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Luzerner Kantonalbank

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Luzerner Kantonalbank

SACP	aa-

Anchor	a	
Business Position	Adequate	0
Capital and Earnings	Very Strong	+2
Risk Position	Adequate	0
Funding	Average	0
Liquidity	Strong	

+

Support	+2

GRE Support	+2
Group Support	0
Sovereign Support	0

+

Additional Factors	0

Issuer Credit Rating
AA+/Negative/A-1+

Major Rating Factors

Strengths:	Weaknesses:
• Strong retail franchise in the bank's home region. • Sound financial profile, characterized by very strong capitalization, a low risk appetite, and sustainable earnings. • Close ties with the Canton of Lucerne, facilitated by the bank's majority ownership and a statutory guarantee.	• Limited regional, business, and earnings diversity. • Concentration risk due to the focus on real estate lending in the Canton of Lucerne. • Lack of growth potential.

Outlook: Negative

Standard & Poor's Ratings Services' outlook on Switzerland-based Luzerner Kantonalbank (LUKB) is negative. This reflects our view of growing economic imbalances in the Swiss Confederation stemming from increases in residential real estate prices over the past four years. If these prices were to drop more significantly than our base-case assumption over the next couple of years, the current high asset quality of LUKB's mortgage loan book would be negatively affected.

If we were to take a more negative view of the economic environment in which Swiss banks operate, based on growing economic imbalances in Swiss real estate markets, we would review our ratings on all banks that are domestically oriented, including LUKB. This could result in a downward revision of our anchor for Swiss banks and a one-notch downward revision of LUKB's stand-alone credit profile (SACP) and issuer credit rating (ICR), if all other rating factors remained unchanged.

Further negative rating actions could be triggered by a change in LUKB's close relationship with the Canton of Lucerne, or changes in the canton's statutory guarantee. However, we currently consider this scenario to be unlikely and we would expect LUKB's existing obligations to be grandfathered.

We view the likelihood of an upgrade of LUKB as remote at this stage, barring an upgrade of the canton. We might revise the outlook to stable if we believed that the risks arising from the increase in real estate prices would not meaningfully affect LUKB's creditworthiness.

Rationale

Our ratings on LUKB reflect its anchor of 'a', "adequate" business position, "very strong" capital and earnings, "adequate" risk position, "average" funding, and "strong" liquidity, as our criteria define these terms. The SACP is 'aa-'.

We continue to consider LUKB to be a government-related entity (GRE) with an "extremely high" likelihood of receiving timely and sufficient extraordinary government support in the event of financial stress. We base our view on LUKB's "very important" role for and "integral" link with its home canton, Lucerne. We consequently factor a two-notch uplift from our assessment of the SACP into our long-term ICR on LUKB.

Anchor: 'a' for banks operating solely in the Swiss Confederation

The anchor reflects LUKB's Swiss headquarters and its credit exposures, which are almost exclusively to Swiss-domiciled counterparties.

We use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an ICR to a bank under our bank criteria. Switzerland is in our strongest BICRA, group '1', owing to our assessments of its very low economic risk and low industry risk. Consequently, the anchor for a commercial bank operating only in Switzerland is 'a'.

We view Switzerland as a highly diversified and competitive economy, benefiting from one of the highest GDPs per capita in the world and very robust government finances. We believe Switzerland demonstrates a conservative risk and lending culture, which has accompanied recent moderate growth in house prices and loan portfolios.

Economic risk for banks in Switzerland is growing, however, owing to the recent acceleration of residential real estate price increases and real estate loan growth during the past few years, which have led to increasing economic imbalances.

The Swiss banking industry is supported by its sizable and very stable customer deposit base. Swiss banks have not loosened their credit standards in recent years, thanks to sound earnings potential from core products. In addition, we consider regulatory standards to be more stringent than in other developed countries.

Table 1

Luzerner Kantonalbank Key Figures					
		--Year ended Dec. 31--			
(Mil. CHF)	**2014***	**2013**	**2012**	**2011**	**2010**
Adjusted assets	28,631.6	28,443.7	28,043.8	26,856.2	25,841.9
Customer loans (gross)	24,205.6	23,424.1	22,785.7	21,870.1	20,682.4
Adjusted common equity	2,147.8	2,090.8	2,037.6	1,910.8	1,821.5
Operating revenues	230.3	446.6	442.0	446.4	455.1
Noninterest expenses	112.5	221.1	228.8	224.1	231.7
Core earnings	94.4	179.3	175.2	173.1	173.6

*Data as of June 30. CHF--Swiss franc.

Business position: A strong retail banking franchise in its small home region

We assess LUKB's business position as "adequate," owing to its strong retail franchise in the Canton of Lucerne and its prudent and conservative management. We expect these factors to provide stability to LUKB's business model and to partly offset its high regional and product concentration.

LUKB is a midsize cantonal bank, and its assets totaled Swiss franc (CHF) 28.6 billion (about €23.6 billion) as of June 30, 2014. It is the leading commercial bank in the region of Lucerne, with a large market share of about 30% in retail and corporate banking, especially in business with small and midsize enterprises. Like most other cantonal banks, we expect LUKB to continue to operate mainly in its home region and neighboring cantons, focusing on residential mortgage lending. This continues to expose the bank to significant concentration risk and therefore to volatility within the small local economy. We don't expect the bank's narrow business focus and operating region to change in the near future.

On the positive side, thanks to LUKB's outstanding brand and a statutory guarantee from the canton, we expect it to continue to have strong customer confidence, reflected in its sustainable revenues dominated by net interest income and its stable deposit base. Its total income breaks down into 70%-75% from net interest income, 20% from fee income and 5%-10% from market-sensitive income.

Furthermore, LUKB is active in private banking; we estimate its assets under management at Swiss franc (CHF)13 billion. LUKB targets mainly affluent clients in its home region and aims to exit gradually the foreign client assets acquired in the past by the former private banking subsidiary Adler & Co Privatbank, which LUKB has fully integrated since 2010. We expect LUKB's private banking business to expand organically and to steadily contribute about a quarter of its revenues, which results in revenue diversification that we assess as slightly more positive than other Swiss cantonal banks. We don't believe this activity will offset our view of regional and business concentration or lift our overall assessment of the bank's business position.

Unlike most cantonal banks, LUKB is a public-law joint-stock company. We believe the Canton of Lucerne will maintain its majority stake in LUKB at the current 61.5%, as stated in its shareholder strategy. Consequently, we believe that the stable shareholder structure will provide the bank with continuous business stability. At the same time however, LUKB's legal and ownership structure means that it experiences slightly more pressure to report reasonable returns on equity to satisfy its owners. Given that we expect the current low interest rate environment to prevail and to continue pressuring earnings, we will closely monitor how LUKB will operate over the next few years to achieve satisfactory dividends to its shareholders. Nevertheless, we generally believe that the management will maintain its prudent and conservative underwriting standards, despite rising competition in its home region. These factors will, in our view, allow LUKB to preserve its sound financial position.

We believe that the changes in LUKB's management in 2013 and 2014 will not lead to major disruptions in the bank's business model or operations.

Table 2

Luzerner Kantonalbank Business Position

		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Loan market share in country of domicile	2.2	2.2	2.3	2.3	2.2
Deposit market share in country of domicile	1.9	1.9	2.0	2.0	1.9
Total revenues from business line (mil. CHF)	230.4	446.6	445.5	447.1	458.2
Commercial banking/total revenues from business line	N/A	N/A	N/A	N/A	N/A
Retail banking/total revenues from business line	N/A	N/A	N/A	N/A	N/A
Commercial & retail banking/total revenues from business line	100.0	87.3	89.9	87.3	85.1
Trading and sales income/total revenues from business line	N/A	N/A	N/A	N/A	N/A
Corporate finance/total revenues from business line	N/A	N/A	N/A	N/A	N/A
Brokerage/total revenues from business line	N/A	N/A	N/A	N/A	N/A
Insurance activities/total revenues from business line	N/A	N/A	N/A	N/A	N/A
Payments and settlements/total revenues from business line	N/A	N/A	N/A	N/A	N/A
Asset management/total revenues from business line	N/A	N/A	N/A	N/A	N/A
Other revenues/total revenues from business line	N/A	12.7	10.1	12.7	14.9
Investment banking/total revenues from business line	N/A	N/A	N/A	N/A	N/A
Return on equity	8.6	8.1	8.2	8.1	8.0

*Data as of June 30. CHF--Swiss franc. N/A--Not applicable.

Capital and earnings: Robust capitalization is a key rating strength

In our opinion LUKB's capital and earnings are "very strong," compared with the banks we rate globally. We expect that LUKB's earnings retention will allow the bank to gradually increase our risk-adjusted capital (RAC) ratio to about 19.0% over the next 12-18 months, assuming moderate loan growth of 3%-4%, stable noninterest income, and continuously low cost of risk. This is in line with a RAC ratio of 18.2% as of Dec. 31, 2013, which is, however, at the lower end of our range among the rated Swiss cantonal banks. LUKB's regulatory Tier 1 ratio stood at 14.1% and its total capital ratio at year-end 2013 at 15.8%. The difference in these two ratios stems from LUKB's issue of a non-deferrable subordinated Tier 2 bond in 2011 in the amount of CHF175 million, which will be phased out as regulatory capital over a period of 10 years. We do not include this instrument in our own measure of total adjusted capital.

We view LUKB's earnings capacity as strong and stable, supporting the bank's very strong capital position over the near to medium term. We project LUKB's three-year average earnings buffer, which measures the capacity for a bank's earnings to cover normalized losses, at a comfortable 110-115 basis points (bps). Still, this figure is lower than the average for rated cantonal banks.

A potential revision of our view of economic risk in Switzerland would have a negative effect on LUKB's RAC ratio because we would use higher risk weights on Swiss exposures in our calculation. However, we expect the impact of such a scenario not to exceed a reduction of 150bps in the bank's RAC ratio, and therefore not to change our overall capital and earnings assessment.

In addition, we understand that robust capitalization remains one of LUKB's strategic targets, and we believe that the majority owner, the Canton of Lucerne, remains supportive of keeping LUKB's capital at the current level. We expect LUKB to maintain its 50% dividend payout ratio but to preserve sufficient internal capital generation to finance loan growth. We understand at the same time, however, that unlike other cantonal banks, LUKB faces constraints in its ongoing build-up of capital, because it aims to satisfy its owners with reasonable returns on equity.

Table 3

Luzerner Kantonalbank Capital And Earnings

		--Year ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Tier 1 capital ratio	N/A	14.1	14.1	13.7	13.3
S&P RAC ratio before diversification	N.M.	18.2	16.6	18.4	17.9
S&P RAC ratio after diversification	N.M.	15.4	14.5	15.8	15.8
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Double leverage	N.M.	N.M.	N.M.	N.M.	N.M.
Net interest income/operating revenues	72.1	72.4	74.9	73.0	70.3
Fee income/operating revenues	18.3	18.1	17.3	18.3	20.9
Market-sensitive income/operating revenues	7.7	8.2	6.9	7.6	7.6
Noninterest expenses/operating revenues	48.8	49.5	51.8	50.2	50.9
Preprovision operating income/average assets	0.8	0.8	0.8	0.8	0.9
Core earnings/average managed assets	0.7	0.6	0.6	0.7	0.7

*Data as of June 30. RAC--Risk-adjusted capital. N/A--Not applicable. N.M.--Not meaningful.

Table 4

Luzerner Kantonalbank Risk-Adjusted Capital Framework Data

(Mil. CHF)	**Exposure***	**Basel II RWA**	**Average Basel II RW (%)**	**Standard & Poor's RWA**	**Average Standard & Poor's RW (%)**
Credit risk					
Government and central banks	2,077	0	0	62	3

Table 4

Luzerner Kantonalbank Risk-Adjusted Capital Framework Data (cont.)					
Institutions	2,061	425	21	505	24
Corporate	8,256	5,448	66	5,449	66
Retail	15,799	7,119	45	3,002	19
Of which mortgage	15,799	7,119	45	3,002	19
Securitization§	0	0	0	0	0
Other assets	649	653	101	584	90
Total credit risk	28,842	13,645	47	9,602	33
Market risk					
Equity in the banking book†	126	189	150	739	587
Trading book market risk	--	223	--	334	--
Total market risk	--	412	--	1,073	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	825	--	837	--
(Mil. CHF)		**Basel II RWA**		**Standard & Poor's RWA**	**% of Standard & Poor's RWA**
Diversification adjustments					
RWA before diversification		14,881		11,512	100
Total adjustments to RWA		--		2,096	18
RWA after diversification		14,881		13,608	118
(Mil. CHF)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**Standard & Poor's RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		2,098	14.1	2,091	18.2
Capital ratio after adjustments‡		2,098	14.1	2,091	15.4

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. CHF--Swiss franc. Sources: Company data as of Dec. 31, 2013, Standard & Poor's.

Risk position: Focus on mortgage lending exposes the bank to real estate market trends

In our view, LUKB's overall risk position is "adequate." LUKB's prudent risk management and low risk appetite are reflected in the high asset quality of its loan portfolio.

The loan book is dominated by residential real estate loans, which account for 67% of the loan portfolio and expose the bank to significant concentration risk. We see, however, that the mortgage portfolio is granular and highly collateralized, with an estimated average loan-to-value ratio of about 60% for mortgage loans, partly mitigating the concentration risk. We project that risk costs will stay low at about 5-10 bps per year, given our expectation of a prolonged low interest rate environment in Switzerland. LUKB's nonperforming loan (NPL) ratio has increased slightly in recent months, but we expect it to remain at a very low level of about 30-35 basis points of the overall loan portfolio.

Like its domestic peers, LUKB is exposed to risks related to the steady increase in residential real estate prices. Nevertheless, we recognize that the real estate price increases have been more moderate in the Canton of Lucerne than in some other Swiss cantons, and we understand that the bank does not finance real estate to any large extent in so-called "hot spots" in the area along Lake Lucerne. Furthermore, we expect LUKB to maintain conservative underwriting practices in mortgage lending.

LUKB's limited participation in syndicated corporate loans (about 5% of its loan book) exposes it to elevated credit risk. This is, however, mitigated by borrowers' generally sound creditworthiness, LUKB's selective participation in this type of lending, and its adherence to conservative underwriting standards. Therefore, we believe that this activity does not provide any significant diversification benefit for LUKB and that it won't lead to a lower risk assessment if it stays at the current magnitude.

In our view, LUKB's former subsidiary Adler & Co. Privatbank was active in cross-border business, while LUKB has traditionally catered to private banking clients in its home canton. The bank introduced a stricter client acquisition policy in its private banking business in 2007-2008 and started to withdraw from international business. LUKB's revised strategy focuses on private banking clients in Lucerne and neighboring regions. However, like many Swiss domestic banks active in private banking , LUKB has applied as a financial institution in category 2 of the current U.S. investigation program, because it could not rule out that some of its clients might have broken U.S. tax laws in the past. LUKB has provisioned certain amounts on its balance sheet to account for potential fines and related costs associated with the current investigations of U.S. tax authorities and our base-case assumption is that these amounts will be sufficient and additional related provisioning may not be necessary in the future.

Table 5

Luzerner Kantonalbank Risk Position

		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Growth in customer loans	6.7	2.8	4.2	5.7	7.4
Total diversification adjustment/S&P RWA before diversification	N.M.	18.2	14.5	16.8	13.2
Total managed assets/adjusted common equity (x)	13.3	13.6	13.8	14.1	14.2
New loan loss provisions/average customer loans	0.1	0.1	0.0	0.1	0.1
Net charge-offs/average customer loans	N.M.	0.0	0.1	0.0	0.0
Gross nonperforming assets/customer loans + other real estate owned	0.3	0.3	0.3	0.2	0.3
Loan loss reserves/gross nonperforming assets	395.7	499.6	415.0	522.9	486.4

*Data as of June 30. RWA--Risk-weighted assets. N.M.--Not meaningful.

Funding and liquidity: A stable funding base, owing to a strong retail franchise

We assess LUKB's funding as "average" and its liquidity as "strong."

We anticipate that the bank's funding will continue to benefit from its large share of core customer deposits (81% of total funding as of June 30, 2014), which we consider very stable owing to LUKB's business strength and the statutory guarantee for its liabilities. The core deposit funds are complemented by wholesale funding, mainly issuance of covered bonds (roughly 5% of the funding base) and unsecured bonds (11%). We expect LUKB's stable funding ratio according to our internal specifications to remain at a comfortable of 105%-110% over 2014-2015 (against 108.4% as of December 2013) and believe that its funding profile would withstand a possible economic downturn, as shown by the "flight to quality" during the most recent crises.

Our assessment of LUKB's liquidity as "strong" mirrors our view of its improved liquidity ratio of 4.8x at the end of 2013, stemming from recent reductions in the use of wholesale refinancing sources. Our assessment compares favorably with the Swiss average and the liquidity position of universal banks globally. Moreover, we believe that owing to LUKB's close ties with the Lucerne canton and its statutory guarantee, the bank would not be exposed to large withdrawals of customer deposits in times of stress. Owing to the loyalty of its customer deposit base, we anticipate that LUKB could cover maturing short-term wholesale debt and keep operating for more than 12 months without access to wholesale funding.

Table 6

Luzerner Kantonalbank Funding And Liquidity					
		--Year ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Core deposits/funding base	80.6	81.3	77.9	74.5	73.3
Customer loans (net)/customer deposits	115.9	112.1	115.9	121.4	125.7
Long-term funding ratio	97.7	97.5	95.4	94.2	93.6
Stable funding ratio	103.2	108.4	107.3	105.6	102.9
Short-term wholesale funding/funding base	2.5	2.7	4.9	6.3	6.9
Broad liquid assets/short-term wholesale funding (x)	3.0	4.8	2.8	2.1	1.8
Net broad liquid assets/short-term customer deposits	6.7	13.0	12.1	10.2	7.9
Short-term wholesale funding/total wholesale funding	13.0	14.3	22.4	24.8	26.0
Narrow liquid assets/3-month wholesale funding (x)	3.8	5.9	3.7	3.2	2.7

*Data as of June 30.

External support: Two notches of uplift owing to strong ties with the Canton of Lucerne

We regard LUKB as a GRE and assess the likelihood that LUKB's owner, the Canton of Lucerne, would provide timely and sufficient support to LUKB as "extremely high." We base our assessment on the bank's "integral" link with the canton, which we expect to provide considerable and timely credit support in all circumstances to LUKB due to the canton's majority ownership and provision of a statutory guarantee for LUKB. In addition, LUKB has a "very important" role to the canton, in our view, owing to the significant impact of its activities on the local economy. Because of this, we incorporate a two-notch uplift from LUKB's 'aa-' SACP into our long-term ICR on the bank.

LUKB benefits from Lucerne's statutory guarantee, which ultimately covers all of LUKB's liabilities, excluding those of its subsidiaries. We note, however, that the guarantee does not ensure timely repayment, as defined by our criteria. Nevertheless, we believe that the canton has strong incentives to help LUKB meet its obligations on time, due to the bank's importance to the regional economy.

We generally equalize the ratings on LUKB's issued senior unsecured debt with the long-term ICR. However, we rate the non-deferrable subordinated Tier 2 bond issued in 2011 one notch below the bank's SACP, at 'A+', given the bond's subordination and our view of weaker support for this instrument from the guaranteeing canton.

Additional rating factors: None

No additional factors affect this rating.

Related Criteria And Research

Related Criteria

- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Sept. 18, 2014
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related Research

- Swiss Canton of Lucerne 'AA+/A-1+' Ratings Affirmed; Outlook Stable, Aug. 22, 2014
- Banking Industry Country Risk Assessment: Switzerland, Dec. 6, 2013
- Outlook On Nine Swiss Banks To Negative On Exposure To Rising Property Prices; Ratings On All Swiss Bank Affirmed, July 3, 2012
- Outlook On Luzerner Kantonalbank Revised To Negative On Risk From Rising Property Prices; 'AA+/A-1+' Ratings Affirmed, July 3, 2012

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	**a**	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of September 25, 2014)	
Luzerner Kantonalbank	
Counterparty Credit Rating	AA+/Negative/A-1+
Senior Unsecured	AA+
Subordinated	A+
Counterparty Credit Ratings History	
03-Jul-2012	AA+/Negative/A-1+

Ratings Detail (As Of September 25, 2014) (cont.)	
12-Sep-2008	AA+/Stable/A-1+
13-Aug-2007	AA/Positive/A-1+
Sovereign Rating	
Swiss Confederation (Unsolicited Ratings)	AAA/Stable/A-1+
Related Entities	
Lucerne (Canton of) (Unsolicited Ratings)	
Issuer Credit Rating	AA+/Stable/A-1+
Senior Unsecured	AA+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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