec-2007		AAA/Stable/A-1+
01-Dec-2014	*Local Currency*	AA+/Stable/A-1+
03-Jul-2012		AAA/Negative/A-1+
19-Dec-2007		AAA/Stable/A-1+
Sovereign Rating		
Swiss Confederation		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. Issue and

Ratings Detail (As Of September 8, 2015) (cont.)

debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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