FitchRatings

Banks
Universal Commercial Banks
Switzerland

Zuercher Kantonalbank

Key Rating Drivers

IDR Equalised with Owner's: Zuercher Kantonalbank's (ZKB) Issuer Default Ratings (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 under a specific cantonal law.

Manageable Recapitalisation if Needed: ZKB's balance sheet is large relative to the Canton's budgetary resources, but Fitch Ratings believes the bank's stable and resilient business model and capital buffers would mean manageable recapitalisation needs in a realistic stress scenario. A recapitalisation of ZKB would not on its own drive a negative action on the Canton's ratings, or trigger a reassessment of our support assumptions underpinning ZKB's IDRs.

Strong Standalone Credit Profile: ZKB's Viability Rating (VR) reflects the bank's stable and resilient business model, conservative risk appetite, strong asset quality, funding and capitalisation and adequate profitability. ZKB's leading deposit-and-residential mortgage franchise in the Canton of Zurich supports the VR. Geographic concentration is mitigated by Zurich's economic strength as Switzerland's largest economic region and the bank's diversified business activities covering retail and commercial banking.

Material Real Estate Exposure: ZKB's main risk stems from its large real estate exposure in Zurich. We believe loan quality would be resilient to a significant decline in residential property values due to the bank's strict credit underwriting standards. Loan impairment charges (LICs) were low in 2020 due to effective borrower-support measures, a resilient economy and low unemployment. We expect LICs to increase in 2021 and 2022, particularly in the unsecured corporates and SME portfolios, but to remain manageable.

Strong Capitalisation: ZKB's common equity Tier 1 (CET1) ratio remained strong at 17.4% at end-2020, despite loan growth and negative rating migrations. At this level, it can comfortably absorb the impact from the initial recognition of valuation allowances for expected losses, which from 2021 applies to banks reporting under Swiss GAAP.

Very Stable Funding: ZKB's funding is underpinned by a large and mostly granular deposit base despite some more concentrated corporate and institutional deposits. Customer deposits account for over half of non-equity funding and cover almost the full volume of loans. Wholesale funding needs are moderate and benefit from the bank's cantonal guarantee, and from investor perception of ZKB as a safe haven in times of increased market uncertainty.

Rating Sensitivities

IDRs Support Sensitive: ZKB's IDRs and Support Rating are primarily sensitive to changes in the Canton's ratings and its 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 its IDRs and, therefore, on ZKB's IDRs.

VR Property Market Sensitive: The VR would likely be downgraded if large real estate-related losses lead to a CET1 or an impaired loans ratio materially and durably below 16% and above 2%, respectively. The rating would also come under pressure if operating profit/risk weighted assets (RWAs) deteriorates durably to 0.5% or 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 loan book.

VR Upgrade Constrained by Concentration: An upgrade is unlikely given the concentration of ZKB's business model on the Zurich area, resulting in a large exposure to the local property market. An upgrade would also require an improvement in the bank's profitability.

Ratings

Foreign Currency	
Long-Term IDR	AAA
Short-Term IDR	F1+
Viability Rating	a+
Support Rating	1
Sovereign Risk	
Long-Term Foreign-Currency IDR	AAA
Long-Term Local-Currency IDR	AAA
Country Ceiling	AAA
Outlooks	
Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Local-Currency IDR	Stable

Applicable Criteria

Bank Rating Criteria (February 2020)

Related Research

Fitch Affirms Zuercher Kantonalbank at 'AAA'/Stable (April 2021)

Fitch Affirms Canton of Zurich at 'AAA'; Outlooks Stable (July 2020)

Analysts

Sima, Ioana
+44 20 3530 1736
ioana.sima@fitchratings.com

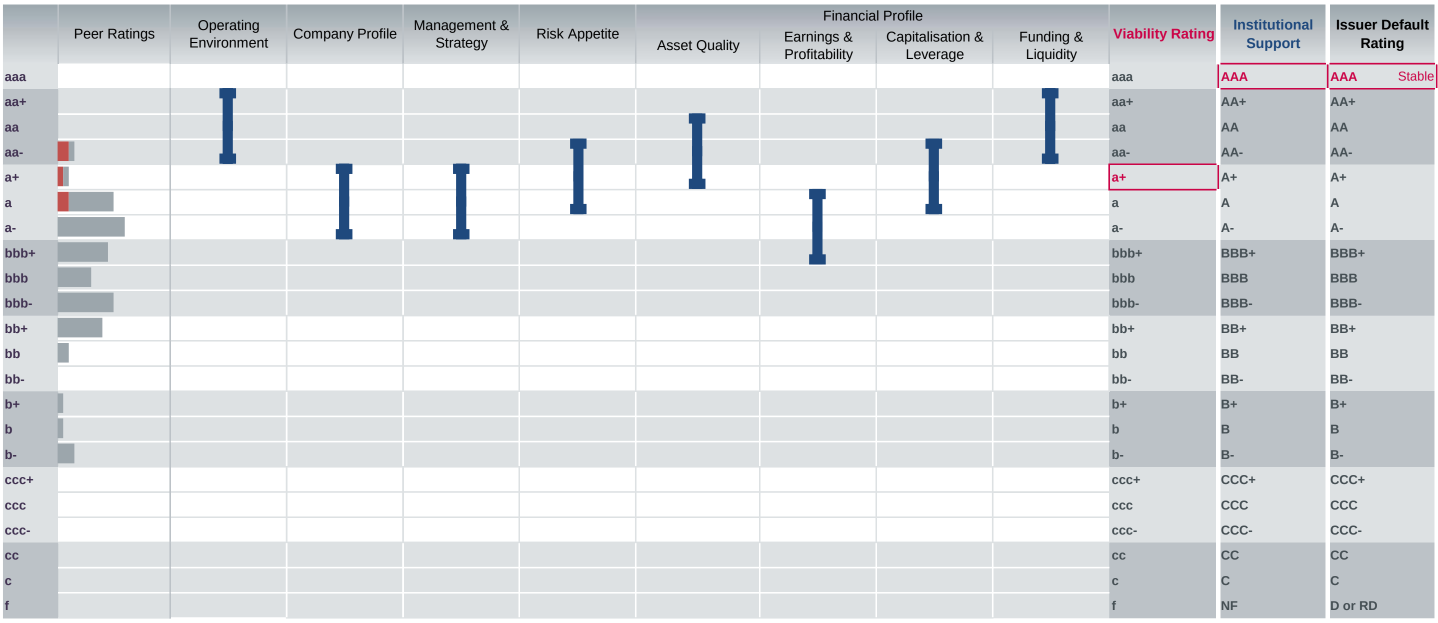
Diamantini, Marco
+49 69 768076 114
marco.diamantini@fitchratings.com

Ratings Navigator

Zuercher Kantonalbank

ESG Relevance:

Banks
Ratings Navigator



Institutional Support			Value
Parent IDR			AAA
Total Adjustments (notches)			+0
Institutional Support:			**AAA**
Support Factors (negative)	Equalised	1 Notch	2+ Notches
Parent ability to support and subsidiary ability to use support			
Parent/group regulation	✓		
Relative size		✓	
Country risks	✓		
Parent Propensity to Support			
Role in group	✓		
Potential for disposal	✓		
Implication of subsidiary default	✓		
Integration		✓	
Size of ownership stake	✓		
Support track record	✓		
Subsidiary performance and prospects	✓		
Branding	✓		
Legal commitments	✓		
Cross-default clauses			✓

Bar Chart Legend

Vertical bars – VR range of Rating Factor

Bar Colors – Influence on final VR

- Higher influence
- Moderate influence
- Lower influence

Bar Arrows – Rating Factor Outlook

- ⇧ Positive
- ⇩ Negative
- ⇳ Evolving
- ▫ Stable

Institutional Support Assessment

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 (the 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, funding and capital buffers would mean manageable recapitalisation or liquidity support needs in a realistic stress scenario.

The Canton's guarantee does not explicitly address the timeliness of 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 is underpinned by the bank's mandate to provide financial services to individuals and companies in the Canton. The bank's nationwide and international activities are limited. The Canton of Zurich's constitution also requires the canton to have a cantonal bank, making the institutional owner more likely to support the bank in financial distress.

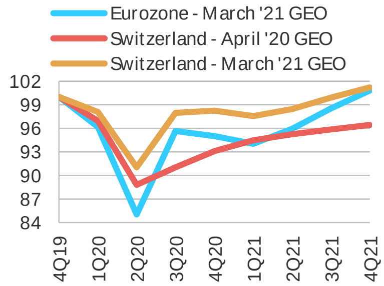
As a domestically systemically important bank (D-SIB), ZKB has a contingency plan to be approved by the Swiss banking supervisor (FINMA). The plan could require the canton to commit a large volume of contingent capital relative to its own resources. We believe that the provision of this contingent capital, if needed, would be manageable for the Canton given its strong financial position, and would not on its own drive a negative action on the Canton's ratings, or trigger a reassessment of our support assumptions underpinning ZKB's IDRs.

Significant Changes

Operating Environment Outlook for Swiss Banks Revised to Stable

We revised ZKB's operating environment outlook from negative to stable, in line with the outlook for the operating environment scores of ZKB's domestic peers. The operating environement score for Swiss banks was placed on negative outlook in March 2020 to reflect emerging risks from the coronavirus pandemic. The Swiss economy performed better than expected and better than most peers in 2020. This was due to much shorter and less stringent lockdown than elsewhere in Europe, as well as the strong rebound of economic activity after the containment measures were lifted. Fitch's latest Global Economic Outlook (GEO) confirms GDP should return to pre-pandemic levels in 2021, with only a modest downward revision due to the lockdown which Switzerland entered in early January.

GDP Level Forecast
(Index 4Q19 = 100)



Source: Fitch Ratings Estimate

Brief Company Summary

Public Sector Retail-Focused Bank with Leading Franchise in Zurich

ZKB is the largest cantonal bank in Switzerland and the third-largest bank by assets. ZKB's public mandate, set out in the ZKB law, governs its focus on the Zurich region. The law prescribes the bank's activities, focused on providing full banking services to local households and SMEs, as well as supporting the Canton's economic and social development by supporting access to residential property. Accordingly, ZKB operates the densest branch network in the Canton of Zurich and has a leading regional franchise, with market shares between 30% and 40% in retail deposits and mortgage lending.

Beyond Zurich, ZKB mostly lends to Swiss SMEs and export-focused companies, but the bank's national-level market shares are more modest. ZKB is also the third-largest fund provider in the country and one of the largest asset managers in Switzerland, with CHF362 billion of assets under management (AuM) at end-2020. The bank's domestic and international private banking franchise remains niche.

Public Service Mandate Ensures Stable Strategy

ZKB's clear and stable strategic objectives, defined in the ZKB law, underpin its sustainable business model. This is reflected in the bank's stable through-the-cycle performance record. The bank's cantonal owners maintain good oversight of ZKB's activities, including through board representation, and the bank is ultimately supervised by the Canton's parliament. In combination with the ZKB law, this helps to support the stability of ZKB's strategic objectives, also constraining the bank's ability to expand its business activities. At the same time, we believe that ZKB's management is independent and not subject to undue political influence.

Conservative Underwriting; Robust Risk Controls

ZKB's public mandate drives the bank's conservative risk appetite. We consider ZKB's underwriting standards to be very low-risk and conservative to the benefit of the stable and sound loan quality. The bank is proactive in tightening its lending policies based on market changes. ZKB also bases its loan-to-value calculations on indexed property values, providing an extra buffer in the event of a significant market price correction. ZKB has limited risk appetite for commercial real estate lending outside the residential sector.

Growth Focused on Asset Management

ZKB pursues organic growth in its investment and asset management business to strengthen income diversification. We believe that the bank's expertise is sufficiently advanced to cope with future increased volumes. There is limited scope for significant further growth in retail and corporate banking given ZKB's already high local market shares, and the constraints on developing additional activities imposed by the ZKB law.

Market Risk Mainly in the Banking Book

Compared with peers, ZKB's exposure to interest-rate risk is high given its appetite to assume interest-rate risk in the banking book (IRRBB). The IRRBB exposure mainly serves as a strategic hedge against persistently low Swiss franc interest rates, as well as offering stabilisation of interest income. The bank has been able to manage IRRBB well to date, but an increased appetite for this risk could put the VR under pressure.

The trading book (CHF10.9 billion at end-2020) mainly consists of domestic bonds, equity-linked securities and precious metals linked to ZKB's large issuance of structured products, warrants and exchange-traded funds in Switzerland. Following losses incurred during the global financial crisis, the management has adopted a more cautious approach to traded market risk by reducing equity trading to focus on client-driven activities and products. This has mostly been in foreign exchange (mainly francs to euros), interest-rate and credit derivatives, commodities, Swiss franc and euro-denominated bonds as well as other securities.

Key Financial Metrics

Asset Quality Resilient in the Crisis

ZKB's main risk stems from a large real estate exposure in Zurich, with about 90% of end-2020 gross customer loans represented by mainly residential mortgages. But we believe that concentration on real estate is compensated for by the Canton of Zurich's strong economic fundamentals and the stability of ZKB's strong asset quality metrics. Loan quality would be resilient to a significant decline in residential property values due to the bank's strict credit underwriting standards and moderate overall loan-to-value ratios, while severe price correction is a rating sensitivity.

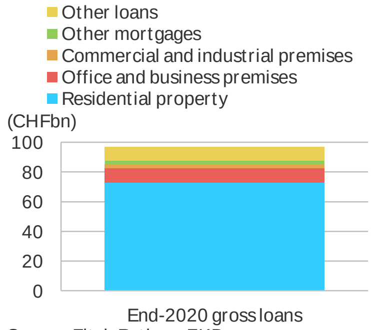
LICs were low in 2020 due to effective borrower-support measures, a resilient economy and low unemployment and because Swiss GAAP did not require the frontloading of expected credit losses to the same extent as IFRS 9. We expect LICs to increase in 2021 and 2022, particularly in the unsecured corporates and SME portfolios, but remain manageable for the bank. The impaired loan ratio should also only moderately increase over the next two years and remain under 1% on average. This, along with a benign outlook for pre-impairment profitability, has led us to revise the trend on ZBK's asset quality and earnings and profitability scores to stable from negative.

Earnings Stable Over the Econmic Cycle

ZKB's profitability was adequate going into the Covid-19 crisis and has remained resilient in 2020. Risk-weighted operating profitability should remain above 1% over the rating horizon.

Core revenues increased by about 10% in 2020 on the back of a strong trading and securities business result. Net interest income also benefited from loan growth and the raise in the threshold for deposits exempted from negative rates in April 2020. This absorbed part of the costs for ZKB's increased regulatory liquidity requirements, given that a significant proportion

ZKB's CHF97.1bn Loan Book



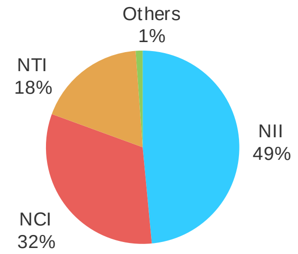
Source: Fitch Ratings, ZKB

of ZKB's large cash balance at the SNB is subject to negative interest rates, which are in part passed on to interbank and selected large corporate clients, but not retail depositors.

ZKB's universal banking model provides good earnings diversification and mitigates pressure on the net interest margin. Fee income formed one-third of total revenue in 2020. We expect it to grow in the medium-term driven by continued efforts to expand the investment product offering. Trading activities continue to contribute a material, though volatile, proportion of operating income as the bank has well-established franchises in some trading segments, including structured products.

Management is working on reducing costs. But we believe ZKB's cost base will remain heavier and less flexible than many peers' given the cantonal mandate, which limits the bank's ability to reduce headcount and close branches, and the investments required to digitize its processes and product offering.

Operating Income Split
(End-2020)



Source: Fitch Ratings, ZKB

Strong Capitalisation and Very Stable Funding

ZKB's common equity Tier 1 (CET1) ratio remained strong at 17.4% at end-2020, despite loan growth and negative rating migrations. We expect RWA growth to slow down in 2021 and 2022 from 5% in 2020. ZKB's capital ratios can comfortably absorb the impact from the initial recognition of valuation allowances for expected credit losses, which from 2021 applies to banks reporting under Swiss GAAP.

They can also accommodate ZKB's owners' pay-out expectations. In 2020 ZKB paid out 60% of the bank’s consolidated 2019 profit, including a special CHF150 million dividend for the 150-years anniversary of the bank. In 2021 ZKB paid out 52% of 2020 net profits. These included a special CHF100 million coronavirus dividend. Pay-out ratios were usually below 50% in the past. ZKB also pays the Canton financial compensation of around CHF22 million a year for its guarantee.

In 2020 the cantonal parliament increased ZKB's undrawn endowment capital by CHF425 million to CHF1 billion. The Canton's guarantee covers half of ZKB's gone-concern capital requirement, which will be fully phased in at 7.86% in 2026. The remaining gap should be covered with Tier 2 capital until ZKB is allowed to issue bail-in debt. Besides this, wholesale funding needs are moderate and benefit from ordinary support via the bank's cantonal guarantee and investor perception of ZKB as a safe haven. ZKB's funding profile is underpinned by a large and mostly granular deposit base despite some concentrated corporate deposits. Customer deposits account for over half of non-equity funding and cover almost the bank's full volume of loans.

As a D-SIB, ZKB is subject to a minimum 135% average liquidity coverage ratio (LCR) requirement starting from January 2021. To meet this requirement, the bank increased its already large liquid assets portfolio to CHF53 billion at end-2020 from CHF44 billion at end-2019. This was mainly achieved by issuing money market instruments as well as opening investment accounts for institutional clients with withdrawal restrictions and interbank term deposits. The proceeds were placed as sight deposits with the SNB. These measures led to an LCR of 160% at end-2020.

Summary Financials and Key Ratios

	31 Dec 20		31 Dec 19	31 Dec 18	31 Dec 17
	Year end	Year end	Year end	Year end	Year end
	(USDm)	(CHFm)	(CHFm)	(CHFm)	(CHFm)
	Audited - unqualified	Audited - unqualified	Audited - unqualified	Audited - unqualified	Audited - unqualified
Summary income statement					
Net interest and dividend income	1,414	1,258.0	1,210.0	1,223.0	1,211.0
Net fees and commissions	906	806.0	777.0	776.0	770.0
Other operating income	548	488.0	421.0	331.0	365.0
Total operating income	2,868	2,552.0	2,408.0	2,330.0	2,346.0
Operating costs	1,871	1,664.8	1,568.0	1,563.0	1,536.0
Pre-impairment operating profit	997	887.2	840.0	767.0	810.0
Loan and other impairment charges	44	39.0	-6.0	10.0	25.0
Operating profit	953	848.2	846.0	757.0	785.0
Other non-operating items (net)	28	24.8	4.0	38.0	8.0
Tax	9	8.0	5.0	7.0	11.0
Net income	972	865.0	845.0	788.0	782.0
Summary balance sheet					
Assets					
Gross loans	109,142	97,120.0	93,375.0	89,906.0	87,096.0
- Of which impaired	562	500.0	435.0	504.0	472.0
Loan loss allowances	211	188.0	159.0	181.0	177.0
Net loans	108,931	96,932.0	93,216.0	89,725.0	86,919.0
Interbank	3,816	3,396.0	4,917.0	4,803.0	4,457.0
Derivatives	1,790	1,593.0	1,486.0	1,278.0	1,535.0
Other securities and earning assets	37,121	33,032.0	29,316.0	31,211.0	28,118.0
Total earning assets	151,658	134,953.0	128,935.0	127,017.0	121,029.0
Cash and due from banks	58,610	52,154.0	36,786.0	40,989.0	41,147.0
Other assets	1,413	1,257.0	1,333.0	1,402.0	1,705.0
Total assets	211,681	188,364.0	167,054.0	169,408.0	163,881.0
Liabilities					
Customer deposits	104,073	92,609.0	85,089.0	85,537.0	81,381.0
Interbank and other short-term funding	44,570	39,661.0	39,051.0	46,979.0	47,711.0
Other long-term funding	40,778	36,286.0	23,250.0	16,721.0	14,676.0
Trading liabilities and derivatives	6,429	5,721.0	6,205.0	5,642.0	5,595.0
Total funding	195,850	174,277.0	153,595.0	154,879.0	149,363.0
Other liabilities	1,615	1,437.0	1,122.0	1,186.0	1,777.0
Preference shares and hybrid capital	n.a.	n.a.	n.a.	1,491.0	1,513.0
Total equity	14,216	12,650.0	12,337.0	11,852.0	11,228.0
Total liabilities and equity	211,681	188,364.0	167,054.0	169,408.0	163,881.0
Exchange rate		USD1 = CHF0.88985	USD1 = CHF0.97165	USD1 = CHF0.9811	USD1 = CHF0.9758

Source: Fitch Ratings, Fitch Solutions, ZKB

Summary Financials and Key Ratios

	31 Dec 20	31 Dec 19	31 Dec 18	31 Dec 17
Ratios (annualised as appropriate)				
Profitability				
Operating profit/risk-weighted assets	1.2	1.3	1.2	1.2
Net interest income/average earning assets	0.9	1.0	1.0	1.0
Non-interest expense/gross revenue	65.6	65.8	68.0	65.9
Net income/average equity	7.0	7.0	6.9	7.1
Asset quality				
Impaired loans ratio	0.5	0.5	0.6	0.5
Growth in gross loans	4.0	3.9	3.2	2.5
Loan loss allowances/impaired loans	37.6	36.6	35.9	37.5
Loan impairment charges/average gross loans	0.0	0.0	0.0	0.0
Capitalisation				
Common equity Tier 1 ratio	17.4	17.7	17.8	16.5
Tangible common equity/tangible assets	6.7	7.3	6.9	6.7
Basel leverage ratio	6.2	6.6	6.4	6.4
Net impaired loans/common equity Tier 1	2.6	2.4	2.9	2.8
Funding and liquidity				
Loans/customer deposits	104.9	109.7	105.1	107.0
Liquidity coverage ratio	160.0	123.0	127.0	153.0
Customer deposits/funding	53.4	55.9	55.0	54.3

Source: Fitch Ratings, Fitch Solutions, ZKB

Environmental, Social and Governance Considerations

FitchRatings **Zuercher Kantonalbank**

Banks
Ratings Navigator

Credit-Relevant ESG Derivation

Zuercher Kantonalbank has 5 ESG potential rating drivers

- Zuercher Kantonalbank has exposure to compliance risks including fair lending practices, mis-selling, repossession/foreclosure practices, consumer data protection (data security) but this has very low impact on the rating.
- Governance is minimally relevant to the rating and is not currently a driver.

			Overall ESG Scale
key driver	0	issues	5
driver	0	issues	4
potential driver	5	issues	3
not a rating driver	4	issues	2
	5	issues	1

Environmental (E)

General Issues	E Score	Sector-Specific Issues	Reference	E Scale
GHG Emissions & Air Quality	1	n.a.	n.a.	5
Energy Management	1	n.a.	n.a.	4
Water & Wastewater Management	1	n.a.	n.a.	3
Waste & Hazardous Materials Management; Ecological Impacts	1	n.a.	n.a.	2
Exposure to Environmental Impacts	2	Impact of extreme weather events on assets and/or operations and corresponding risk appetite & management; catastrophe risk; credit concentrations	Company Profile; Management & Strategy; Risk Appetite; Asset Quality	1

Social (S)

General Issues	S Score	Sector-Specific Issues	Reference	S Scale
Human Rights, Community Relations, Access & Affordability	2	Services for underbanked and underserved communities: SME and community development programs; financial literacy programs	Company Profile; Management & Strategy; Risk Appetite	5
Customer Welfare - Fair Messaging, Privacy & Data Security	3	Compliance risks including fair lending practices, mis-selling, repossession/foreclosure practices, consumer data protection (data security)	Operating Environment; Company Profile; Management & Strategy; Risk Appetite	4
Labor Relations & Practices	2	Impact of labor negotiations, including board/employee compensation and composition	Company Profile; Management & Strategy	3
Employee Wellbeing	1	n.a.	n.a.	2
Exposure to Social Impacts	2	Shift in social or consumer preferences as a result of an institution's social positions, or social and/or political disapproval of core banking practices	Company Profile; Financial Profile	1

Governance (G)

General Issues	G Score	Sector-Specific Issues	Reference	G Scale
Management Strategy	3	Operational implementation of strategy	Management & Strategy	5
Governance Structure	3	Board independence and effectiveness; ownership concentration; protection of creditor/stakeholder rights; legal /compliance risks; business continuity; key person risk; related party transactions	Management & Strategy; Earnings & Profitability; Capitalisation & Leverage	4
Group Structure	3	Organizational structure; appropriateness relative to business model; opacity; intra-group dynamics; ownership	Company Profile	3
Financial Transparency	3	Quality and frequency of financial reporting and auditing processes	Management & Strategy	2
				1

How to Read This Page
ESG scores range from 1 to 5 based on a 15-level color gradation. Red (5) is most relevant and green (1) is least relevant.

The Environmental (E), Social (S) and Governance (G) tables break out the individual components of the scale. The right-hand box shows the aggregate E, S, or G score. General Issues are relevant across all markets with Sector-Specific Issues unique to a particular industry group. Scores are assigned to each sector-specific issue. These scores signify the credit-relevance of the sector-specific issues to the issuing entity's overall credit rating. The Reference box highlights the factor(s) within which the corresponding ESG issues are captured in Fitch's credit analysis.

The Credit-Relevant ESG Derivation table shows the overall ESG score. This score signifies the credit relevance of combined E, S and G issues to the entity's credit rating. The three columns to the left of the overall ESG score summarize the issuing entity's sub-component ESG scores. The box on the far left identifies some of the main ESG issues that are drivers or potential drivers of the issuing entity's credit rating (corresponding with scores of 3, 4 or 5) and provides a brief explanation for the score.

Classification of ESG issues has been developed from Fitch's sector ratings criteria. The General Issues and Sector-Specific Issues draw on the classification standards published by the United Nations Principles for Responsible Investing (PRI) and the Sustainability Accounting Standards Board (SASB).

Sector references in the scale definitions below refer to Sector as displayed in the Sector Details box on page 1 of the navigator.

CREDIT-RELEVANT ESG SCALE

How relevant are E, S and G issues to the overall credit rating?

5	Highly relevant, a key rating driver that has a significant impact on the rating on an individual basis. Equivalent to "higher" relative importance within Navigator.
4	Relevant to rating, not a key rating driver but has an impact on the rating in combination with other factors. Equivalent to "moderate" relative importance within Navigator.
3	Minimally relevant to rating, either very low impact or actively managed in a way that results in no impact on the entity rating. Equivalent to "lower" relative importance within Navigator.
2	Irrelevant to the entity rating but relevant to the sector.
1	Irrelevant to the entity rating and irrelevant to the sector.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.