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Banque Cantonale Vaudoise

Primary Credit Analyst:
Francois Moneger, Paris (33) 1-4420-6688; francois.moneger@standardandpoors.com

Secondary Contact:
Sylvie Dalmaz, PhD, Paris (33) 1-4420-6682; sylvie.dalmaz@standardandpoors.com

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Banque Cantonale Vaudoise

SACP	a

+

Support	+3

+

Additional Factors	0

Anchor	a-	
Business Position	Adequate	0
Capital and Earnings	Strong	+1
Risk Position	Adequate	0
Funding	Average	0
Liquidity	Strong	

GRE Support	+3
Group Support	0
Sovereign Support	0

Issuer Credit Rating
AA/Stable/A-1+

Major Rating Factors

Strengths:

- Very high likelihood of support from the Swiss Canton of Vaud in the event of stress.
- Good franchise in Vaud's resilient economy.
- More diverse business model than those of traditional Swiss cantonal banks.
- Strong liquidity, despite management's intention to partly fund growth by drawing on excess liquidity.

Weaknesses:

- High exposure to real estate market in the Canton of Vaud.
- Presence in high-risk, low-granularity trade finance business.

Outlook: Stable

Our outlook on Switzerland-based Banque Cantonale Vaudoise (BCV) is stable, reflecting our current view that the Swiss bank resolution regime is unlikely to prevent the government of the Swiss Canton of Vaud from providing timely support to the bank in the event of stress.

Even if BCV's credit quality changed such that we revised the bank's stand-alone credit profile (SACP) downward or upward by one notch, we would not revise our long-term rating on the bank, all else being equal. This is because, according to our criteria, and given our 'AAA' rating on the Canton of Vaud, any one-notch revision of the SACP would be offset by an opposite change in the uplift we attribute for extraordinary government support. All else being equal, a two-notch change in BCV's SACP, upward or downward, would result in a one notch change (in the same direction) of the issuer credit rating, but we do not consider this likely in the next two years.

Rationale

The rating on BCV reflects the bank's 'a-' anchor, "adequate" business position, "strong" capital and earnings, "adequate" risk position, "average" funding, and "strong" liquidity, as our criteria define these terms. The SACP is 'a'.

Anchor: 'a-' for Swiss banks

Our bank criteria 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 issuer credit rating. Our anchor for a commercial bank operating only in Switzerland is 'a-'.

The BICRA score includes our evaluation of economic risk. In this respect, 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 that large parts of the Swiss banking market demonstrate a conservative risk and lending culture, which has accompanied moderate growth of housing prices and loan portfolios.

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

Table 1

Banque Cantonale Vaudoise Key Figures					
		--Year-ended Dec. 31--			
(Mil. CHF)	**2014***	**2013**	**2012**	**2011**	**2010**
Adjusted assets	41,133.0	40,344.0	39,680.0	37,783.0	35,501.0
Customer loans (gross)	29,256.0	28,932.0	28,124.0	28,165.0	25,723.5
Adjusted common equity	2,942.2	2,937.0	2,920.0	2,906.0	2,911.7
Operating revenues	502.5	990.6	1,009.8	1,017.2	995.8
Noninterest expenses	311.4	647.1	614.1	627.7	598.5
Core earnings	152.5	270.6	308.8	303.5	331.8

*Data as of June 30.

Business position: Good franchise in Vaud and a more diverse business profile than a typical Swiss cantonal bank

We assess BCV's business position as "adequate." With total assets of Swiss franc (CHF) 41.9 billion (about €35 billion) on Sept. 30, 2014, BCV is the sixth-largest banking group in Switzerland. It has a market share of about 33% in retail banking and among small and midsize enterprises (SMEs) in Vaud, one of the country's richest and most resilient cantons. Vaud's GDP growth has outperformed Switzerland's GDP growth by an annual average of about 0.6% over the past five years; the average annual growth rate is 1.8% compared with 1.2% for Switzerland.

With CHF86.8 billion of assets under management (AuM) on Sept. 30, 2014, BCV has a good franchise in asset and wealth management, although its market share in private banking is much smaller than that in retail banking. In the first three quarters of 2014, CHF0.6 billion in net new funding from "onshore" AuM was offset by CHF0.8 billion in outflows of "offshore" AuM. BCV consolidated its wealth management franchise in 2011 with the acquisition of Banque

Franck Galland, which had about CHF3 billion in AuM. Banque Franck Galland then merged with Banque Piguet, one of BCV's subsidiaries, to become Piguet Galland & Cie SA.

We believe that control of immigration in Switzerland and ongoing reform of the country's corporate tax law could slow demand for bank services, but BCV is confident about the ability of the Swiss government and the Canton of Vaud to find appropriate solutions, which will ultimately allow these changes to have a marginal impact on the bank's activities. In addition, the impact on BCV's private banking revenues, due to pressures on Swiss banks from foreign countries with regard to tax conformity, is limited, in our view. This is because most of BCV's assets are "onshore" AuM and we expect net inflows from such AuM to partly offset outflows from "offshore" AuM over the next two years. BCV participates as a Category 2 bank in a U.S. Department of Justice (U.S. DoJ) program for Swiss banks (a Category 2 Swiss Bank is one requesting a non-prosecution agreement and that is not under criminal investigation but which might be considered by the U.S. DoJ to have committed tax-related or monetary transaction offenses).

In addition to its traditional activities as a Swiss cantonal bank, BCV has a structured product business and is one of the main players in French-speaking Switzerland in transaction-based commodity trade finance. The issuance of structured products by the bank has increased significantly since 2012, and reached about CHF1.3 billion in the first half of 2014. The bank's trade finance activity relates mainly to steel, agro-business, and petroleum derived products.

Apart from issuing structured products, 80% of the bank's trading activity is focused on foreign exchange spot and derivatives transactions to serve clients' needs.

Table 2

Banque Cantonale Vaudoise Business Position					
		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Total revenues from business line (currency in millions)	503.9	1,003.0	1,014.4	1,021.9	1,008.2
Commercial banking/total revenues from business line	27.8	27.5	28.2	28.1	26.5
Retail banking/total revenues from business line	19.2	19.5	20.6	20.9	20.6
Commercial & retail banking/total revenues from business line	47.0	47.1	48.8	49.0	47.1
Trading and sales income/total revenues from business line	4.8	6.1	5.6	6.1	5.3
Asset management/total revenues from business line	37.3	37.0	36.1	36.0	34.5
Investment banking/total revenues from business line	4.8	6.1	5.6	6.1	5.3
Return on equity	9.4	8.4	9.4	9.2	9.7

*Data as of June 30.

Capital and earnings: Strong capital position

We view BCV's capital and earnings as "strong" overall. The quality of the bank's capital is high as it is composed almost entirely of common equity Tier 1 (CET1) capital. The bank's risk-adjusted capital (RAC) ratio was 13.2% as of Dec. 31, 2013 (proforma our revision of the Swiss BICRA score to '2' from '1' on Dec. 1, 2014, and proforma all our risk parameters at the same date). This level is lower than the 14.3% computation at end-2013 based on historic risk parameters, and reflects the downward revision of the Swiss BICRA score. We do not expect the bank's RAC ratio to exceed 15% over the next 18 to 24 months, given planned growth of exposures and management's stated intention to continue paying high dividends. In May 2014, BCV distributed CHF275 million to shareholders, out of its CHF280 million post-tax net income for 2013.

The implementation of Basel III in January 2013 translated into a substantial 310 basis-point (bp) increase in BCV's core equity Tier 1 ratio. Most of the improvement came from the removal of a specific regulatory add-on that applied to internal ratings-based capital requirements under Basel II. This did not apply to any other Swiss cantonal banks because they use the standardized approach.

To address rising property prices, the Swiss regulator (FINMA) implemented in 2013 a counter-cyclical buffer based on total regulatory risk-weighted assets on mortgage exposures. The buffer was set at 1% in September 2013, then raised to 2% in mid-2014, which brought the impact on BCV's regulatory capital ratios to minus 0.5%. In addition, FINMA has introduced a bank-specific multiplier for regulatory risk-weighted assets on mortgages to reduce the difference in risk weights between banks using an internal rating based approach and those using the standardized approach. The multiplier for BCV will increase gradually until 2019, and we estimate that it will reduce the bank's CET1 ratio by 130 bps over this time frame (already down by 15 bps in 2013). BCV targets a minimum 13% CET1 ratio over time, against 17.1% as of June 30, 2014 (the total capital ratio at the same date was 17.3%, reflecting marginal additional contribution from CHF21 million in Tier 2 capital.) FINMA would intervene if the total capital ratio fell below 11%.

Margins on the liability side remain constrained by very low short-term interest rates. We expect BCV's annual post-tax profit to be very stable, at about CHF300 million from 2014 onward, after the CHF280 million achieved in 2013 (which included a net charge of CHF43 million in value adjustments, provisions, and losses, which was mostly constituted of new provisions for tax conformity issues). We will continue to monitor the resolution of the U.S. DoJ's program, and related costs that could be incurred by BCV. We see material upside potential for revenues if interest rates normalize or the yield curve steepens further. We note that the bank's profitability, adjusted for risk, is strong, with a three-year average earnings buffer of about 100 bps in 2013, indicating strong capacity for earnings to cover expected losses.

Table 3

Banque Cantonale Vaudoise Capital And Earnings					
		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Tier 1 capital ratio	17.1	17.8	18.4	16.8	17.6
S&P RAC ratio before diversification	N.A.	14.3	14.6	14.3	15.5
S&P RAC ratio after diversification	N.A.	14.0	14.3	14.1	15.0
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	50.3	50.6	51.4	50.8	51.3
Fee income/operating revenues	34.7	34.5	34.4	35.1	35.3
Market-sensitive income/operating revenues	10.4	11.4	11.2	11.3	9.8
Noninterest expenses/operating revenues	62.0	65.3	60.8	61.7	60.1
Preprovision operating income/average assets	0.9	0.9	1.0	1.1	1.1
Core earnings/average managed assets	0.7	0.7	0.8	0.8	0.9

*Data as of June 30. N.A.--Not available.

Table 4

Banque Cantonale Vaudoise 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	2,235	0	0	69	3
Institutions	3,281	1,004	31	339	10
Corporate	14,296	8,926	62	9,860	69
Retail	17,207	2,951	17	4,404	26
Of which mortgage	15,446	2,326	15	3,286	21
Securitization§	0	0	0	0	0
Other assets	837	736	88	797	95
Total credit risk	37,856	13,617	36	15,468	41
Market risk					
Equity in the banking book†	229	511	482	1,633	713
Trading book market risk	--	340	--	510	--
Total market risk	--	851	--	2,143	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	1,774	--	2,934	--

(Mil. CHF)	Basel II RWA	Standard & Poor's RWA	% of Standard & Poor's RWA
Diversification adjustments			
RWA before diversification	16,379	20,545	100
Total Diversification/Concentration Adjustments	--	404	2
RWA after diversification	16,379	20,949	102

(Mil. CHF)	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	Standard & Poor's RAC ratio (%)
Capital ratio				
Capital ratio before adjustments	2,915	17.8	2,937	14.3
Capital ratio after adjustments‡	2,915	17.8	2,937	14.0

*Exposure at default. §Securitization exposure includes 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: Concentration of risk in the Canton of Vaud's real estate markets and sizable trade finance exposures

We assess BCV's risk position as "adequate." Our view reflects the balance between the bank's high exposure to Vaud's property markets with close to 80% of BCV's loans being for owner-occupier mortgages or income-producing real estate (although these loans account for only one-third of total income) and a good track record of very low cost of risk on real estate exposures over the past five years.

We consider that strong cumulative growth in residential real-estate prices and domestic lending in Switzerland over the past several years, particularly mortgage lending, represents an incremental risk for those Swiss banks that have mainly domestic operations and large exposure to the Swiss real estate market. Moreover, real estate prices in Vaud have increased by more than the Swiss average since 2002, with annual average growth of 6%-7% against about 4% nationally. We acknowledge, though, that housing price increases in Vaud partly reflect above-average economic growth in the canton and strong immigration-led demand compared with limited supply. Although housing prices have slowed somewhat in 2014, they remain historically high, and given BCV's significant exposure to residential real estate, we consider that an unexpected deterioration in prices could increase the bank's loan losses. However, we see a low risk of a sharp correction in property prices.

In addition, we regard BCV's stricter application of underwriting standards since 2011 as positive. For example, loan-to-value ratios on new mortgage lending are capped at 80% for borrower-occupied housing (lower levels are applied for buy-to-let), and borrowers must provide a minimum down payment of 20% in cash. Moreover, the annual cost of borrowing (calculated on a theoretical 7% interest rate) must not exceed one-third of a customer's annual net income. In addition, BCV limited the growth of its mortgage portfolio to 2% in 2013 compared with 4% in 2012 and almost 9% in 2011.

BCV is the only cantonal bank that the Swiss regulator has approved to use the regulatory internal ratings-based approach for regulatory purposes. This reflects, in our view, the quality of BCV's credit risk management. Gross nonperforming loans stood at a low 1.2% of total customer loans at end 2013.

BCV's riskiest positions include trade finance exposures, which stood at about CHF1.5 billion at mid-2014, from CHF1.8 billion at the end of 2013. Due to low granularity in the portfolio, the cost of risk incurred in this business segment is volatile (it was zero in 2011 and 2013), but we estimate that it accounted for a portion of the bank's total provisioning needs which averaged one-third over the past six years. BCV has modest exposures to Russia and Ukraine.

Although BCV hedges market risk arising from its structured products and certificates businesses, some residual risk remains, mainly dividend and correlation risk. Revenues associated with structured products and certificates account for less than 2% of total revenues, according to our estimates.

Table 5

Banque Cantonale Vaudoise Risk Position

		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Growth in customer loans	2.2	2.9	(0.1)	9.5	4.7
Total diversification adjustment / S&P RWA before diversification	N.A.	2.0	2.2	1.3	3.2
Total managed assets/adjusted common equity (x)	14.0	13.8	13.6	13.0	12.2
New loan loss provisions/average customer loans	(0.0)	(0.0)	(0.0)	(0.0)	(0.1)
Gross nonperforming assets/customer loans + other real estate owned	1.1	1.2	1.6	1.8	2.2
Loan loss reserves/gross nonperforming assets	39.7	36.3	36.9	38.8	39.4

*Data as of June 30. N.A.--Not available.

Funding and liquidity: Largely funded by deposits, with strong cash liquidity buffers

We assess BCV's funding as "average," and its liquidity as "strong." Customer deposits represented 77% of BCV's funding base on June 30, 2014, according to our calculations, in line with the levels of Swiss cantonal bank peers. Customer deposits increased by 3% in the first three quarters of 2014 despite record low interest rates and some outflows of off-shore deposits.

Like other cantonal banks, BCV issues covered bonds through the Centrale de lettres de gage (CLG). Through this mutualized source of funding, the bank benefits from the excellent creditworthiness of the CLG, which is backed by Swiss cantonal banks and ultimately by most cantons. BCV's stable funding ratio at end-2013 was 114%, which compares favorably with the ratios of the bank's domestic peers.

As of June 30, 2014, BCV's liquidity buffer comprised mainly cash held at the Swiss National Bank (SNB). In addition, BCV has a pool of unencumbered bonds that are eligible as collateral with the SNB. Investing the liquidity buffer in domestic repurchase agreements is a limited alternative because most banks actively using this option are cash rich and volumes have dropped.

BCV's ratio of broad liquid assets to short-term wholesale funding was a strong 2.8x at end-2013. However, a significant portion of the deposit base contains private banking deposits and uninsured institutional investors' deposits, which are more volatile than traditional retail deposits, in our view. Preliminary data indicate a Basel III liquidity coverage ratio of 100% at year-end 2013, far above the 60% minimum regulatory requirement at that date. BCV's aim is to exceed the minimum regulatory requirement by 10%. We believe BCV's liquidity position will remain strong, as we expect the bank to keep a sound balance between additional long-term issuance and use of its liquidity buffer, while preserving its capacity to attract deposits.

Table 6

Banque Cantonale Vaudoise Funding And Liquidity

		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Core deposits/funding base	76.8	77.7	76.4	76.4	75.8
Customer loans (net)/customer deposits	101.6	102.0	102.8	108.8	107.3
Long term funding ratio	N.A.	93.1	91.4	92.5	N.A.
Stable funding ratio	N.A.	113.5	120.0	113.2	N.A.
Short-term wholesale funding/funding base	N.A.	7.6	9.3	8.2	N.A.
Broad liquid assets/short-term wholesale funding (x)	N.A.	2.8	3.0	2.8	N.A.
Net broad liquid assets/short-term customer deposits	N.A.	39.3	54.2	20.2	N.A.
Short-term wholesale funding/total wholesale funding	N.A.	33.9	39.5	34.6	N.A.
Narrow liquid assets/3-month wholesale funding (x)	N.A.	3.8	4.1	3.3	N.A.

*Data as of June 30. N.A.--Not available.

External support: Government-related entity status puts the long-term rating three notches above the SACP

We view BCV as a government-related entity (GRE). In accordance with our criteria for GREs, we believe that there is a "very high" likelihood that the Canton of Vaud would provide timely and sufficient extraordinary support to BCV in the event of financial stress, as it did early in the past decade. For this reason, the long-term rating on BCV stands three notches above its SACP.

Our view that there is a very high likelihood of extraordinary support is based on our assessment of BCV's:

- "Very important" role in the local economy, reflecting its public policy role in the canton's economic development and the possibility that a default could damage the canton's reputation; and
- "Very strong" link with the canton. A law passed in March 2010 stipulates that the canton will keep a majority stake of at least 50% plus one share in the bank. The Canton of Vaud currently owns 67% of BCV. Unlike some other Swiss cantonal banks, however, BCV does not benefit from a cantonal statutory guarantee.

Additional rating factors: None

No additional factors affect the rating.

Related Criteria And Research

Related Criteria

- 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

- Various Ratings Actions On Swiss Banking Groups On Rising Economic Imbalances, Dec. 1, 2014
- Switzerland-Based Banque Cantonale Vaudoise Affirmed At 'AA/A-1+' Following Government Support Review; Outlook Stable, April 30, 2014
- Outlook On Banque Cantonale Vaudoise Revised To Stable On Upgrade Of The Canton Of Vaud; Ratings Affirmed At 'AA/A-1+', June 18, 2013

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 December 16, 2014)	
Banque Cantonale Vaudoise	
Counterparty Credit Rating	AA/Stable/A-1+
Counterparty Credit Ratings History	
18-Jun-2013	AA/Stable/A-1+
03-Jul-2012	AA/Negative/A-1+
05-Dec-2011	AA/Stable/A-1+
06-Dec-2010	AA-/Positive/A-1+
Sovereign Rating	
Swiss Confederation (Unsolicited Ratings)	AAA/Stable/A-1+

*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.

Additional Contact:
Financial Institutions Ratings Europe; FIG_Europe@standardandpoors.com