MOODY'S INVESTORS SERVICE

Credit Opinion: Banque Cantonale Vaudoise

Global Credit Research - 20 Nov 2015

Lausanne, Switzerland

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Aa2/P-1
Baseline Credit Assessment	a2
Adjusted Baseline Credit Assessment	a2
Counterparty Risk Assessment	A1(cr)/P-1(cr)

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Key Indicators

Banque Cantonale Vaudoise (Consolidated Financials)[1]

	[2]**6-15**	[2]**12-14**	[2]**12-13**	[3]**12-12**	[3]**12-11**	**Avg.**
Total Assets (CHF billion)	**43.3**	**42.0**	**40.3**	**39.6**	**37.7**	[4]**3.5**
Total Assets (EUR billion)	**41.6**	**34.9**	**32.9**	**32.8**	**31.1**	[4]**7.6**
Total Assets (USD billion)	**46.3**	**42.3**	**45.3**	**43.3**	**40.3**	[4]**3.5**
Tangible Common Equity (CHF billion)	**3.2**	**3.3**	**3.3**	**3.3**	**3.2**	[4]**-0.2**
Tangible Common Equity (EUR billion)	**3.1**	**2.8**	**2.7**	**2.7**	**2.7**	[4]**3.7**
Tangible Common Equity (USD billion)	**3.4**	**3.3**	**3.7**	**3.6**	**3.5**	[4]**-0.2**
Problem Loans / Gross Loans (%)	**1.3**	**1.4**	**1.5**	**1.8**	**2.1**	[5]**1.6**
Tangible Common Equity / Risk Weighted Assets (%)	**19.0**	**19.7**	**20.1**	**16.2**	**15.0**	[6]**19.6**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**11.7**	**12.1**	**13.0**	**14.7**	**16.9**	[5]**13.7**
Net Interest Margin (%)	**1.2**	**1.3**	**1.3**	**1.4**	**1.5**	[5]**1.3**
PPI / Average RWA (%)	**2.6**	**2.4**	**2.3**	**1.9**	**1.9**	[6]**2.4**
Net Income / Tangible Assets (%)	**0.7**	**0.7**	**0.7**	**0.8**	**0.8**	[5]**0.7**
Cost / Income Ratio (%)	**58.1**	**60.4**	**61.7**	**60.7**	**60.8**	[5]**60.3**
Market Funds / Tangible Banking Assets (%)	**17.3**	**15.3**	**14.5**	**15.6**	**21.7**	[5]**16.9**
Liquid Banking Assets / Tangible Banking Assets (%)	**22.0**	**18.6**	**18.1**	**18.9**	**14.7**	[5]**18.5**
Gross loans / Due to customers (%)	**101.4**	**101.5**	**101.7**	**102.3**	**107.9**	[5]**103.0**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; LOCAL GAAP [3] Basel II; LOCAL GAAP [4] Compound Annual Growth Rate based on LOCAL GAAP reporting periods [5] LOCAL GAAP reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & LOCAL GAAP reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Banque Cantonale Vaudoise's (BCV) Aa2 long-term deposit ratings benefit from a two-notch uplift from the bank's a2 adjusted baseline credit assessment (BCA) as a result of our Loss Given Failure (LGF) analysis, which measures the expected loss across the various debt classes in the bank's liability structure. In addition, the long-term ratings benefit from one additional notch of government support, reflecting the majority ownership of the bank by the Canton de Vaud (unrated) and the bank's strong market position in the region.

We further assign an A1(cr)/Prime-1(cr) Counterparty Risk Assessment to BCV.

BCV's a2 BCA reflects (1) the bank's relatively low on-balance-sheet risks, despite displaying a high concentration in the Canton of Vaud, including relatively large exposures to the region's real-estate markets; (2) BCV's high-quality capitalisation with a fully-loaded common equity Tier 1 (CET1) ratio of 16.2% as of end-June 2015 (phased-in CET1 ratio 17.0%); and (3) its ability to generate sufficient and stable profits in order to cover both expected losses and a relatively high share of unexpected losses without compromising its franchise stability.

Our assessment also incorporates pressure on Swiss banks' earnings resulting from persistently and lower-than-anticipated interest rates as well the bank's limited ability to improve operating efficiency in a competitive domestic banking market.

Rating Drivers

- The bank's focused activity in the Swiss canton of Vaud and its domestic exposures determine its Very Strong- Macro Profile

- Solid capital adequacy ratios mitigate asset-quality risks

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

- Stable deposit base and low market sensitivity safeguard BCV's sound funding and liquidity profile

- Deposit holders benefit from large volume of deposits (LGF analysis)

Rating Outlook

BCV's long-term deposit ratings carry a stable outlook.

What Could Change the Rating - Up

Due to the challenging market environment characterised by persistently low interest rates, upward pressure on the bank's BCA and thus its long-term ratings is currently unlikely. However, upward pressure on BCV's BCA could be exerted if BCV (1) sustainably and further reduces its earnings sensitivity to lower interest rates by further diversifying earnings; (2) continues to improve profitability as well as its efficiency metrics; and (3) improves its sound capital adequacy metrics displaying a meaningful buffer over and above the regulatory minimum set by the Swiss Financial Market Authority (FINMA).

Any upgrade of BCV's BCA would most likely exert upwards pressure on the bank's deposit ratings, provided that our current support assumptions remain unchanged. This takes into account the Canton of Vaud's long-standing majority ownership, albeit without an explicit statutory guarantee. In addition, BCV's deposit ratings could be upgraded if the volume of (junior) deposits rises meaningfully and thus provides a higher rating uplift under our LGF framework.

What Could Change the Rating - Down

Challenges for the bank's BCA may arise from (1) a sustained and/or unexpected weakening of its recurring earnings power and levels of operating efficiency; (2) material asset-quality deterioration, especially if following a marked slowdown in the domestic real-estate market; and (3) impairment to its franchise (i.e., if the bank were to face reputational issues, which would hamper the bank's private wealth management or other businesses).

Although unlikely at present, we could downgrade the bank's long-term deposit ratings if (1) the credit profile of the Canton of Vaud deteriorates substantially; (2) there is a growing likelihood that the canton's stake in BCV (currently 67%) will fall below the 50.1% legal threshold; and/or (3) if the volume of (junior) deposits falls meaningfully so it does no longer provide the same notches of rating uplift under our LGF framework.

DETAILED RATING CONSIDERATIONS

THE BANK'S FOCUSED ACTIVITY IN THE SWISS CANTON OF VAUD AND ITS DOMESTIC EXPOSURES DETERMINE ITS VERY STRONG- MACRO PROFILE

BCV is predominantly active in its Swiss home canton, aligning its Macro Profile with that of its home country. The very high degree of economic, institutional and government financial strength and very low susceptibility to event risk thus support the bank's BCA. Together with the relatively high and rising private sector debt that is well covered by private sector assets as well as funding conditions benefitting from a strong domestic deposit base and liquid covered bond and interbank markets, BCV's Macro Profile stands at Very Strong-.

SOLID CAPITAL ADEQUACY RATIOS MITIGATE ASSET-QUALITY RISKS

BCV's 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. While we take account of the recent slowdown in real-estate prices and lower transaction volumes, the bank remains susceptible to shocks potentially emanating from the domestic real-estate market or during a prolonged period of weaker economic growth in Switzerland. This vulnerability may, in an adverse scenario, weaken the bank's sound capital buffers, despite the slowdown in mortgage-loan growth from high levels witnessed during the 2009-11 period. We have reflected these tail risks by adjusting our Asset Risk score to a2.

BCV's asset quality improved strongly in recent years, reflecting the bank's strong focus on credit risk and its conservative credit risk management. The average loan-to-value of BCV's real-estate loan exposures remained at a low level compared with those of its closest peers. Thus, we do not expect that BCV will 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 since 2010 (H1 2015: 1.3%).

As a Category 3 institution according to the FINMA definition, BCV must maintain an adequacy target with a (total) capital ratio of at least 12%. As of end-June 2015, BCV reported fully-loaded CET1, phased-in CET1 and total capital ratios of 16.2%, 17.0% and 17.1%, respectively (under the foundation internal ratings-based approach). During 2015 and beyond, we expect that BCV will maintain its strong capital adequacy ratios and thus a meaningful buffer over and above its announced 13% target CET1 capital ratio target despite high dividend payouts to its majority owner and stakeholders that amounted to approximately 90% of net profits from 2009-14. The low (absolute) capital retention and BCV's lower average risk-weights compared to other rated regional banks in Switzerland led to an adjustment of its Capital score by two notches to aa3.

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

BCV's profitability metrics will continue to display sound underlying performance thanks to the bank's earnings split being less dependent on net interest income, thereby protecting BCV's revenue base against adverse developments resulting from the low interest-rate environment. We further anticipate that risk costs will stay at a low level, supported by a continued benign credit environment.

BCV's profitability is strong relative to that of its regional peers in Switzerland and in other European countries. In our view, this profitability provides BCV with a substantial cushion against losses potentially arising from adverse developments. Over the past three years, BCV realised a net-income-to-tangible-assets ratio of 0.73% on average (H1 2015: 0.75%), reflecting BCV's successful measures to improve its commercial performance and reduce its risk profile. We have reflected this relative strength in the bank's baa2 Profitability score, one of the highest among its domestic peers.

The bank's 9M 2015 operating result was driven by strong trading income, reflecting the Swiss National Bank's abolition of the peg to the euro in January 2015 and the bank's pro-active management of interest-rate risks. Net interest income only declined slightly, driven by persistently low interest rates and reduced trade finance activities. Good cost management further contributed to BCV's efficiency indicators improving slightly from prior year levels.

During H1 2015, BCV recorded an extraordinary gain on the sale of its stake in Swisscanto (unrated) to Zuercher Kantonalbank (deposits Aaa stable, senior unsecured Aaa stable, BCA a2). This gain mitigated the negative P&L effect of an additional provision for risks potentially resulting from the bank's participation in the US Swiss Tax Program as a Category 2 institution.

BCV's assets under management stood at CHF84.8 billion as of 30 September 2015, down 2% (CHF1.6 billion) compared to year-end 2014. This was achieved despite the significant strengthening of the Swiss Franc and was supported by net new inflows of CHF1.4 billion during the first nine months of 2015. The development reflects the continued refocusing of BCV's private banking franchises to onshore money and reducing exposures to offshore clients.

STABLE DEPOSIT BASE AND LOW MARKET SENSITIVITY SAFEGUARD BCV'S SOUND FUNDING AND LIQUIDITY PROFILE

We expect that BCV will continue to benefit from a strong funding structure, with a loan-to-deposit ratio of around 100% in recent years and sound liquidity management, supported by a liquid balance sheet with CHF6.7 billion of cash at end-September 2015, and approximately CHF5.0 billion of financial investments and interbank assets. The bank's liquidity is additionally supported by access to Swiss covered bond funding via Pfandbriefzentrale (unrated, issued mortgage covered bonds rated Aaa). This is reflected in the bank's Funding Structure and Liquidity Resources scores of a2 and a3, respectively.

Notching Considerations

DEPOSIT HOLDERS BENEFIT FROM LARGE VOLUME OF DEPOSITS (LGF ANALYSIS)

BCV's high and stable volume of deposits is beneficial to deposit holders because it substantially reduces the expected loss at failure or in resolution. The bank is subject to Swiss banking regulation, which we consider to represent an Operational Resolution Regime. We therefore apply our Advanced LGF analysis, considering the risks faced by the different debt and deposit classes across the liability structure at failure. We assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and assign a 100% probability to deposits being preferred to senior unsecured debt, thereby reflecting depositor preference by law in Switzerland.

The high volume of deposits protecting deposit holders in the unlikely event of failure or resolution indicates a very low loss-given-failure for BCV's 'junior' deposits, leading us to position the respective Preliminary Rating Assessment (PRA) two notches above the bank's a2 Adjusted BCA, prior to government support.

GOVERNMENT SUPPORT

BCV's long-term senior debt and deposit ratings benefit from one additional notch of government support uplift taking into account our assessment of a high probability of regional and local government support from the Canton of Vaud as the majority owner of the bank.

The bank continues to remain an important financial institution within the regional economy of the canton, reflected by its strong local market position in retail and commercial (largely small and medium-sized enterprise) banking. 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.

Despite its strong local market position, we consider the probability of additional national government support for BCV in the event of a stress scenario as low, reflecting BCV's relatively small national market shares in key banking products and its relative importance to the country's banking system.

Issuer Profile

BCV was established in 1845 by the Vaud Cantonal Parliament as a corporation organized under public law. The bank is Switzerland's second-largest cantonal bank, with total assets of CHF43.2 billion as of 30 September 2015.

BCV has a corporate mandate of contributing to the economic development of its home region, the Canton of Vaud, and also of providing mortgage financing there. Other than operating in its traditional areas of business, including retail banking (deposit-taking and lending) and wealth management, BCV is also engaged in corporate banking and selected trade-financing operations in commodities. Through these activities, BCV is also exposed to other cantons in Switzerland and, to a limited extent, overseas markets.

As of 31 December 2014, the Canton of Vaud held a 67% stake in the bank. In contrast with most Swiss cantonal banks, BCV does not benefit from an explicit guarantee of the canton.

Output of the Baseline Credit Assessment Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard 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

Macro Factors	
Weighted Macro Profile	**Very Strong -**

Financial Profile						
Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	1.5%	aa3	←→	a2	Geographical concentration	Unseasoned risk
Capital						
TCE / RWA	19.0%	aa1	↓	aa3	Capital retention	
Profitability						
Net Income / Tangible Assets	0.7%	baa2	←→	baa2		
Combined Solvency Score		aa3		a2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	15.3%	a2	←→	a2		
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	18.6%	baa2	←→	a3	Access to committed facilities	Additional liquidity resources
Combined Liquidity Score		a3		a2		

Financial Profile	**a2**

Qualitative Adjustments	**Adjustment**
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	0
Total Qualitative Adjustments	**0**

Sovereign or Affiliate constraint	Aaa

Scorecard Calculated BCA range	**a1 - a3**

Assigned BCA	**a2**
Affiliate Support notching	**0**
Adjusted BCA	**a2**

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency rating**	**Foreign Currency rating**
Deposits	2	0	aa3	1	Aa2	Aa2

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