

## RATING ACTION COMMENTARY

# Fitch Affirms Zuercher Kantonalbank at 'AAA'; Outlook Stable

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Fitch Ratings - London - 03 Jul 2024: Fitch Ratings has affirmed Zuercher Kantonalbank's (ZKB) Long-Term Issuer Default Rating (IDR) at 'AAA' with a Stable Outlook and Viability Rating (VR) at 'a+'. A full list of rating actions is below.

## KEY RATING DRIVERS

**Support Drives Ratings:** ZKB's IDRs are driven by support from its guarantor and sole owner, the Canton of Zurich (AAA/Stable/F1+). ZKB's Shareholder Support Rating (SSR) is equalised with the canton's Long-Term IDR. ZKB's VR reflects the bank's stable and resilient business model, conservative risk appetite, strong asset quality, funding and capitalisation, and adequate profitability.

**Cantonal Guarantee:** 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 we believe 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 we believe that support would be provided in a timely fashion, given ZKB's high importance for the canton and the potential repercussions of a systemically important bank's failure for the Swiss financial sector. The canton's constitution also requires it to have a cantonal bank, making the owner more likely to support the bank in financial distress.

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

managers in Switzerland. This benefits its revenue diversification, with fee and commission income contributing around a third of total income.

**Material Real Estate Exposure:** ZKB's impaired loans ratio is very low compared with international peers. Its main risk stems from a large real estate exposure in Zurich, with 74% of end-2023 gross loans in residential property financing. We believe loan quality would be resilient to a significant decline in property values due to the bank's strict underwriting standards and moderate loan-to-value ratios. ZKB's non-mortgage exposure, which comprises 10% of gross loans, is more vulnerable to adverse economic conditions. We expect ZKB's impaired loan ratio to remain below 1% in 2024 and 2025.

**Declining Earnings on Lower Rates:** 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 increased significantly in 2023 (1.9% of risk-weighted assets); 2022: 1.4%) benefiting from rising interest rates and slow deposit repricing. With policy rates now declining, we expect operating profitability to decline in 2024 but remain above 1.5%

**Strong Capitalisation:** ZKB's common equity Tier 1 (CET1) ratio improved to 17.4% at end-2023, despite strong loan growth, due to robust earnings and CHF225 million transfer to reserves for general banking risks. 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 half is mainly covered with bail-in debt (CHF1.8 billion at end-1Q24) and undrawn endowment capital (CHF1 billion). Going-concern leverage ratio of 6.6% is comfortably above the 4.5% regulatory requirement.

**Stable Funding:** The bank'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. They decreased in 2023, leading to an increase in ZKB's loan-to-deposit ratio to 111% at end-2023. Wholesale funding needs are moderate and benefit from the bank's cantonal guarantee and investors' perception of ZKB as a safe haven in times of market uncertainty. As a domestic systemically important bank, ZKB is subject to more stringent liquidity requirements, which it comfortably complies with.

**Recovery and Resolution Plan:** ZKB has a recovery and resolution plan approved by the Swiss banking supervisor. According to this plan, the canton could be required to provide around CHF3 billion of capital to recapitalise ZKB. Fitch believes the provision of this capital 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.

## **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 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 was 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.

We would likely downgrade the VR if large real estate-related losses, which could arise from a sharp drop in residential property prices in Zurich, led to a CET1 ratio materially below 16%, or an impaired loans ratio durably above 2%. 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**

The Long-Term IDR is at the highest level on Fitch's scale and 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 large exposure to the local property market. An upgrade would also require an improvement in the bank's profitability.

## **VR 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 reason: liquidity access and ordinary support

(positive).

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

ZKB's IDRs are aligned with those of the Canton of Zurich.

## ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit <https://www.fitchratings.com/topics/esg/products#esg-relevance-scores>.

## RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕			PRIOR ↕
Zuercher Kantonalbank	LT IDR	AAA Rating Outlook Stable		AAA Rating Outlook Stable
	Affirmed			
	ST IDR	F1+	Affirmed	F1+
	Viability	a+	Affirmed	a+
	Shareholder Support	aaa	Affirmed	aaa

[VIEW ADDITIONAL RATING DETAILS](#)

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Zuercher Kantonalbank

UK Issued, EU Endorsed

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