MOODY'S INVESTORS SERVICE

Credit Opinion: Banque Cantonale Vaudoise

Global Credit Research - 13 Nov 2013

Lausanne, Switzerland

Ratings

Category	**Moody's Rating**
Outlook	Stable
Bank Deposits	A1/P-1
Bank Financial Strength	C
Baseline Credit Assessment	(a3)
Adjusted Baseline Credit Assessment	(a3)

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Key Indicators

Banque Cantonale Vaudoise (Consolidated Financials)[1]

	[2]**6-13**	[2]**12-12**	[2]**12-11**	[2]**12-10**	[2]**12-09**	**Avg.**
Total Assets (CHF million)	**40,210.0**	**39,639.0**	**37,710.0**	**35,363.0**	**35,452.0**	[3]**3.2**
Total Assets (EUR million)	**32,695.0**	**32,846.7**	**31,065.3**	**28,280.2**	**23,903.0**	[3]**8.1**
Total Assets (USD million)	**42,498.5**	**43,304.7**	**40,327.2**	**37,939.1**	**34,294.6**	[3]**5.5**
Tangible Common Equity (CHF million)	**3,158.0**	**3,277.0**	**3,246.0**	**3,253.0**	**3,203.6**	[3]**-0.4**
Tangible Common Equity (EUR million)	**2,567.8**	**2,715.5**	**2,674.0**	**2,601.5**	**2,160.0**	[3]**4.4**
Tangible Common Equity (USD million)	**3,337.7**	**3,580.1**	**3,471.3**	**3,490.0**	**3,099.0**	[3]**1.9**
Net Interest Margin (%)	**1.3**	**1.4**	**1.5**	**1.5**	**1.5**	[4]**1.4**
PPI / Average RWA (%)	**2.0**	**1.9**	**1.9**	**1.9**	**1.8**	[5]**1.9**
Net Income / Average RWA (%)	**1.6**	**1.5**	**1.4**	**1.5**	**1.4**	[5]**1.5**
(Market Funds - Liquid Assets) / Total Assets (%)	**0.7**	**2.3**	**6.0**	**3.9**	**0.7**	[4]**2.7**
Core Deposits / Average Gross Loans (%)	**100.6**	**97.0**	**96.4**	**95.9**	**101.3**	[4]**98.3**
Tier 1 Ratio (%)	**17.8**	**14.4**	**13.2**	**14.0**	**14.1**	[5]**14.7**
Tangible Common Equity / RWA (%)	**19.1**	**16.2**	**15.0**	**15.9**	**15.3**	[5]**16.3**
Cost / Income Ratio (%)	**62.4**	**60.7**	**60.8**	**59.8**	**60.4**	[4]**60.8**
Problem Loans / Gross Loans (%)	**1.8**	**1.8**	**2.1**	**2.4**	**2.4**	[4]**2.1**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**14.8**	**13.9**	**15.8**	**16.5**	**16.8**	[4]**15.6**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel II; LOCAL GAAP [3] Compound Annual Growth Rate based on LOCAL GAAP reporting periods [4] LOCAL GAAP reporting periods have been used for average calculation [5] Basel II & LOCAL GAAP reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Banque Cantonale Vaudoise's (BCV) A1/Prime-1 long-term and short-term global local- and foreign-currency deposit ratings reflect the bank's importance in the local economy and its majority ownership and proven support (albeit not explicitly guaranteed) by the Canton of Vaud. Under our Joint Default Analysis (JDA) methodology, we assess the probability of both regional local government and systemic support for BCV in the event of distress as high, resulting in a two-notch uplift from BCV's standalone credit assessment (BCA) of a3.

We assign a standalone bank financial strength rating (BFSR) of C to BCV, equivalent to a BCA of a3. The rating reflects BCV's (1) significant role within the canton's economy; (2) improved and high-quality capitalisation with a Tier 1 ratio of 17.8% and a total capital ratio of 17.9% as of end-June 2013; and (3) ability to generate sufficient profits in order to cover both expected losses and a relatively high share of unexpected losses without compromising its franchise stability.

However, the rating also reflects BCV's (1) very high concentration in the Canton of Vaud, including large exposures to the region's residential real-estate markets which recently experienced above-Swiss-average price inflation; and (2) higher operational and reputational risks inherent in its private banking business.

Rating Drivers

- Well-positioned and deeply entrenched regional retail and commercial banking franchise, and small player in international private banking / wealth management subject to competitive, reputational and margin pressures

- Solid capital adequacy ratios, largely sufficient to absorb losses even in a stressed scenario

- Above-average profitability and efficiency metrics maintained despite challenging market environment

- Strong deposit inflows and low market sensitivity safeguard BCV's sound liquidity profile

- Growth in residential mortgage-loan book increases the group's exposure to real-estate market developments, despite good asset quality

Rating Outlook

Improvements in BCV's intrinsic fundamentals are well balanced with its risk exposure, as reflected in the stable outlook. The stable outlook on BCV's debt and deposit ratings additionally reflects the Canton of Vaud's long-standing majority ownership, albeit without an explicit statutory guarantee.

What Could Change the Rating - Up

Upwards pressure on the BFSR could result from (1) a sustained reduction in mortgage-loan growth coupled with continued strong asset quality indicators, and / or (2) risk reduction in trade finance activities further supporting the bank's high capitalisation and / or (3) a continued stable, conservative risk profile and risk-management culture.

The bank's debt and deposit ratings could also be upgraded if the Canton of Vaud granted a full guarantee to the bank which, however, we consider unlikely at present.

What Could Change the Rating - Down

Challenges for the bank's standalone BFSR may arise from (1) a sustained weakening of its recurring earnings power and levels of operating efficiency, especially if caused by any greater loss in market share; (2) material asset-quality deterioration beyond levels that are consistent with the bank's risk absorption capacity, especially if this is based on a marked slowdown in the domestic real estate market; (3) impairment to its franchise, i.e., if the bank were to face reputational issues which hamper the bank's private banking / wealth-management business.

The bank's long-term debt and deposit ratings could be downgraded if (1) the credit profile of the Canton of Vaud would deteriorate meaningfully; and/or (2) there is a growing likelihood that the canton's stake in BCV (currently 67%) falls below the 50.1% threshold (unlikely because of legal restrictions).

DETAILED RATING CONSIDERATIONS

WELL-POSITIONED AND DEEPLY ENTRENCHED REGIONAL RETAIL AND COMMERCIAL BANKING FRANCHISE, AND SMALL PLAYER IN INTERNATIONAL PRIVATE BANKING / WEALTH MANAGEMENT SUBJECT TO COMPETITIVE, REPUTATIONAL AND MARGIN PRESSURES

BCV has a strong market position in retail and commercial SME banking within the Swiss canton of Vaud. Its corporate mission -- as expressed by Article 4 of the `Cantonal Act Governing the Organisation of Banque Cantonale Vaudoise' (referred to locally as LBCV) -- is to contribute to the development of all areas of the private-sector economy, financing of cantonal public-sector entities and mortgage lending within the canton. As a result, BCV holds the largest branch network in the Canton of Vaud, representing approximately 30% of the mortgage market in Vaud and showing a very high penetration rate among Vaud-based SMEs, contributing to its strong recognition. However, the bank is not immune to intensifying competition in the Swiss market, particularly in key retail products such as mortgages and savings deposits.

The bank also benefits from a solid onshore private banking / wealth management franchise, part of a strong and defensible client base, that provides income diversification, albeit vulnerable to some capital-market volatility. Nevertheless, we consider BCV to be a niche player in the globally fragmented and highly competitive international private banking and wealth management industry for which we expect persistent challenges including continued subdued client-risk appetite, potentially leading to lower transaction and fee volumes.

SOLID CAPITAL ADEQUACY RATIOS, LARGELY SUFFICIENT TO ABSORB LOSSES EVEN IN A STRESSED SCENARIO

As a Category 3 institution according to the Swiss Financial Markets Authority (FINMA) definition, BCV must maintain a total capital ratio of 12.0% as of 31 December 2016. As of H1 2013, BCV reported Common Equity Tier 1 (CET1) and total capital ratios of 17.8% and 17.9%, respectively.

We note that these ratios were positively influenced by the abolition of a BCV-specific multiplier on risk-weighted asset (RWA) categories effective 1 January 2013. Furthermore, BCV reports its risk-weighted assets under the foundation IRB approach, thereby displaying significantly lower risk-weights on mortgage-loans while displaying higher risk-weights for trade finance exposures if compared to other Swiss regional and cantonal banks using the standard approach.

During 2013 and beyond, we expect that BCV will maintain its strong capital adequacy ratios comprising a meaningful buffer over and above its 13% target CET1 capital ratio despite high dividend payouts to its majority owner and stakeholders that amounted to approximately 90% of net profits from 2009-12.

ABOVE-AVERAGE PROFITABILITY AND EFFICIENCY METRICS MAINTAINED DESPITE CHALLENGING MARKET ENVIRONMENT

We regard BCV's profitability as strong relative to that of its regional peers in Switzerland and in other European countries. In our view, this provides BCV with a substantial cushion against losses potentially arising from adverse developments in its real-estate and/or trade finance books. Over the past three years, BCV realised a pre-provision income (PPI)-to-risk-weighted assets (RWA) ratio of 1.90% on average (2012: 1.87%). This ratio has improved considerably, due to BCV's successful measures to improve its commercial performance and reduce its risk profile.

The bank's H1 2013 result was again driven by solid commission as well as trading income generation. Net interest income, however, started to decline as a result of BCV's decision to slow down mortgage-loan growth during the past 18-24 months. The negative re-pricing effect from persistent low interest-rates could thus no longer be offset by volume growth. Good cost management further contributed to BCV's efficiency indicators remaining at prior year levels and thus in-line with those of its domestic peers. Finally, new provisions for credit risk of CHF7 million (annualized 8 bps of risk-weighted assets) remained at a very low level, indicating a solid asset quality development.

Furthermore, the volume of assets under management continued to increase, and amounted to CHF84.4 billion as of end-June 2013, up CHF2.7 billion versus FY 2012. Net new money growth was positive at CHF540 million as at end-June 2013, characterized by offshore outflows being offset by strong onshore inflows from Swiss private and corporate customers. This represents an annualised 1.3% growth rate, still below the average of the larger pure-play Swiss private banks yet in-line with its regional private banking peers.

In our opinion, BCV's profitability metrics may suffer in an environment of (1) persistent low interest rates exerting pressure on the bank's operating revenue base due to the re-pricing of assets at lower rates; and/or (2) higher risk costs caused by a less benign credit environment marked by a potential gradual erosion in the bank's asset quality.

STRONG DEPOSIT INFLOWS AND LOW MARKET SENSITIVITY SAFEGUARD BCV'S SOUND LIQUIDITY

PROFILE

BCV benefits from a strong liquidity structure, with a loan-to-deposit ratio of slightly below 100% in recent years and sound liquidity management, supported by a liquid balance sheet comprising CHF5.0 billion of cash at end-June 2013, repo-eligible trading securities and interbank assets. We note that during H1 2013, BCV experienced continued deposit inflows from clients, further reflecting the trust that the bank has successfully regained among its customers and market participants since its restructuring and de-risking program started in 2003.

The bank's liquidity is additionally supported by access to Swiss covered bond funding via Pfandbriefzentrale (unrated). While we acknowledge that BCV has a large amount of loans available for covered bond issuance, we note that in a highly adverse market environment, the market may only be willing to absorb a limited amount of these issues. We nevertheless believe the bank has sufficient liquidity buffers to survive specific stress scenarios of a shutdown in wholesale markets, in addition to assumed outflows in retail and corporate deposits, which supports its credit rating.

GROWTH IN RESIDENTIAL MORTGAGE-LOAN BOOK INCREASES THE GROUP'S EXPOSURE TO REAL-ESTATE MARKET DEVELOPMENTS, DESPITE GOOD ASSET QUALITY

BCV's mortgage-loan book grew by a compound average growth rate of 6.4% during the period 2007-12, to CHF22.9 billion. We positively note that BCV actively stepped down from this growth path over the last 18-24 months; however, its loan book remains concentrated in the highly dynamic Vaud region which, supported by strong demographic factors, experienced above-average real-estate price inflation in the past.

In our view, the past rapid growth in the bank's mortgage-loan book has increased the group's susceptibility to shocks potentially emanating from the domestic real-estate market or during a prolonged period of weaker economic growth in Switzerland and thus has the potential to weaken the bank's capital buffers. Nonetheless, BCV's capital buffers display strong loss-absorption capacity which should help preserve the group's aggregate capitalisation above the regulatory intervention level (11.0% total capital ratio), even under our adverse scenario of a significant downturn in the domestic real-estate market.

In addition, the average LTV of BCV's real-estate loan exposures remained at a relatively low level if compared to its closest peers. We thus do not expect BCV to be immediately affected by negative price movements in the Vaud real-estate market, and we see this further supported by the bank's declining problem loan ratio (1.4% as reported as of 30 June 2013).

Excluding the above-mentioned real-estate market exposures, we note the bank's continued management of important trade finance activities, which we continue to regard as riskier if compared to traditional collateralised retail or corporate finance activities, especially in the current macro-economic environment. On a more positive note, we acknowledge the reduction in related activities as reported during H1 2013.

We believe the overall strong improvement in asset quality reflects the bank's strong focus on credit risk and its conservative credit risk management. Against that backdrop, we do not expect BCV to compromise on its lending standards in spite of significant growth opportunities marked by the current buoyant real-estate market developments in the Lake of Geneva region, as reflected by the recent slowdown of mortgage-loan growth from levels witnessed during the 2007-12 period.

Global Local Currency Deposit Rating (Joint Default Analysis)

We assign a global local-currency (GLC) deposit rating of A1 to BCV. The GLC deposit rating is supported by BCV's a3 BCA as well as by the ratings of its underlying support providers: the Canton of Vaud's creditworthiness and Switzerland's Aaa local-currency deposit ceiling. The bank receives a two-notch uplift from its standalone credit strength, bringing the GLC rating to A1.

We assess a high probability of regional and local government (RLG) support from the Canton of Vaud, as it is the majority owner of the bank. In our view, the bank continues to remain an important financial institution within the regional economy as a public-law institute (`oeffentlich-rechtliche Anstalt') of the canton. We understand that the canton has no current plans to reduce the government's ownership of the institution.

As a result, BCV's GLC deposit ratings receive a two-notch uplift to A1 from the bank's a3 BCA.

Foreign Currency Deposit Rating

BCV's foreign-currency deposit ratings are A1/Prime-1, stable.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. Bank Financial Strength Ratings do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of Bank Financial Strength Ratings include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although Bank Financial Strength Ratings exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Moody's uses the Baseline Credit Assessment (BCA) to map BFSRs onto the 21-point Aaa-C rating scale and like the BFSR, it reflects a bank stand- alone default risk. Each point on the Aaa-C scale represents a specific probability of default and therefore allows Moody's to use the BCA as an input to Moody's Joint Default Analysis (JDA), described below. The baseline credit assessment reflects what the local currency deposit rating of the bank with the given BFSR would be without any assumed external support from a government or third party.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the Bank Financial Strength Rating as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, Moody's Bank Deposit Ratings are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, and includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of any external elements of support into the bank's Baseline Credit Assessment. In assigning the local currency deposit rating to a bank, the JDA methodology also factors in the rating of the various potential support providers (parent company, cooperative group, regional or national governments), as well as the degree of dependence that may exist between each one of them and the bank. Moody's assessment of the probability of systemic support (by a national government) is derived from the analysis of the capacity of a government and its central bank to provide support on a system-wide basis. The systemic support indicator is determined for a particular country and serves as an input for all bank ratings in that country. The support indicator can be set at, above or, in rare cases, below the government's local currency bond rating for that country.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's bank financial strength scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Banque Cantonale Vaudoise

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (50%)						C+	
Factor: Franchise Value						C	Neutral
Market share and sustainability		x					
Geographical diversification				x			
Earnings stability			x				
Earnings Diversification [2]							
Factor: Risk Positioning						C-	Neutral
Corporate Governance [2]				x			
- Ownership and Organizational Complexity				x			
- Key Man Risk							
- Insider and Related-Party Risks							
Controls and Risk Management			x				
- Risk Management			x				
- Controls		x					
Financial Reporting Transparency		x					
- Global Comparability	x						
- Frequency and Timeliness		x					
- Quality of Financial Information		x					
Credit Risk Concentration				x			
- Borrower Concentration				x			
- Industry Concentration				x			
Liquidity Management			x				
Market Risk Appetite		x					
Factor: Operating Environment						A-	Neutral
Economic Stability		x					
Integrity and Corruption	x						
Legal System	x						
Financial Factors (50%)						C+	
Factor: Profitability						C	Neutral
PPI % Average RWA (Basel II)			1.90%				
Net Income % Average RWA (Basel II)			1.48%				
Factor: Liquidity						C	Neutral
(Market Funds - Liquid Assets) % Total Assets			4.08%				

Liquidity Management			x				
Factor: Capital Adequacy						A	Neutral
Tier 1 Ratio (%) (Basel II)	13.87%						
Tangible Common Equity % RWA (Basel II)	15.72%						
Factor: Efficiency						C	Neutral
Cost / Income Ratio			60.45%				
Factor: Asset Quality						C+	Neutral
Problem Loans % Gross Loans			2.08%				
Problem Loans % (Equity + LLR)		15.42%					
Lowest Combined Financial Factor Score (15%)						C	
Economic Insolvency Override						Neutral	
Aggregate BFSR Score						C+	
Aggregate BCA Score						a2	
Assigned BFSR						C	
Assigned BCA						a3	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.
[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.