S&P Global Ratings

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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

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

+

Additional Factors	0

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

Major Rating Factors

Strengths:	Weaknesses:
• A sound financial profile, underpinned by very strong capitalization and sustained profitability. • High-quality loan book, dominated by granular and well-collateralized residential mortgages. • Ownership and statutory guarantee by and extremely high likelihood of support from the financially strong Canton of Aargau, if needed.	• Concentration risks from limited geographic diversity and focus on residential mortgage lending. • Subdued growth prospects in the competitive home market. • Limited earnings diversification due to focus on real estate lending.

Outlook: Negative

S&P Global Ratings' negative outlook on Switzerland-based Aargauische Kantonalbank (AKB) solely reflects that on its majority owner and guarantor, the Canton of Aargau. A downgrade of Aargau would trigger a negative rating action on AKB. Under our government-related entity (GRE) criteria, with all other rating factors remaining unchanged, a one-notch downgrade of the canton would result in the removal of one of the three notches of uplift that we currently factor into the long-term rating on AKB.

Notwithstanding that, we expect that the bank's status as a GRE, and our view that there is 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 over the next 18-24 months.

We could also take a negative rating action if AKB's ties with the Canton of Aargau were to loosen or if 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 would be grandfathered.

If we considered that the downside scenario of the canton was becoming less likely, we would revise the outlook on Aargau to stable. All other rating factors remaining the same, we would then accordingly revise the outlook on AKB to stable. A positive rating action based on AKB's stand-alone credit strength is remote at this stage because we do not expect the bank will revise its concentrated business model or will be able to materially improve its risk and funding position.

Rationale

The 'AA+' long-term rating on AKB is based on our 'a-' anchor for Swiss domestic banks and the bank's stable but concentrated business operations. The rating also takes into account AKB's very strong risk-adjusted capitalization and the high quality of its loan portfolio. We also take into account AKB's diversified funding profile that is dominated by stable retail deposits and its strong liquidity position. Based on these factors, we view AKB's stand-alone credit profile (SACP) at 'a+'.

Furthermore, we consider AKB to be a 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. We therefore apply a three-notch uplift to our assessment of AKB's SACP.

Anchor: 'a-' for domestic banks operating solely 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. Our anchor for a bank operating mainly in Switzerland is 'a-'. We view the trends for both economic and industry risk as stable. The anchor for AKB reflects its Swiss headquarters and its credit exposures, which are exclusively to Swiss-domiciled counterparties.

Our economic risk score of '2' for Switzerland is supported by the country's highly diversified and competitive economy, very high household income levels, and banks' prudent loan underwriting standards. However, it also reflects that risks have increased, owing to the cumulative rise in Swiss house prices and domestic lending over the past several years. Although these imbalances are still low in a global context, they have led the regulator to enact macro-prudential measures to rein in robust growth in mortgage indebtedness.

We recognize that house price and lending growth have cooled since the beginning of 2014. However, in our view, house prices and household indebtedness remain historically high, in particular when considering the low rate of home ownership in Switzerland. The very high mortgage debt level is mitigated by the large amount of financial assets, including pensions, held by households in Switzerland.

Our industry risk score of '2' primarily reflects the banking sector stability and a high share of deposit funding. Banks' net interest margins continue to decline gradually, given the pressure on deposit margins from the negative yield environment. This is partly offset, however, by higher margins on lending products, fee income from investment advisory-related activities, and cost management. As a result, banks are still able to generate returns on core banking products that are adequate to meet their cost of capital. Moreover, in our view, the Swiss regulator's regulatory initiatives are more stringent than those in other European banking industries.

Table 1

Aargauische Kantonalbank Key Figures

		--Year-ended Dec. 31--			
(Mil. CHF)	**2017***	**2016**	**2015**	**2014**	**2013**
Adjusted assets	26,607.0	25,243.6	24,284.5	22,932.9	22,217.1
Customer loans (gross)	21,417.6	20,952.3	19,898.9	19,229.6	18,472.4
Adjusted common equity	2,178.0	2,086.8	1,998.1	1,888.2	1,794.1
Operating revenues	187.6	363.6	369.2	366.8	370.3
Noninterest expenses	98.0	187.4	185.2	185.3	190.1
Core earnings	91.1	182.6	181.5	161.7	161.8

*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 in 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. Our assessment is further supported by customer loyalty instilled by the cantonal ownership and guarantee.

AKB is a midsize cantonal bank and ranks No. 7 out of a total of 24 cantonal banks in Switzerland (by total assets at year-end 2016) 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 75% of the current loan book) and in financing local small and midsize enterprises. 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 because several other domestic and regional banks compete in the canton as well. AKB consequently holds a lower market share than other cantonal banks of approximately 20%. 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 its business volumes and earnings to economic swings in a rather small economy, which is however located between the metropolitan areas of Basel and Zurich. 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.

Table 2

Aargauische Kantonalbank Business Position					
		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Total revenues from business line (mil. CHF)	187.8	371.1	412.0	370.7	396.3
Commercial & retail banking/total revenues from business line	100.0	100.0	100.0	100.0	100.0
Return on equity	6.9	6.6	7.7	5.5	5.7

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

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

We continue to view AKB's capital position as very strong, based on our projected risk-adjusted capital (RAC) ratio. At year-end 2016, our RAC ratio for AKB had improved to 20.5% from 20.1% at year-end 2015, as earnings retention outweighed the growth in risk-weighted assets. We expect this ratio to remain broadly stable over the next 18-24 months.

The stability in capital ratios is supported by the bank's capital target of a 16% common equity tier 1 (CET1) ratio, which has been agreed with the canton. This regulatory ratio, where the countercyclical capital buffer is deducted from capital, was 16.2% at year-end 2016. Although we understand that this agreement is not binding, we expect that the canton would adjust its dividend requirement to allow AKB's CET1 ratio to stay in the target range of 15.8%-16.2%. It is noteworthy that AKB has not issued any hybrid securities, indicating the high quality of capital.

In our view, AKB's earnings are predictable and stable. We forecast profit before tax of above Swiss franc (CHF) 140 million (about €123 million) in 2017, and expect a range of CHF125 million–CHF135 million over 2018 and 2019, owing to further declining net interest margins and normalizing credit losses. Furthermore, we expect that the bank's flexible dividend policy as agreed with the canton will ensure a broadly stable capitalization.

Based on our projections, we expect AKB to maintain an earnings buffer of about 1.0x broadly in line with that of its Swiss peers. This buffer, which measures a bank's capacity of preprovision operating income to cover normalized (annual average through the cycle) credit losses, would act as a first line of defence and cover 1% of RWAs beyond normalized losses in a potential adverse macroeconomic scenario.

Table 3

Aargauische Kantonalbank Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Tier 1 capital ratio	N/A	17.2	17.1	16.5	16.1
S&P Global Ratings' RAC ratio before diversification	N.M.	20.5	20.1	19.6	21.4
S&P Global Ratings' RAC ratio after diversification	N.M.	16.6	18.3	17.3	19.2
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	64.9	68.4	68.6	69.1	71.7
Fee income/operating revenues	16.5	16.2	16.4	19.8	17.6
Market-sensitive income/operating revenues	17.3	14.3	13.5	9.7	8.1
Noninterest expenses/operating revenues	52.2	51.5	50.2	50.5	51.3
Preprovision operating income/average assets	0.7	0.7	0.8	0.8	0.8
Core earnings/average managed assets	0.7	0.7	0.8	0.7	0.7

*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 at default**	**Basel III RWA**	**Average Basel III RW (%)**	**S&P Global Ratings' RWA**	**Average S&P Global Ratings' RW (%)**
Credit risk					
Government and central banks	2,725	0	0	82	3
Institutions and CCPs	1,118	298	27	224	20
Corporate	7,197	4,939	69	4,750	66
Retail	14,205	5,971	42	3,931	28
Of which mortgage	12,715	4,765	37	2,949	23
Securitization*	0	0	0	0	0
Other assets†	64	64	100	64	99
Total credit risk	25,309	11,272	45	9,051	36
Credit valuation adjustment					
Total credit valuation adjustment	--	64	--	0	--
Market risk					
Equity in the banking book	32	43	134	260	810
Trading book market risk	--	112	--	168	--
Total market risk	--	155	--	427	--
Operational risk					
Total operational risk	--	683	--	698	--
		Basel III RWA		**S&P Global Ratings' RWA**	**% of S&P Global Ratings' RWA**
Diversification adjustments					
RWA before diversification		12,174		10,177	100
Total diversification/concentration adjustments		--		2,386	23

Table 4

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

RWA after diversification	12,174		12,562	123
	Tier 1 capital	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings' RAC ratio (%)**
Capital ratio				
Capital ratio before adjustments	2,089	17.2	2,087	20.5
Capital ratio after adjustments†	2,089	17.2	2,087	16.6

*Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. §Other assets includes Deferred Tax Assets (DTAs) not deducted from ACE. †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, 2016, Standard & Poor's.

Risk position: 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, despite its inherent concentrations. We base our view on AKB's prudent risk management and lending standards, which we consider to be more comprehensive than those of competitors in the Swiss market.

We expect that loan book growth will slow slightly, because management is putting more emphasis on risk-adjusted-margins rather than volume growth. AKB's mortgage loan portfolio represents more than 93% of the loan book and consists mostly of residential real estate loans (75% of total loans). It is very granular, highly collateralized, and its average loan-to-value ratio was 63% at year-end 2016.

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 currently 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 stabilized. 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 to be very sound because exposure to cyclical and riskier sectors, such as tourism or real estate development, is modest. The portfolio is collateralized by real estate to a large extent, nevertheless, we expect that the commercial lending exposes AKB to higher credit losses in a recessionary scenario than its retail business.

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.

AKB makes negligible use of complex products because it is dedicated to the local market and operates only with standard products. 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 note that the relative amount of money market mortgages is increasing, while AKB increasingly issues long-term senior unsecured bonds, making it easier to naturally hedge against rising interest rates. AKB engages in very limited trading activities, which are generally client initiated.

AKB, as many other Swiss banks, was subject to the tax investigations by U.S. authorities and applied for category 2 of the investigation program in 2013. In 2015, AKB was able to sign a non-prosecution agreement with the U.S. department of justice and to close the investigation. We do not expect any further repercussions for AKB's financial situation or reputation.

Table 5

Aargauische Kantonalbank Risk Position

		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Growth in customer loans	4.4	5.3	3.5	4.1	3.4
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N.M.	23.4	10.0	13.0	11.6
Total managed assets/adjusted common equity (x)	12.2	12.1	12.2	12.1	12.4
New loan loss provisions/average customer loans	(0.1)	(0.1)	(0.0)	0.1	0.1
Net charge-offs/average customer loans	N.M.	0.0	0.0	0.0	0.1
Gross nonperforming assets/customer loans + other real estate owned	N/A	1.0	1.4	1.8	2.1
Loan loss reserves/gross nonperforming assets	N/A	53.4	45.8	47.1	43.6

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

Funding and liquidity: Stable funding base, owing to a strong retail franchise

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 accounted for 72% of its funding base and 80% of its loan portfolio in 2016. In addition, it has a comparably large equity position on its balance sheet of 8.7% of total assets. Due to the cantonal guarantee, we expect AKB's customer deposits will remain very stable, also in times of stress. That said, we expect loans will continue to exceed deposits, with the ratio staying between 125% and 130%, which indicates AKB's dependency on other means of funding.

These additional sources of AKB's funding mix are divided roughly equally between interbank funding and capital market funding, via secured and unsecured instruments. AKB's comparably large equity position on its balance sheet caters for the remainder of the long-term funding sources. We expect AKB's stable funding ratio--S&P Global Ratings' measure of available long-term funding relative to long-term funding needs--will remain between 100% and 105% over the next few years, broadly comparable with metrics of other rated cantonal banks.

Our strong liquidity assessment reflects that AKB's broad liquid assets covered its short-term wholesale funding needs by 1.8x as of June 2017, implying that it is able to operate for more than 12 months with no access to market funding. Although this ratio is slightly lower compared to some rated domestic-oriented Swiss banks we see as a mitigating factor, that short-term wholesale funding largely consists of interbank deposits, which are in turn placed with Swiss National Bank (SNB) to gain an additional yield. We believe that some Swiss banks are able to earn an additional spread by placing excess liquidity at the SNB at zero rate under the current negative interest rate environment within their threshold (equivalent to 20x the minimum reserve requirement). We believe that this partly explains AKB's CHF3 billion cash position as well as part of its interbank deposits.

Furthermore, the excess of net broad liquid assets over short-term wholesale funding still covers about 9% of the short-term customer deposits as of year-end 2016. Notably, the regulatory liquidity coverage ratio that is based on the 30-day time horizon has further increased to 101% as of year-end 2016.

We believe that owing to AKB's close ties with and the statutory guarantee by the canton, the bank would not be exposed to large withdrawals of customer deposits in times of stress. During the most recent financial crisis, we actually observed a flight to quality that has strengthened AKB's funding profile.

Table 6

Aargauische Kantonalbank Funding And Liquidity

		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Core deposits/funding base	70.6	71.5	71.9	75.6	76.2
Customer loans (net)/customer deposits	125.0	127.8	125.6	123.3	121.1
Long-term funding ratio	90.7	91.0	89.6	89.8	90.9
Stable funding ratio	108.2	105.5	104.9	101.3	103.7
Short-term wholesale funding/funding base	10.1	9.8	11.4	11.2	9.9
Broad liquid assets/short-term wholesale funding (x)	1.8	1.6	1.5	1.3	1.6
Net broad liquid assets/short-term customer deposits	12.5	8.8	8.2	5.0	8.1
Short-term wholesale funding/total wholesale funding	34.5	34.5	40.5	46.0	41.8
Narrow liquid assets/3-month wholesale funding (x)	2.7	2.6	2.1	1.8	1.9

*Data as of June 30.

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 government support for AKB from its owner in the event of financial distress.

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

- Risk-Adjusted Capital Framework Methodology, July 20, 2017
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- Swiss Canton Of Aargau Ratings Affirmed at 'AAA/A-1+'; Outlook Remains Negative, July 21, 2017
- Aargauische Kantonalbank Outlook Revised To Negative After Similar Action On Its Cantonal Owner; 'AA+/A-1+' Affirmed, July 26, 2016
- Banking Industry Country Risk Assessment: Switzerland, Sept. 2, 2016

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 13, 2017)	
Aargauische Kantonalbank	
Counterparty Credit Rating	AA+/Negative/A-1+
Counterparty Credit Ratings History	
26-Jul-2016	AA+/Negative/A-1+
01-Dec-2014	AA+/Stable/A-1+

Ratings Detail (As Of September 13, 2017) (cont.)	
03-Jul-2012	AAA/Negative/A-1+
Sovereign Rating	
Swiss Confederation	AAA/Stable/A-1+
Related Entities	
Aargau (Canton of)	
Issuer Credit Rating	AAA/Negative/A-1+
Senior Unsecured	AAA

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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