FITCH AFFIRMS ZUERCHER KANTONALBANK AT 'AAA'/STABLE/'A+'

Fitch Ratings-London-26 September 2018: Fitch Ratings has affirmed Zuercher Kantonalbank's (ZKB) Long-Term Issuer Default Rating (IDR) at 'AAA', Short-Term IDR at 'F1+', Viability Rating (VR) at 'a+' and Support Rating at '1'. The Outlook on the Long-Term IDR is Stable.

KEY RATING DRIVERS
IDRS AND SUPPORT RATING
ZKB's IDRs and Support Rating are based on institutional support from the Canton of Zurich (AAA/Stable), the bank's guarantor and sole owner, and are equalised with the canton's IDRs. The canton guarantees all of ZKB's non-subordinated liabilities according to a specific cantonal law (ZKB Law).

ZKB's balance sheet is large relative to the canton's budgetary resources, but Fitch believes the bank's stable and resilient business model and strong capitalisation would trigger manageable recapitalisation needs in a realistic stress scenario. Given ZKB's domestic systemically relevant bank (D-SIB) status, we also expect that the Swiss central bank would provide liquidity to ZKB in case of need.

The canton's guarantee does not explicitly ensure timely support, but Fitch believes that support, if necessary, would be provided in a timely fashion, given ZKB's high importance for the canton and the potential repercussions of a failure for the Swiss financial sector. ZKB's strategic importance to the canton is underpinned by the bank's mandate as a cantonal bank, which requires the bank to concentrate its activities on the Canton of Zurich, with limited nationwide or international activities. The Canton of Zurich is also required to have a cantonal bank according to the cantonal constitution.

As a D-SIB, ZKB must prepare a contingency plan to be approved by the Swiss banking supervisor (FINMA) and the canton in its capacity as the sole potential contributor of capital support. The plan could require the canton to commit a large volume of contingent capital relative to its own resources. However, we do not expect this to jeopardise the canton's ratings or trigger a reassessment of our support assumptions underpinning ZKB's IDRs.

VR
ZKB's VR reflects the bank's stable and resilient business model, sound profitability, strong asset quality, conservative risk appetite, and strong funding and capitalisation. The VR also benefits from ZKB's leading deposit and residential mortgage lending franchise in the Canton of Zurich, where the bank's operations are concentrated. This geographic concentration is mitigated by Zurich's economic strength as Switzerland's largest economic region.

ZKB's main risk stems from a large exposure of property loans in Zurich, which is mitigated by the bank's sound credit underwriting standards, with moderate loan-to-value ratios. In a stress scenario, we believe that ZKB could comfortably absorb credit losses arising from a meaningful fall in regional property prices.

ZKB's profits have been fairly stable through the economic cycle but are under pressure from negative interest rates A significant share of ZKB's large cash balance at the Swiss National Bank is also subject to the negative rates. As with most of its competitors, the bank has responded by adjusting pricing in mortgage lending, passing negative interest rates on to interbank and selected large corporate clients, although the bank does not apply such charges to retail deposits.

The negative rate environment is partially mitigated by ZKB's good earnings diversification, with growing fee income forming one-third of total 1H18 revenue. Trading income also continues to contribute a material proportion of operating income as the bank has good franchises in some trading segments, including structured products. We expect ZKB's cost base to remain higher and less flexible than many peers given the cantonal mandate, although costs appear adequately controlled.

In August 2018, ZKB reached an agreement with the US Department of Justice (DoJ) to pay a settlement of CHF98.5 million following the conclusion of the DoJ's investigation into the bank's legacy US off-shore private banking clients, which began in 2011. The bank will recognise this payment in 2H18, and in line with our previous assumptions we do not expect the payment to have a material P&L impact.

Loan impairment charges (LICs) remain low and we expect impairment volumes to remain at low levels in the near term, although we believe net LICs will rise moderately as releases from loan loss reserves are likely to decline. Low impairment rates are supported by the borrower-friendly interest rate environment and a resilient Swiss economy; Fitch expects moderate GDP growth to continue in the next two years.

ZKB's end-June 2018 CET1 ratio of 16.3% reflects the high regulatory capital requirements imposed on Swiss global and domestic SIBs, and benefits from the bank's use of the internal ratings-based approach (IRB) for risk-weighted asset measurement from end-2017. Internal capital generation is adequate, even though ZKB typically distributes about half of its net income to the canton and its municipalities. The CHF575 million undrawn portion of its endowment capital committed by the canton supports the VR, as we would view a drawdown as ordinary institutional support.

ZKB's funding is underpinned by a large and mostly granular deposit base despite some concentrated corporate deposits. Client funds account for over half of non-equity funding and cover almost the full volume of client loans. Wholesale funding needs are moderate and market access is supported by the canton's guarantee.

RATING SENSITIVITIES

IDRS AND SUPPORT RATING

ZKB's IDRs and Support Rating are primarily sensitive to changes in its owner's ability or propensity to support the bank. A downgrade of the Canton of Zurich's IDRs would result in a downgrade of ZKB's IDRs. A material increase in the canton's contingent liabilities, which are dominated by ZKB, could put pressure on the canton's and thus ZKB's IDRs. For instance, sustained growth of the bank's balance sheet in excess of the canton's GDP growth or a multi-notch downgrade of ZKB's VR could signal a higher likelihood of support requirements for the canton.

ZKB's IDRs and Support Rating are also sensitive to changes to ZKB's relationship with the canton, especially if the ZKB Law is amended in a way that would weaken the guarantee's effectiveness or cast doubt on the timeliness of support. However, we view this scenario as unlikely in the foreseeable future.

VR

We believe that an upgrade of the VR is unlikely given the concentration of ZKB's business model on the Canton of Zurich, resulting in a large exposure to the local property market.

Downward pressure on the VR could be driven by large property-related losses that could arise from a sharp drop of property prices in Zurich, particularly for non-owner-occupied properties. However, Fitch does not expect significant house price correction in Zurich in the near term. The ratings would also come under pressure if the bank increases its risk appetite, which could be indicated by higher loan growth or by greater exposure to interest rate risk in the banking book.

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Applicable Criteria
Bank Rating Criteria (pub. 22 Jun 2018)
https://www.fitchratings.com/site/re/10034713