Fitch Ratings

Banks
Universal Commercial Banks
Switzerland

Zuercher Kantonalbank

Ratings

Issuer Ratings	
Long-Term IDR	AAA
Short-Term IDR	F1+
Viability Rating	a+
Shareholder Support Rating	aaa

Sovereign Risk (Switzerland)	
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

Key Rating Drivers

Zuercher Kantonalbank's (ZKB) Issuer Default Ratings (IDRs) are driven by support from its guarantor and sole owner, the Canton of Zurich (AAA/Stable/F1+), and ZKB's Shareholder Support Rating (SSR) is equalised with the Canton's Long-Term IDR. 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.

Manageable Recapitalisation if Needed: 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, funding and capital buffers mean that recapitalisation or liquidity support needs would be manageable in a realistic stress scenario.

Timely Support Expected: The Canton's guarantee does not explicitly address the timeliness of support, but Fitch Ratings believes that, if necessary, support 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. The Canton's constitution also requires it to have a cantonal bank, making the institutional owner more likely to support the bank in financial distress.

Contingency Plan Required: As a domestic systemically important bank, 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 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 negative action on the canton's ratings, or trigger a reassessment of our support assumptions underpinning ZKB's IDRs.

Strong Regional Franchise: ZKB's leading franchise in deposit-taking and residential mortgage lending in the Canton of Zurich, where the bank's operations are concentrated, supports the VR. Geographic concentration is mitigated by Zurich's economic strength and the bank's diversified business activities covering retail and commercial banking. ZKB is also the third-largest fund provider and one of the largest asset managers in Switzerland.

Material Real Estate Exposure: ZKB's impaired loans ratio is very low compared with international peers. ZKB's main risk stems from a large real estate exposure in Zurich, with about 90% of end-2021 gross customer loans mainly consisting in residential mortgages. We believe loan quality would be resilient to a significant decline in property values due to the bank's strict credit standards and moderate overall loan-to-value ratios.

Stable Earnings: Our assessment of ZKB's profitability reflects its long record of adequate, stable and fairly diversified earnings despite a material share of trading income in the bank's revenue. Operating profitability should remain above 1% of risk-weighted assets (RWAs) in the coming years.

Strong Capitalisation: ZKB's common equity Tier 1 (CET1) ratio remained strong at 17% at end-2021, despite strong loan growth. 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 will be covered with ZKB's CHF1 billion undrawn endowment capital as well as Tier 2 capital until ZKB is allowed to issue bail-in debt.

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 almost cover the full volume of loans. Wholesale funding needs are moderate and benefit from the bank's cantonal guarantee, thanks to which investors perceive ZKB as a safe haven in times of increased market uncertainty.

Applicable Criteria

Bank Rating Criteria (November 2021)

Related Research

Fitch Affirms Zuercher Kantonalbank at 'AAA'; Outlook Stable (April 2022)
Global Economic Outlook (March 2022)

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Rating Sensitivities

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

A downgrade of the Canton of Zurich's IDRs would result in a downgrade of ZKB's IDRs and SSR. A material increase in the canton's contingent liabilities, which are dominated by ZKB, could put pressure on the canton's and ZKB's IDRs and SSR. Contingent liabilities could increase, for instance because of sustained growth in the bank's balance sheet in excess of the canton's GDP growth, or due to a material delay by the canton in promptly addressing a potential capital shortfall at ZKB.

ZKB's IDRs and SSR are also sensitive to changes to the bank'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.

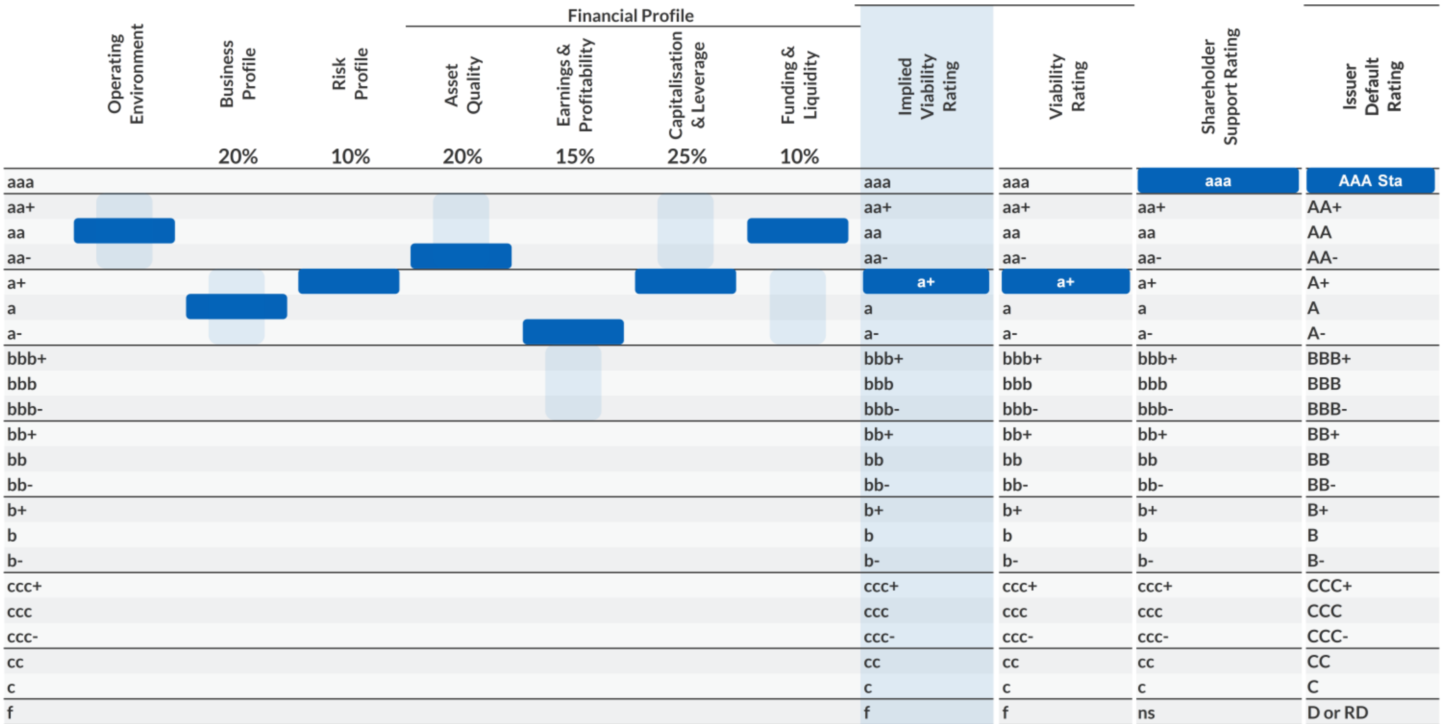
The VR would likely be downgraded if large real estate-related losses, which could arise from a sharp drop in residential property prices in Zurich, led to a CET1 or an impaired loans ratio materially and durably below 16% and above 2%, respectively. The rating would also come under pressure if profitability deteriorated durably, or if the bank increased its risk appetite, which could be indicated by higher loan growth or by greater exposure to interest-rate risk in the loan book.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

As the Long-Term IDR is already at the highest level on Fitch's scale, it cannot be upgraded.

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. An upgrade would also require an improvement in the bank's profitability.

Rating Navigator



The Key Rating Driver (KRD) weightings used to determine the implied VR are shown as percentages at the top. In cases where the implied VR is adjusted upwards or downwards to arrive at the VR, the KRD associated with the adjustment reason is highlighted in red. The shaded areas indicate the benchmark-implied scores for each KRD.

VR - Key Rating Drivers Adjustments

The Earnings and Profitability score of 'a-' has been assigned above the 'bbb' category implied score, due to the following adjustment reason: earnings stability (positive).

The Capitalisation and Leverage score of 'a+' has been assigned below the 'aa' category implied score, due to the following adjustment reason: capital flexibility and ordinary support (negative).

The Funding and Liquidity score of 'aa' has been assigned above the 'a' category implied score, due to the following adjustment reasons: deposit structure (positive) and liquidity access and ordinary support (positive).

Company Summary and Key Qualitative Factors

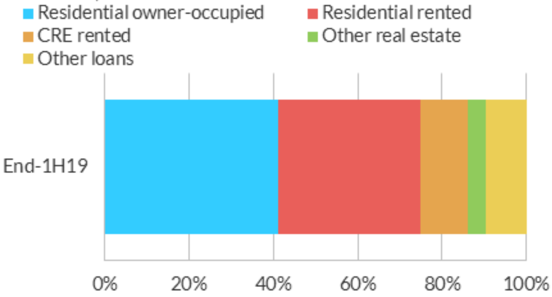
Business Profile

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 more than CHF300 billion of assets under management (AuM) at end-2021. The bank's domestic and international private banking franchise remains niche.

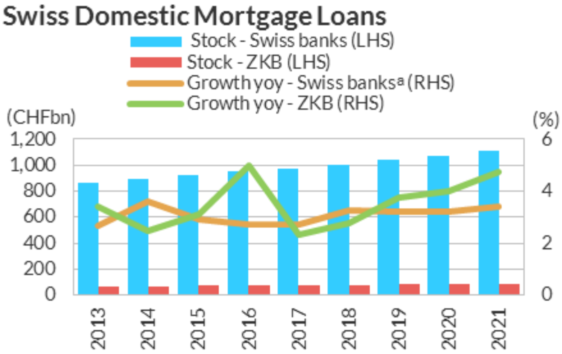
The bank's cantonal owners maintain good oversight of ZKB's activities, including through board representation, and the bank is ultimately supervised by the Canton's parliament. In combination with the ZKB law, this helps to support the stability of ZKB's business model and strategy, also constraining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

Loan Porfolio Split
End-2021, CHF102bn



Source: Fitch Ratings, ZKB

Swiss Domestic Mortgage Loans



Source: Fitch Ratings, ZKB, SNB

Risk Profile

ZKB's public mandate drives the bank's conservative risk appetite. We consider ZKB's underwriting standards to be low-risk and conservative, to the benefit of its 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.

ZKB pursues organic growth in its investment and asset management business to strengthen income diversification. We believe the bank's expertise is sufficiently advanced to cope with future volume increases. 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.

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. Trading is client-driven and focuses on foreign exchange (mainly francs to euros), interest-rate and credit derivatives, commodities, Swiss franc and euro-denominated bonds as well as other securities.

Financial Key Rating Drivers

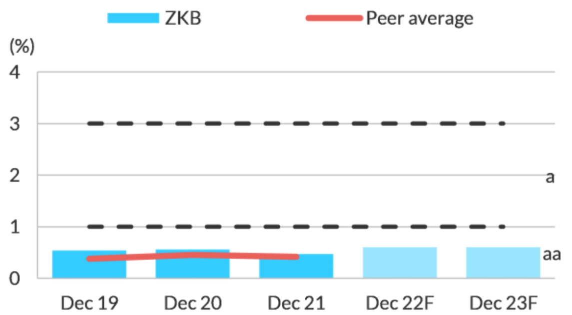
Asset Quality

ZKB's main risk stems from a large real estate exposure in Zurich, with about 90% of end-2021 gross customer loans mainly consisting of residential mortgages. However, we believe this concentration on real estate is adequately mitigated by the Canton of Zurich's strong economic fundamentals and the stability of ZKB's asset quality metrics. 86% of owner-occupied and 90% of rented residential properties in ZKB's loan book had a loan-to value ratio below 66.6% at end-2021. Loan quality would therefore be resilient to a significant decline in residential property values, while severe price correction is a rating sensitivity.

The strong economic rebound in 2021 reduced ZKB's loan defaults below their pre-pandemic level, leading to immaterial specific loan impairment charges (LICs). Total 2021 risk costs were in line with their 2020 level due to the booking of expected credit losses in line with portfolio growth. Expected credit losses apply to banks reporting under Swiss GAAP since 2021 and ZKB calculates them according to the same approach used for regulatory expected loss.

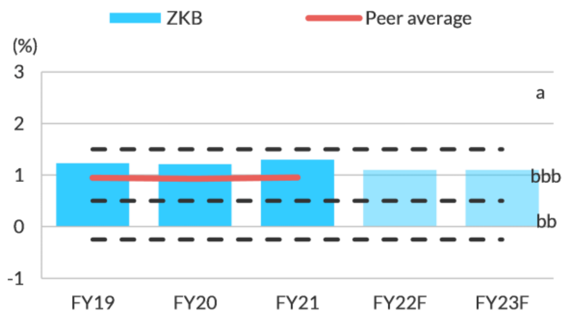
Switzerland is less exposed than neighbouring countries to the economic fallout from the conflict in Ukraine. However, the rise in commodity prices and the disruption in global supply chains could affect the bank's unsecured Swiss corporates portfolio and its unsecured exposure to commodity traders (CHF700 million at end-2021). We therefore expect LICs and impaired loans to moderately increase in 2022, but the impaired loans ratio should remain under 1% in the coming years.

Impaired Loans/Gross Loans



Source: Fitch Ratings, banks

Operating Profit/Risk-Weighted Assets



Source: Fitch Ratings, banks

Earnings and Profitability

ZKB's universal model provides good earnings diversification. The bank posted a record high profit of CHF942 million in 2021. Mortgage lending grew 5%, above market average. This, combined with the charging of negative interest rates on a larger volume of deposits and the opportunistic issuance of money market instruments led to net interest income growth of over 2% in 2021, compensating for declining gross margins. We expect margin pressure to b sustained as long as interest rates remain negative and competition strong.

Net commission income accounts for more than one third of ZKB's revenue and remains key in offsetting interest margin pressure. It increased by 15% in 2021, mainly owing to strong capital markets and CHF26 billion net AuM inflows that increased fees from the fund and wealth management business. We expect that net commission income will decline in 2022 due to weaker capital markets, but it is likely to grow in the medium term driven by ZKB's efforts to expand its investment product offering. Trading activities continue to contribute a material, though more volatile, proportion of operating income as the bank has well-established franchises in some trading segments, including structured products.

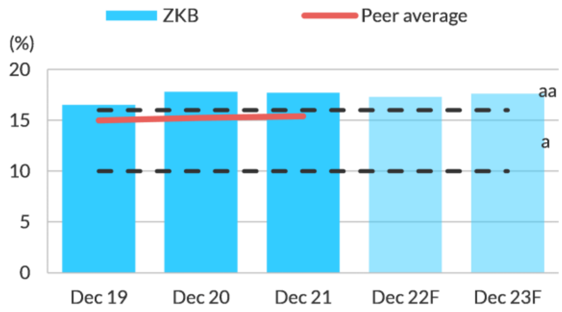
Personnel expenses increased by about 1% in 2022 excluding a CHF46 million special anniversary bonus paid to ZKB's employees in 2021. This was more than offset by a decline in other expenses on the back of lower project-related marketing and IT costs as well as lower depreciation. As a result of higher revenues and lower costs, the cost-income ratio calculated based on Fitch's methodology declined to 62% in 2021 from 66% in 2019 and 2020. Management is working on reducing costs, but we believe ZKB's cost base will remain heavier and less flexible than that of many peers given the cantonal mandate, which limits the bank's ability to reduce headcounts and close branches and to make the investments required to digitise its processes and product offering.

Capital and Leverage

ZKB's CET1 ratio remained strong at 17% at end-2021. This was despite strong loan growth and the impact from the initial recognition of CHF460 million valuation allowances for expected credit losses on ZKB's credit exposure, equivalent to 64bp of end-2021 RWAs. We expect the CET1 ratio to increase in the next two years as RWAs growth should be more than compensated by earnings retention. In particular, we expect RWA growth to slow down in 2022 and 2023 from 5% in 2020 and 2021 along with more moderate loan growth. At the same time, we expect the dividend pay-out ratio to remain below 50% of net profits, in line with ZKB's pre-pandemic distribution level. ZKB paid out special dividends in 2020 and 2021.

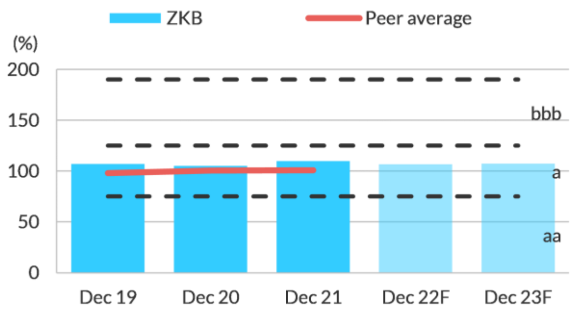
ZKB also pays the Canton a financial compensation of CHF20-30 million a year for its guarantee. The Canton's guarantee covers half of ZKB's gone-concern capital requirement, which will be fully phased in at 7.86% in 2026. In 2020, the cantonal parliament increased ZKB's undrawn endowment capital by CHF425 million to CHF1 billion. The remaining gap, which we estimate at around CHF1.7 billion at end-2026, will be mostly covered with Tier 2 capital and bail-in bonds, which ZKB expects to issue once a detailed regulation governing the issuance of bail-in bonds by cantonal banks is in place.

CET1 Ratio



Source: Fitch Ratings, banks

Gross Loans/Customer Deposits



Source: Fitch Ratings, banks

Funding and Liquidity

ZKB's 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. Since mid-2021 ZKB has been required to report its net stable funding ratio, which at 118% at the end of the year comfortably exceeded regulatory requirements.

As a domestic systemically important bank (D-SIB), ZKB is subject to a minimum 135% average liquidity coverage ratio (LCR) requirement. To meet this requirement, the bank increased its liquid assets portfolio to CHF52 billion at end-2021 from an already large CHF44billion 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 Swiss National Bank. In 2021, ZKB reallocated 20% of its cash to repurchase agreements to optimise funding costs. These measures led to an average LCR of 160% at end-2021. The Swiss government is currently examining the imposition of even stricter liquidity requirements for D-SIBs.

Note on Charts

Dashed lines: indicative ranges and implied scores for core financial metrics for banks operating in environments scored in the 'aa' category.

Peer averages include ZKB, UBS Switzerland AG (VR: a+), Credit Suisse (Schweiz) AG (a), and Raiffeisen Group (a+).

Financials

Financial Statements

	31 Dec 21		31 Dec 20	31 Dec 19	31 Dec 18
	(USDm)	(CHFm)	(CHFm)	(CHFm)	(CHFm)
Summary income statement					
Net interest and dividend income	1,399	1,287	1,258	1,210	1,223
Net fees and commissions	1,006	926	806	777	776
Other operating income	403	371	488	421	331
Total operating income	2,808	2,584	2,552	2,408	2,330
Operating costs	1,732	1,594	1,665	1,568	1,563
Pre-impairment operating profit	1,076	990	887	840	767
Loan and other impairment charges	42	39	39	-6	10
Operating profit	1,033	951	848	846	757
Other non-operating items (net)	0	0	25	4	38
Tax	10	9	8	5	7
Net income	1,024	942	865	845	788
Summary balance sheet					
Assets					
Gross loans	111,242	102,365	97,120	93,375	89,906
- Of which impaired	454	418	500	435	504
Loan loss allowances	681	627	188	159	181
Net loans	110,561	101,738	96,932	93,216	89,725
Interbank	3,448	3,173	3,396	4,917	4,803
Derivatives	1,382	1,272	1,593	1,486	1,278
Other securities and earning assets	47,430	43,645	33,032	29,316	31,211
Total earning assets	162,821	149,828	134,953	128,935	127,017
Cash and due from banks	44,428	40,883	52,154	36,786	40,989
Other assets	1,515	1,394	1,257	1,333	1,402
Total assets	208,764	192,105	188,364	167,054	169,408
Liabilities					
Customer deposits	105,170	96,777	92,609	85,089	85,537
Interbank and other short-term funding	42,708	39,300	39,661	39,051	46,979
Other long-term funding	41,956	38,608	36,286	23,250	16,721
Trading liabilities and derivatives	3,324	3,059	5,721	6,205	5,642
Total funding and derivatives	193,158	177,744	174,277	153,595	154,879
Other liabilities	1,833	1,687	1,437	1,122	1,186
Preference shares and hybrid capital	n.a.	n.a.	n.a.	n.a.	1,491
Total equity	13,773	12,674	12,650	12,337	11,852
Total liabilities and equity	208,764	192,105	188,364	167,054	169,408
Exchange rate		USD1 = CHF0.9202	USD1 = CHF0.88985	USD1 = CHF0.97165	USD1 = CHF0.9811

Source: Fitch Ratings, Fitch Solutions, ZKB

Key Ratios

	31 Dec 21	31 Dec 20	31 Dec 19	31 Dec 18
Profitability				
Operating profit/risk-weighted assets	1.3	1.2	1.3	1.2
Net interest income/average earning assets	0.9	0.9	1.0	1.0
Non-interest expense/gross revenue	62.0	65.6	65.8	68.0
Net income/average equity	7.5	7.0	7.0	6.9
Asset quality				
Impaired loans ratio	0.4	0.5	0.5	0.6
Growth in gross loans	5.4	4.0	3.9	3.2
Loan loss allowances/impaired loans	150.0	37.6	36.6	35.9
Loan impairment charges/average gross loans	0.0	0.0	0.0	0.0
Capitalisation				
Common equity Tier 1 ratio	17.0	17.4	17.7	17.8
Tangible common equity/tangible assets	6.6	6.7	7.3	6.9
Basel leverage ratio	6.2	6.2	6.6	6.4
Net impaired loans/common equity Tier 1	-1.7	2.6	2.4	2.9
Funding and liquidity				
Gross loans/customer deposits	105.8	104.9	109.7	105.1
Liquidity coverage ratio	160.0	160.0	123.0	127.0
Customer deposits/total non-equity funding	54.8	53.4	55.9	55.0
Net stable funding ratio	118.0	n.a.	n.a.	n.a.

Source: Fitch Ratings, Fitch Solutions, ZKB

Support Assessment

Shareholder Support Rating KRDs	
Parent IDR	AAA / ROS
Total adjustments (notches)	
Shareholder Support Rating	aaa

Shareholder Ability to Support	
Shareholder Rating	AAA / Stable
Shareholder Regulation	Equalised
Relative Size	1 Notch
Country Risks	Equalised

Shareholder Propensity to Support	
Role in Group	Equalised
Reputational Risk	
Integration	1 Notch
Support Record	Equalised
Subsidiary Performance and Prospects	Equalised
Legal Commitments	Equalised

The colours indicate the weighting of each KRD in the assessment.
Higher influence Moderate influence Lower influence

ZKB's Shareholder Support Rating is based on 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 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.

Environmental, Social and Governance Considerations

Overall ESG

5
4
3
2
1

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.

Environmental (E)

General Issues	Score	Impact	Sector-Specific Issues	Reference
GHG Emissions & Air Quality	1		n.a.	n.a.
Energy Management	1		n.a.	n.a.
Water & Wastewater Management	1		n.a.	n.a.
Waste & Hazardous Materials Management; Ecological Impacts	1		n.a.	n.a.
Exposure to Environmental Impacts	2		Impact of extreme weather events on assets and/or operations and corresponding risk appetite & management; catastrophe risk; credit concentrations	Business Profile (incl. Management & governance); Risk Profile; Asset Quality

E Scale

5
4
3
2
1

Social (S)

General Issues	Score	Impact	Sector-Specific Issues	Reference
Human Rights, Community Relations, Access & Affordability	2		Services for underbanked and underserved communities: SME and community development programs; financial literacy programs	Business Profile (incl. Management & governance); Risk Profile
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; Business Profile (incl. Management & governance); Risk Profile
Labor Relations & Practices	2		Impact of labor negotiations, including board/employee compensation and composition	Business Profile (incl. Management & governance)
Employee Wellbeing	1		n.a.	n.a.
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	Business Profile (incl. Management & governance); Financial Profile

S Scale

5
4
3
2
1

Governance (G)

General Issues	Score	Impact	Sector-Specific Issues	Reference
Management Strategy	3		Operational implementation of strategy	Business Profile (incl. Management & governance)
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	Business Profile (incl. Management & governance); Earnings & Profitability; Capitalisation & Leverage
Group Structure	3		Organizational structure; appropriateness relative to business model; opacity; intra-group dynamics; ownership	Business Profile (incl. Management & governance)
Financial Transparency	3		Quality and frequency of financial reporting and auditing processes	Business Profile (incl. Management & governance)

G Scale

5
4
3
2
1

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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.

DISCLAIMER & DISCLOSURES