MOODY'S
INVESTORS SERVICE

Credit Opinion: Banque Cantonale Vaudoise

Global Credit Research - 28 May 2015

Lausanne, Switzerland

Ratings

Category	**Moody's Rating**
Outlook	Stable
Bank Deposits	Aa2/P-1
Baseline Credit Assessment	a2
Adjusted Baseline Credit Assessment	a2

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Key Indicators

Banque Cantonale Vaudoise (Consolidated Financials)[1]

	[2]**12-14**	[2]**12-13**	[3]**12-12**	[3]**12-11**	[3]**12-10**	**Avg.**
Total Assets (CHF million)	**41,988.0**	**40,331.0**	**39,639.0**	**37,710.0**	**35,363.0**	[4]**4.4**
Total Assets (EUR million)	**34,921.1**	**32,910.6**	**32,846.7**	**31,065.3**	**28,280.2**	[4]**5.4**
Total Assets (USD million)	**42,256.3**	**45,348.9**	**43,304.7**	**40,327.2**	**37,939.1**	[4]**2.7**
Tangible Common Equity (CHF million)	**3,314.0**	**3,290.0**	**3,277.0**	**3,246.0**	**3,253.0**	[4]**0.5**
Tangible Common Equity (EUR million)	**2,756.2**	**2,684.7**	**2,715.5**	**2,674.0**	**2,601.5**	[4]**1.5**
Tangible Common Equity (USD million)	**3,335.2**	**3,699.3**	**3,580.1**	**3,471.3**	**3,490.0**	[4]**-1.1**
Problem Loans / Gross Loans (%)	**1.4**	**1.5**	**1.8**	**2.1**	**2.4**	[5]**1.8**
Tangible Common Equity / Risk Weighted Assets (%)	**19.7**	**20.1**	**16.2**	**15.0**	**15.9**	[6]**19.9**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**12.1**	**13.0**	**14.7**	**16.9**	**17.5**	[5]**14.8**
Net Interest Margin (%)	**1.3**	**1.3**	**1.4**	**1.5**	**1.5**	[5]**1.4**
PPI / Average RWA (%)	**2.4**	**2.3**	**1.9**	**1.9**	**1.9**	[6]**2.3**
Net Income / Tangible Assets (%)	**0.7**	**0.7**	**0.8**	**0.8**	**0.9**	[5]**0.8**
Cost / Income Ratio (%)	**60.4**	**61.7**	**60.7**	**60.8**	**59.8**	[5]**60.7**
Market Funds / Tangible Banking Assets (%)	**15.3**	**14.5**	**15.6**	**21.7**	**21.9**	[5]**17.8**
Liquid Banking Assets / Tangible Banking Assets (%)	**18.6**	**18.1**	**18.9**	**14.7**	**16.7**	[5]**17.4**
Gross Loans / Total Deposits (%)	**94.7**	**95.2**	**93.9**	**99.0**	**98.0**	[5]**96.2**

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

On 21 May, we upgraded Banque Cantonale Vaudoise's (BCV) long-term deposit ratings to Aa2 from A1. At the same, we raised BCV's baseline credit assessment (BCA) by one notch to a2. The Prime-1 short-term deposit ratings were affirmed. We further assigned an A1(cr)/Prime-1(cr) Counterparty Risk Assessment (CR Assessment) to BCV.

The rating actions reflected the implementation of our new bank rating methodology as well as revised considerations regarding public support and concluded the review on BCV's ratings initiated on 17 March 2015.

The upgrade of BCV's long-term deposit ratings results from the implementation of our Loss Given Failure (LGF) analysis, indicating a very low loss-given-failure for the bank's wholesale deposits because of the substantial volume of deposits, leading to a two-notch uplift from its a2 adjusted BCA. This positive rating effect was partially offset by the reduction of government support uplift to one notch (previously two notches).

THE BCA BENEFITS FROM BCV's VERY STRONG- MACRO PROFILE

BCV's Macro Profile is determined by high exposures to the Swiss market environment with a very high degree of economic, institutional and government financial strength and very low susceptibility to event risk. The relatively high and rising private sector debt is well covered by private sector assets, which dampens the risks from persistent, albeit slowing, property price inflation. Funding conditions benefit from a strong domestic deposit base as well as good access to the liquid covered bond and interbank markets.

The raising of the bank's BCA by one notch to a2 reflects (1) the bank's relatively low on-balance-sheet risks, despite displaying a high concentration in the Canton of Vaud (unrated), including relatively large exposures to the region's real estate markets; (2) BCV's high-quality capitalisation with a Common Equity Tier 1 (CET1) ratio of 17.1% as of year-end 2014; and (3) its 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.

Our assessment also incorporates the 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

- Solid capital adequacy ratios mitigate asset-quality risks

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

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

- Deposit holders benefit from large volume of deposits in the unlikely event of resolution (Loss Given Failure 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 persistent low interest rates and subdued client activity, 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 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 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; 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 business).

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 67.0%) 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

SOLID CAPITAL ADEQUACY RATIOS MITIGATE ASSET-QUALITY RISKS

The overall strong improvement in BCV's asset quality in recent years reflects the bank's strong focus on credit risk and its conservative credit risk management. In addition, 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.

Against that backdrop, we do not expect that BCV will compromise on its lending standards despite 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 high levels witnessed during the 2009-11 period.

Nevertheless, 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. The bank thus 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.

BCV's capital buffers display strong loss-absorption capacity, which should help preserve the group's aggregate capitalisation above the regulatory intervention level (11% total capital ratio), even under our adverse scenario of a significant downturn in the domestic real-estate market. 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 year-end 2014, BCV reported Common Equity Tier 1 (CET1) and total capital ratios of 17.1% and 17.2%, respectively (under 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 despite high dividend payouts to its majority owner and stakeholders that amounted to approximately 90% of net profits from 2009-14.

We have incorporated these considerations into the bank's Asset Risk and Capital scores of a2 and aa3, respectively.

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 persistently low interest rates. At the same time, we anticipate that risk costs will stay at a low level, supported by a continued benign credit environment and despite a potential gradual erosion in the bank's asset quality in our adverse scenario.

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 in its real-estate and/or trade finance books. Over the past three years, BCV realised a net-income-to-total-assets ratio of 0.7% on average (2014: 0.7%), 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 2014 result was again driven by solid commission as well as trading income generation. 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 remaining unchanged from prior year levels and thus in line with those of its domestic peers. Finally, new provisions for credit risk of CHF11 million (7 basis points of risk-weighted assets; 2013: 12 basis points) remained at a very low level, indicating an unchanged solid asset quality development.

The volume of assets under management continued to increase, and amounted to CHF86.4 billion as of year-end 2014, up CHF2.5 billion since 2013. Net outflows of CHF1.9 billion as at year-end 2014 were driven by offshore as well as corporate/institutional outflows of CHF2.7 billion, partly being offset by onshore inflows from Swiss private and corporate customers of CHF0.8 billion. The development reflects the continued refocusing of BCV's private banking franchises to onshore money and reducing exposures to offshore clients.

STRONG DEPOSIT INFLOWS AND LOW MARKET SENSITIVITY SAFEGUARD BCV'S SOUND 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 CHF5.0 billion of cash at year-end 2014, and approximately CHF5.1 billion of financial investments and interbank assets. During 2014, BCV experienced continued deposit inflows from clients (4% year-over-year growth), adding to its sound funding profile. The bank's liquidity is additionally supported by access to Swiss covered bond funding via Pfandbriefzentrale (unrated, issued mortgage covered bonds rated Aaa).

Therefore, 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 support its credit rating. We have reflected these considerations in the bank's Funding Structure and Liquidity Resources scores of a2 and a3, respectively.

Notching Considerations

LOSS GIVEN FAILURE (LGF) ANALYSIS

BCV is subject to Swiss banking regulation, which we consider to represent an Operational Resolution Regime. We therefore apply our 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.

Our LGF analysis indicates a very low loss-given-failure for BCV's wholesale deposits. As a result, we assign a Preliminary Rating Assessment (PRA) to BCV's deposits two notches above the a2 adjusted BCA, as deposits will be treated preferentially in a resolution and reflecting the likely reduction in expected loss resulting from the substantial volume of deposits at failure.

GOVERNMENT SUPPORT

We continue assess a high probability of regional and local government support from the Canton of Vaud as the majority owner of the bank. We understand that the canton has no current plans to reduce the government's ownership of the institution. Under our new methodology, however, our revised assessment of government support globally resulted in a one-notch reduction of government support uplift on the bank's deposit ratings, from two notches previously.

The bank continues to remain an important financial institution within the regional economy of the canton as a public-law institute, reflected by its strong market position in retail and commercial small and medium-sized enterprise 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.

Despite its strong local market position, we consider the probability of additional systemic (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.

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	1.6%	aa3	←→	a2	Geographical concentration	Unseasoned risk
Capital						
TCE / RWA	19.7%	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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