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Banque Cantonale Vaudoise

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Banque Cantonale Vaudoise

SACP	a+	
Anchor	a	
Business Position	Adequate	0
Capital and Earnings	Strong	+1
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/Stable/A-1+

Major Rating Factors

Strengths:

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

Weaknesses:

- High exposure to regional real estate markets.
- Sizable trade finance exposures.

Outlook: Stable

Standard & Poor's Ratings Services' stable outlook on Switzerland-based Banque Cantonale Vaudoise (BCV) reflects its view of a very high likelihood of support for BCV from the Canton of Vaud (AAA/Stable/--) in the event of stress. According to our criteria, a downward revision of BCV's stand-alone credit profile (SACP) by two notches would be fully offset by additional notches of support from the canton, leaving the rating on BCV unchanged. We view a deterioration of the SACP by more than two notches as a remote possibility in BCV's current operating environment.

We see a downgrade of BCV as a remote possibility over the next two years.

We could raise the long-term rating if our concerns about the effect of rising house prices on BCV's asset quality abated and BCV improved its capital position, as measured by a risk-adjusted capital ratio exceeding 15% on a sustainable basis, compared with 14.6% at year-end 2012.

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 stand-alone credit profile (SACP) is at 'a+'.

Anchor: 'a' for Swiss banks

Our bank criteria use the 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. The 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 Switzerland demonstrates a conservative risk and lending culture, which has accompanied recent moderate growth of house prices and loan portfolios.

The Swiss banking industry is supported by a sizable and very stable customer deposit base. Pure 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 countries.

Table 1

Banque Cantonale Vaudoise Key Figures					
		--Year-ended Dec. 31--			
(Mil. CHF)	**2013***	**2012**	**2011**	**2010**	**2009**
Adjusted assets	40,271.0	39,680.0	37,783.0	35,501.0	35,648.4
Customer loans (gross)	28,392.0	28,124.0	28,165.0	25,723.5	24,576.5
Adjusted common equity	2,942.7	2,920.0	2,906.0	2,911.7	2,870.2
Operating revenues	497.9	1,009.8	1,017.2	995.8	975.9
Noninterest expenses	305.2	610.2	615.4	593.3	583.7
Core earnings	142.9	305.4	294.3	306.5	294.3

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

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

We assess BCV's business position as "adequate." With total assets of Swiss franc (CHF) 40.3 billion (about €33 billion) on Sept. 30, 2013, BCV is the third largest cantonal banking group in Switzerland, and the sixth bank by size. 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 0.8% over the past five years; the average annual growth rate is 2% compared with 1.2% for Switzerland.

With CHF86.1 billion of assets under management on Sept. 30, 2013, and CHF852 million of net new money in the first three quarters of the year, the bank also has a good franchise in asset and wealth management, although its market share in private banking is much smaller than that in retail banking. The bank further consolidated its wealth management franchise in 2011 with the acquisition of Banque Franck Galland, which had about CHF3 billion in assets under management. Banque Franck Galland then merged with Banque Piguet, one of BCV's subsidiaries, to become Piguet Galland & Cie SA.

Pressures on BCV's private banking revenues, due to threats to Swiss banking secrecy and the U.S. Department of Justice's investigation of some Swiss banks, are contained, in our view. This is because most of the bank's assets are "onshore assets" and we expect net inflows from those assets to partly offset outflows from "offshore assets" over the next two years. BCV is not on the Department of Justice's list of Category 1 Swiss banks.

On top of 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 for transaction-based commodities trade finance. The issue of structured products increased significantly in the first half of 2013, reaching almost CHF1 billion. Exposures to trade finance relate mainly to metals, steel, wheat, and corn. They decreased from highs of about CHF2.5 billion at the end of 2011 to about CHF2.0 billion, notably because of the drop in metals prices worldwide. We expect trade finance exposures to slightly increase in 2014 because the bank intends to diversify into energy products.

Apart from issuing structured products, trading operations are focused on foreign exchange spot and derivatives transactions to serve clients' needs.

Table 2

Banque Cantonale Vaudoise Business Position

		--Year-ended Dec. 31--			
(%)	**2013***	**2012**	**2011**	**2010**	**2009**
Total revenues from business line (mil. CHF)	508.2	1,018.8	1,034.0	N/A	N/A
Commercial banking/total revenues from business line	27.4	28.1	27.8	N.M.	N.M.
Retail banking/total revenues from business line	19.1	20.5	20.7	N.M.	N.M.
Commercial & retail banking/total revenues from business line	46.4	48.6	48.5	N.M.	N.M.
Trading and sales income/total revenues from business line	6.5	5.6	6.0	N.M.	N.M.
Asset management/total revenues from business line	37.0	35.9	35.6	N.M.	N.M.
Other revenues/total revenues from business line	10.1	9.9	10.0	N.M.	N.M.
Investment banking/total revenues from business line	6.5	5.6	6.0	N.M.	N.M.
Return on equity	9.3	9.4	9.2	9.7	9.4

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

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 because it issues no hybrids. Our risk-adjusted capital (RAC) ratio for BCV was 14.6 % as of Dec. 31, 2012. We do not expect it to exceed 15% over the next 18 to 24 months, given the planned growth of exposures and management's stated intention to continue paying high dividends. BCV distributed CHF275 million to shareholders in 2012, out of its CHF311 million in posttax net income.

The implementation of Basel III in January 2013 translated into a substantial 310 basis-point (bp) increase in BCV's Swiss core equity Tier 1 ratio, unlike for all other cantonal banks. 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 a counter-cyclical buffer in 2013: 1% of total regulatory risk-weighted assets (RWA) on mortgage exposures. This reduced BCV's common equity Tier 1 (CET1) ratio by 30bps as of September 2013. In addition FINMA has introduced an IRB bank-specific multiplier for regulatory RWA on mortgages because of its view that IRB models may understate potential losses on mortgage exposures in Switzerland for banks using IRB. The multiplier for BCV will increase gradually until 2019, which we estimate would reduce the CET1 ratio by 130bps over this time frame (already by 15 bps in 2013). BCV targets a CET1 ratio exceeding 13% over the next few years, versus 17.9% as of June 30, 2013. FINMA would intervene if the CET1 ratio were lower than 11 %.

Margins on the liability side remain constrained by very low short-term interest rates. Long-term interest rates have started going up (with a 50bp increase since the beginning of 2013), helping margins on assets increase. We expect BCV's posttax profit to be slightly lower in 2013 than in 2012. However, revenues have bottomed out in our view and we see upside potential as soon as interest rates normalize or the yield curve steepens further. The bank's profitability, adjusted for risk, is strong; the three-year average earnings buffer was about 140bps in 2012, indicating a strong capacity for earnings to cover expected losses.

Table 3

Banque Cantonale Vaudoise Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2013***	**2012**	**2011**	**2010**	**2009**
Tier 1 capital ratio	17.8	18.4	16.8	17.6	17.8
S&P RAC ratio before diversification	N.M.	14.6	14.3	15.5	15.1
S&P RAC ratio after diversification	N.M.	14.3	14.1	15.0	14.8
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	49.8	51.4	50.8	51.3	52.0
Fee income/operating revenues	34.7	34.4	35.1	35.3	33.7
Market-sensitive income/operating revenues	11.9	11.2	11.3	9.8	10.1
Noninterest expenses/operating revenues	61.3	60.4	60.5	59.6	59.8
Preprovision operating income/average assets	1.0	1.0	1.1	1.1	1.1
Core earnings/average managed assets	0.7	0.8	0.8	0.9	0.8

*Data as of June 30. N.M.--Not meaningful.

Table 4

Banque Cantonale Vaudoise RACF [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	1,819	0	0	56	3
Institutions	2,755	873	32	314	11
Corporate	14,247	8,809	62	9,786	69
Retail	16,777	2,645	16	4,240	25

Table 4

Banque Cantonale Vaudoise RACF [Risk-Adjusted Capital Framework] Data (cont.)					
Of which mortgage	15,158	2,065	14	3,214	21
Securitization§	0	0	0	0	0
Other assets	887	847	95	843	95
Total credit risk	36,485	13,174	36	15,240	42
Market risk					
Equity in the banking book†	235	481	263	1,259	536
Trading book market risk	--	360	--	540	--
Total market risk	--	841	--	1,799	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	1,775	--	2,911	--
(Mil. CHF)		**Basel II RWA**		**Standard & Poor's RWA**	**% of Standard & Poor's RWA**
Diversification adjustments					
RWA before diversification		15,790		19,950	100
Total Diversification/Concentration Adjustments		--		441	2
RWA after diversification		15,790		20,391	102
(Mil. CHF)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**Standard & Poor's RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		2,908	18.4	2,920	14.6
Capital ratio after adjustments‡		2,908	18.4	2,920	14.3

*Exposure at default. §Securitisationexposure includes the securitisation 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, 2012, Standard & Poor's.

Risk position: Concentration of risks in regional 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 regional property markets (with close to 60% of BCV's loans for residential mortgages or income-producing real estate) and a good track record of very low cost of risk on real estate exposures over the past five years. Real estate prices in Vaud have increased more than the Swiss average since 2002, with annual average growth of 7%-8% versus 4% nationally. We acknowledge that house price developments in Vaud partly reflect above-average economic growth in the canton and strong immigration-led demand compared with limited supply. However, we've observed a steady increase in house prices since 2002. If this continues, it could increase the economic imbalances and impair the quality of BCV's residential loans book. Consequently, we view positively the substantial slowdown of house price growth that occurred in the first three quarters of 2013, with even a decrease in the luxury segment.

In addition, we regard BCV's stricter application of underwriting standards since 2011 as positive. For example, loan-to-value ratios on new lending are capped at 80%, and borrowers must provide a minimum down payment of 10% in cash. BCV implemented these strict underwriting criteria before the Swiss Banking Association recommended them to the Swiss banking industry in 2012. Moreover, the annual cost of borrowing should not exceed one-third of a customer's annual net income. BCV also opted to limit the growth of the mortgage portfolio to 4% in 2012 and to 3%-3.5% in 2013, versus close to 9% in 2011.

BCV's riskiest positions, in our view, include trade finance exposures of about CHF2.0 billion as of June 30, 2013, which led to almost half of its provisioning needs over the past three years.

BCV is the only cantonal bank the Swiss regulator has approved for using Basel II's internal ratings-based approach for regulatory purposes. This reflects the quality of BCV's credit risk management, in our view. Overall, BCV's cost of credit risk has not represented more than 10bps since 2009, and the ratio of gross nonperforming loans to total customer loans was a low 1.4% as of year-end 2012.

In our view, BCV's market risk has increased this year following double-digit growth in structured products and certificates business. Although BCV hedges market risk from this business, some residual risks remain, mainly dividends and correlation risks. Revenues associated with structured products and certificates now account for about 2%-3% of total revenues, according to our estimates. Moreover, we understand that the bank's inventories of fixed-income securities increased last year, following plans to develop its bonds advisory/brokerage business for institutional clients. We understand that BCV has also increased its share of underwriting of covered bonds issued through the Swiss Centrale des Lettres de gage (CLG).

However, market risk remains substantially lower than levels we observed before 2010. For example, the size of BCV's seed-money portfolio was about CHF25 million at end-June 2013, a fourfold decline, compared with year-end 2009.

Table 5

Banque Cantonale Vaudoise Risk Position

		--Year-ended Dec. 31--			
(%)	**2013***	**2012**	**2011**	**2010**	**2009**
Growth in customer loans	1.9	(0.1)	9.5	4.7	6.0
Total diversification adjustment / S&P RWA before diversification	N.M.	2.2	1.3	3.2	2.4
Total managed assets/adjusted common equity (x)	13.7	13.6	13.0	12.2	12.4
New loan loss provisions/average customer loans	0.1	0.0	0.1	0.0	0.1
Gross nonperforming assets/customer loans + other real estate owned	N/A	1.4	1.6	1.9	2.4
Loan loss reserves/gross nonperforming assets	N/A	41.5	44.5	45.5	45.0

*Data as of June 30. N/A--Not applicable. N.M.--Not meaningful.

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

We assess BCV's funding as "average," and its liquidity as "adequate." Customer deposits represented more than 83% of BCV's funding base on June 30, 2013, according to our calculations, in line with that of Swiss cantonal bank peers. Deposits increased by 3% in the first three quarters of this year, despite record low interest rates and some outflows of off-shore deposits. Covered bonds made up about 14% of the bank's total funding needs.

Like other cantonal banks, BCV issues covered bonds through the CLG. Through this mutualized source of funding, BCV benefits from the CLG's excellent creditworthiness, which is backed by Swiss cantonal banks and ultimately by most cantons. Its funding costs are also quite low, currently between zero and 20bps above the swap rates for the same maturities. Overall, our stable funding ratio for BCV at midyear was 121.3%, in line with domestic peers'.

As of June 30, 2013, BCV's liquidity buffer comprised mainly cash at the Swiss National Bank (SNB). Investing excess liquidity on the domestic repo (repurchase agreements) market is a limited alternative because most banks actively using that platform are cash rich, so repo volumes have dropped. BCV also has a pool of SNB-eligible unencumbered bonds.

The bank's ratio of broad liquid assets to short-term wholesale funding was a strong 350% at midyear 2013. However, a significant portion of the deposit base contains uninsured private banking deposits, which are more volatile than classic retail deposits, in our view. Preliminary data indicate a Basel III liquidity coverage ratio above 100%.

We understand that management intends to partly fund the expected loan growth and any net outflows of offshore deposits with the excess liquidity. However, we believe BCV's liquidity position will stay strong. This is because 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--			
(%)	**2013***	**2012**	**2011**	**2010**	**2009**
Core deposits/funding base	78.0	76.4	76.4	75.8	74.1
Customer loans (net)/customer deposits	99.4	102.8	108.8	107.3	103.9
Long term funding ratio	92.8	91.4	92.5	91.9	90.6
Stable funding ratio	121.3	120.0	113.2	N/A	N/A
Short-term wholesale funding/funding base	7.8	9.3	8.2	8.9	10.3
Broad liquid assets/short-term wholesale funding (x)	3.5	3.0	2.8	N/A	N/A
Net broad liquid assets/short-term customer deposits	57.8	54.2	20.2	N/A	N/A
Short-term wholesale funding/total wholesale funding	35.4	39.5	34.6	37.0	39.7
Narrow liquid assets/3-month wholesale funding (x)	5.1	4.1	3.3	N/A	N/A

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

External support: GRE status puts the long-term rating two notches above the SACP

We view BCV as a GRE, according to our methodology. In accordance with our criteria for GREs, we believe that there is a "very high" likelihood that Vaud would provide timely and sufficient extraordinary support to BCV in the event of financial stress, as it did in the early 2000s. The long-term rating on BCV is therefore two notches higher than its SACP.

Our view of 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 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 at least a 50%

plus one share majority in the bank. The canton of Vaud currently owns 68% of BCV. Unlike some other Swiss cantonal banks, however, BCV does not benefit from the canton's 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

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 November 29, 2013)

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+
02-Dec-2008	AA-/Stable/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.

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