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Research Update:

Zuercher Kantonalbank 'AAA/A-1+' Ratings Affirmed On Bank Criteria Change; Outlook Stable

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Overview

- Following a review under Standard & Poor's revised bank criteria (published on Nov. 9, 2011), we have affirmed our 'AAA/A-1+' ratings on Switzerland-based Zuercher Kantonalbank (ZKB). The outlook is stable.
- In our view, ZKB has an adequate business position, very strong capital and earnings, an adequate risk position, average funding, and strong liquidity, reflecting its stand-alone credit profile (SACP) of 'aa-'.
- We continue to consider ZKB to be a government-related entity with an "extremely high" likelihood of extraordinary support in times of stress, which results in a three-notch rating uplift from the SACP.
- The stable outlook reflects that on ZKB's owner and guarantor the Canton of Zurich. We believe ZKB will continue its close relationship with the canton, and sustain very strong capital and earnings.

Rating Action

As previously announced, on Dec. 5, 2011, Standard & Poor's Ratings Services affirmed its 'AAA/A-1+' long- and short-term counterparty credit ratings on Switzerland-based Zuercher Kantonalbank (ZKB). The outlook is stable.

Rationale

Standard & Poor's bases its ratings on ZKB on its view of an "extremely high" likelihood of support for ZKB from its owner, the Canton of Zurich (AAA/Stable/--), in times of stress. The ratings also reflect our view of the bank's "very strong" capital and earnings, "adequate" business position and risk position, "average" funding, and "strong" liquidity, as our criteria define these terms. The stand-alone credit profile (SACP) is at 'aa-'.

Our bank criteria use the economic risk and industry risk scores from our Banking Industry Country Risk Assessment (BICRA) 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', based on an economic risk score of '1' and an industry risk score of '2'.

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.

We regard ZKB's business position as "adequate" and in line with Switzerland's industry risk score of '2'. With total assets of Swiss franc (CHF) 130 billion (about \$156 billion) at midyear 2011, ZKB is the third largest bank in Switzerland. It is by far the largest cantonal bank and its business activities are more diverse than those of other cantonal banks. For instance, ZKB originates syndicated loans for other cantonal banks and trades in financial instruments. The bank has a long-standing presence in the Canton of Zurich, one of Switzerland's economically strongest regions, with a leading market share of about 30%. We regard ZKB's geographic concentration as a relative weakness. However, this is mitigated by diversification across the retail segment, business with small and midsize enterprises and corporate customers, private banking activities in the canton and further afield, as well as its stable overall financial performance.

Our assessment of ZKB's capital and earnings as "very strong" reflects ZKB's level of capital, the quality of earnings, and our expectation that capital will continue to be conservatively managed. We expect the risk-adjusted capital (RAC) ratio to rise marginally over the medium term, given steady profitability and modest loan growth in the range of 16.0% to 17.0%. This expectation is supported by a robust earnings buffer of more than 100 basis points, even compared with that of peers with a greater risk appetite. Capital generation remains supported by consistent earnings and relatively small distributions to the canton, taking into account the negligible effective tax rate on earnings. The bank has no hybrid capital.

ZKB's "adequate" risk position reflects the economic risk score of '1' (lowest risk) for Swiss banks under our BICRA methodology, as well the bank's high-quality residential mortgage portfolio, which is fully reflected in our RAC ratio. High-quality mortgage loans account for more than 70% ZKB's loan book and 40% of its total assets. We view the loan portfolio as granular, with generally transparent and standard products. Occasional volatility associated with ZKB's trading activity has been evident in ZKB's results, but not to an extent that endangers its very strong capital position. We anticipate annual loan growth of 3%-5% for ZKB, in line with its conservative risk management, which should help the bank maintain its favorable loss record. However, excessive real estate prices in certain regions and the impact of a potential strengthening of the Swiss franc on corporate exposures could heighten ZKB's risks. In addition, we believe a lengthy continuation of low interest rates could restrict ZKB's net interest margin.

ZKB's funding is "average" and its liquidity "strong" in our view. The bank's

funding benefits substantially from its strong franchise in the canton and with private banking customers, which have generated a widespread, loyal depositor base. The loan-to-deposit ratio was 78% on June 30, 2011. The Canton of Zurich's ownership and its guarantee for ZKB's liabilities enhance ZKB's ability to attract funds, which benefits liquidity, since market turbulence can spark a "flight to quality" in ZKB's favor. Furthermore, we consider that ZKB would be able to operate without new funding for up to 12 months, given the maturity structure of its assets and liabilities, the quality of its retail deposits, and the magnitude of its liquid assets.

We continue to consider ZKB to be a government-related entity (GRE). In accordance with our criteria for GREs, our view of an "extremely high" likelihood of timely and sufficient extraordinary government support is based on our assessment of ZKB's:

- "Very important" role as Zurich's largest GRE and a leading credit institution. A default by ZKB might destabilize the Swiss banking system and tarnish the canton's reputation in the capital markets; and
- "Integral" link with the canton based on a strong and durable relationship. ZKB benefits from the canton's statutory guarantee, which ultimately covers ZKB's liabilities, except those of its subsidiaries. We do not anticipate any material changes to ZKB's ownership structure, legal status, or the canton's statutory guarantee over the medium term.

Outlook

The stable outlook reflects our view of ZKB's SACP, the ratings on the Canton of Zurich, and ZKB's role for and link with the canton as a GRE. Although a deterioration of any one of these factors could lead us to lower our ratings on ZKB, we view the bank's position as solid in all respects.

More specifically, a one-notch reduction of ZKB's SACP would lead to a one-notch downgrade of ZKB, all other things remaining equal. This could conceivably be the result of a general deterioration in the Swiss economy or ZKB's declining asset quality. Alternatively, a weakening of the bank's capital and earnings to "strong" from the current "very strong" would also lead to a one-notch reduction in the SACP, the lower score usually being associated with RAC ratios of less than 15%.

Under our criteria, the ratings on ZKB are limited by those on the Canton of Zurich, meaning that a downgrade of the canton would have a corresponding impact on ZKB. In addition, a reduction in the likelihood of support for ZKB to "very high" from "extremely high" would cause us to lower our rating on ZKB by one notch. However, a lower likelihood of support could only result from a fundamental change in ZKB's long-term relationship with the canton that would probably require a change in the law. This scenario currently appears remote.

Ratings Score Snapshot

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

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Group Rating Methodology And Assumptions, Nov. 9, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

Ratings List

Ratings Affirmed

Zuercher Kantonalbank	
Counterparty Credit Rating	AAA/Stable/A-1+
Certificate Of Deposit	AAA/A-1+
Senior Unsecured	AAA

Additional Contact:

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