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Research Update:

Swiss Zuercher Kantonalbank Affirmed At 'AAA/A-1+'; Outlook Revised To Stable Following Settlement In U.S. Tax Dispute

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Overview

- Zuercher Kantonalbank (ZKB) agreed to pay \$98.5 million to settle its tax dispute with the U.S. Department of Justice.
- We believe that tail risks for ZKB's banking franchise due to potential lengthy legal proceedings incurring material reputational risks have materially diminished following the agreement.
- We are therefore revising the outlook on ZKB to stable from negative, and affirming the ratings at 'AAA/A-1+'.
- The stable outlook reflects our view of no anticipated changes in ZKB's stand-alone credit quality alongside continued benefits stemming from its status as a government-related entity (GRE) with an extremely high likelihood of receiving support.

Rating Action

On Aug. 24, 2018, S&P Global Ratings revised to stable from negative its outlook on Zuercher Kantonalbank (ZKB), fully owned by the Swiss Canton of Zurich. At the same time, we affirmed our 'AAA/A-1+' long- and short-term issuer credit ratings on ZKB.

We also affirmed our 'A' ratings on ZKB's Tier 2 subordinated bond issuance.

Rationale

On Aug. 13, 2018, ZKB announced that it had reached an agreement with the U.S. Department of Justice (DOJ) to resolve a tax dispute. ZKB had been under investigation since 2011 for allegedly helping U.S. clients evade tax payments by accepting client transfers of undeclared funds. The bank was listed among the DOJ's "Category 1" banks, meaning that it could have faced a lengthy prosecution with possible material reputational risk for the bank and its customer base. Under the agreed terms, ZKB will pay the DOJ \$98.5 million. In addition, the bank will continue to provide the U.S. authorities with detailed information on accounts held by U.S. citizens and on transferred funds from accounts closed at ZKB to other banks. If ZKB fulfils all the conditions of the agreement, DOJ will likely close the case after three years.

The outlook revision to stable reflects our view that the agreement with the DOJ has materially diminished tail risks for ZKB's banking franchise. We consider the conditions of the agreement to be comparable with those made with other Swiss banks that have already settled their disputes over the past years. We therefore do not account for any elevated risks on ZKB's business stability and consider further prosecution, potentially due to violations of this agreement, as a remote scenario. Furthermore, we take into account our assessment that the legal fine will be comfortably covered by the bank's earnings, reserves, and provisions.

We continue to consider ZKB's business position as a rating strength, mainly reflecting the bank's diversified business activities. In particular, we note the successful integration of asset manager Swisscanto, which was previously owned by all Swiss cantonal banks collectively. ZKB has demonstrated sound profitability, especially during the most recent financial crises, and we expect this will continue to be the case. The guaranty provided by the Canton of Zurich supports ZKB's business stability, where it has a market share of about 40%. Although we consider ZKB's concentration in Zurich a weakness, the bank's material business activities on a national level set it apart from other Swiss cantonal banks.

We continue to see ZKB's capital and earnings as a competitive edge over global peers, mainly mirroring its risk-adjusted capital (RAC) ratio of 17.9% as of year-end 2017 (which is not materially affected by the legal charges, in our view). We also factor in the bank's adequate risk position, reflecting its low-risk residential mortgage portfolio and generally sound asset quality. We view ZKB's funding as average, and its liquidity as strong, supported by sound coverage of loans through customer deposits and strong metrics. The bank's stand-alone credit profile (SACP) remains at 'aa-'.

The 'AAA' rating on ZKB includes a three-notch uplift from our assessment of its SACP. This is because we consider the bank to be a GRE with an extremely high likelihood of receiving extraordinary government support in times of stress. We base this on our view of ZKB's very important role in the Canton of Zurich and its integral link to its home canton.

Outlook

The stable outlook on ZKB indicates that we are unlikely to take a positive or negative rating action over the next two years, as we continue to see the bank benefiting from its GRE status, with an extremely high likelihood of receiving government support if needed.

A downgrade could occur if we negatively reassessed ZKB's role for or link with the Canton of Zurich, or if there were changes in the statutory guarantee, which may also lead to our reassessment of ZKB's status as a GRE. While the outlook on the ratings is stable, a one-notch downgrade of the canton would trigger a similar action on ZKB. Moreover, a sharp weakening in the bank's capitalization, as reflected in the deterioration of the RAC ratio

below 15%, might also result in a downgrade.

An improvement in ZKB's SACP remains a remote scenario at this stage, given the bank's financial position and ownership structure.

Ratings Score Snapshot

Issuer Credit Rating	AAA/Stable/A-1+	AAA/Negative/A-1+
SACP	aa-	aa-
Anchor	a-	a-
Business Position	Strong (+1)	Strong (+1)
Capital and Earnings	Very strong (+2)	Very strong (+2)
Risk Position	Adequate (0)	Adequate (0)
Funding and Liquidity	Average and (0)	Average and (0)
	Strong	Strong
Support	(3)	(3)
ALAC Support	(0)	(0)
GRE Support	(3)	(3)
Group Support	(0)	(0)
Sovereign Support	(0)	(0)

Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 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
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 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: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011

- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Zuercher Kantonalbank		
Issuer Credit Rating	AAA/Stable/A-1+	AAA/Negative/A-1+
Subordinated	A	A

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