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Glarner Kantonalbank

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Glarner Kantonalbank

SACP	a-

Anchor	a-	
Business Position	Moderate	-1
Capital and Earnings	Very Strong	+2
Risk Position	Adequate	0
Funding	Below Average	-1
Liquidity	Adequate	

\+

Support	+4

ALAC Support	0
GRE Support	+4
Group Support	0
Sovereign Support	0

\+

Additional Factors	0

Issuer Credit Rating
AA/Stable/A-1+

Major Rating Factors

Strengths:	Weaknesses:
• Close ties with the Swiss Canton of Glarus, facilitated by its majority ownership of the bank and its statutory guarantee • Very strong capitalization • Sound retail banking franchise in the small canton and a loan book dominated by well-collateralized residential mortgages	• A less stable customer base and weaker cost efficiency than most rated cantonal peers • Stronger reliance on wholesale funding activities than the rated cantonal peer group • Concentration risk because of a focus on residential mortgage lending in Glarus and neighboring economic area

Outlook: Stable

The stable outlook on Glarner Kantonalbank (GLKB) reflects S&P Global Ratings' view that GLKB would receive extraordinary support from its majority owner, Canton of Glarus, if needed. Consequently, the likelihood of a downgrade is remote over the next two years, because, in the event of a moderate deterioration of GLKB's own creditworthiness, we would include additional support from the canton into our ratings, assuming everything else remained equal.

That said, a negative rating action could be triggered if GLKB's ties with the canton loosen, or changes to the statutory guarantee were made. We consider this scenario unlikely and would expect GLKB's existing obligations to be grandfathered. In addition, a negative rating action could occur if we were to lower our assessment of the canton's creditworthiness.

A positive rating action on the canton would trigger an upgrade of GLKB. Conversely, improvements of GLKB stand-alone credit profile (SACP) would not translate into a rating upgrade.

Rationale

We consider GLKB's banking franchise as relatively weaker compared with that of most rated cantonal banks because it materially relies on a less stable and more price-sensitive customer base outside Glarus. GLKB's superior capital position remains its main rating strength, mirrored by our projected risk-adjusted capital (RAC) ratio of over 22% in the next 24 months. The bank's risk profile is characterized by concentration risks in its loan portfolio, mitigated by sound overcollateralization levels and asset quality in the past decade. GLKB's funding profile is a rating weakness compared with domestic peers, reflecting high usage of wholesale funding and moderate funding metrics. We view the bank's liquidity buffers as sufficient to meet expected outflows in a stressed scenario.

We add four notches of uplift to arrive at the long-term issuer credit rating (ICR) at 'AA'. This is because we expect GLKB to receiving timely and sufficient extraordinary support from Glarus if needed. We base this opinion on the bank's very important role for, and integral link with, the local government, the canton.

Anchor:'a-' for banks operating only in Switzerland.

Our criteria use our Banking Industry Country Risk Assessment economic risk and industry risk scores to determine a bank's anchor SACP, the starting point in assigning an ICR. Our anchor for a bank operating mainly in Switzerland is 'a-'. We view the trends for both economic and industry risk as stable.

Our economic risk score of '2' for Switzerland is supported by the country's highly diversified and competitive economy, very high household income levels, and banks' prudent loan underwriting standards. However, we also consider housing market risks. In our view, both house prices and household indebtedness remain historically high. The investment property segment (30% of the market) is a particular risk, in our view, in that we have observed first signs of a price correction. We expect imbalances to remain moderate in a global context, also due to the regulator's macroprudential measures to rein in growth in mortgage indebtedness and because of further strengthening of self-regulatory measures to prevent excessive risk-taking in mortgage financing. We recognize that house price growth have cooled down materially since 2014 with lending growth remaining at moderate levels. We also note that very high mortgage debt levels are mitigated by the large amount of financial assets, including pensions, held by households in Switzerland.

Our industry risk score of '2' primarily reflects the banking sector stability and a relatively high share of deposit funding. In our view, the Swiss regulator's regulatory initiatives are more stringent than those in other European banking industries. Banks' net interest margins continue to decline gradually, given the pressure on deposit margins from the negative yield environment. This is partially offset, however, by higher margins on lending products, fee income from investment advisory-related activities, and cost management. As a result, banks generate returns on core banking products that are adequate to meet their cost of capital. We consider risk for Swiss banks from tech disruption limited, given the population's preference for cash payments, the market's small size with few foreign banks, the own regulatory framework, and technologically well-equipped banks.

Table 1

Glarner Kantonalbank Key Figures

		--Year ended Dec. 31--			
(Mil. CHF)	**2019***	**2018**	**2017**	**2016**	**2015**
Adjusted assets	6,320.1	5,978.7	5,637.5	5,276.7	4,987.0
Customer loans (gross)	5,228.4	4,950.5	4,798.3	4,606.1	4,297.9
Adjusted common equity	319.6	311.0	301.0	292.1	285.7
Operating revenues	62.3	78.8	73.8	65.8	61.7
Noninterest expenses	39.3	50.2	48.2	45.6	43.6
Core earnings	17.7	21.3	19.4	16.8	17.1

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

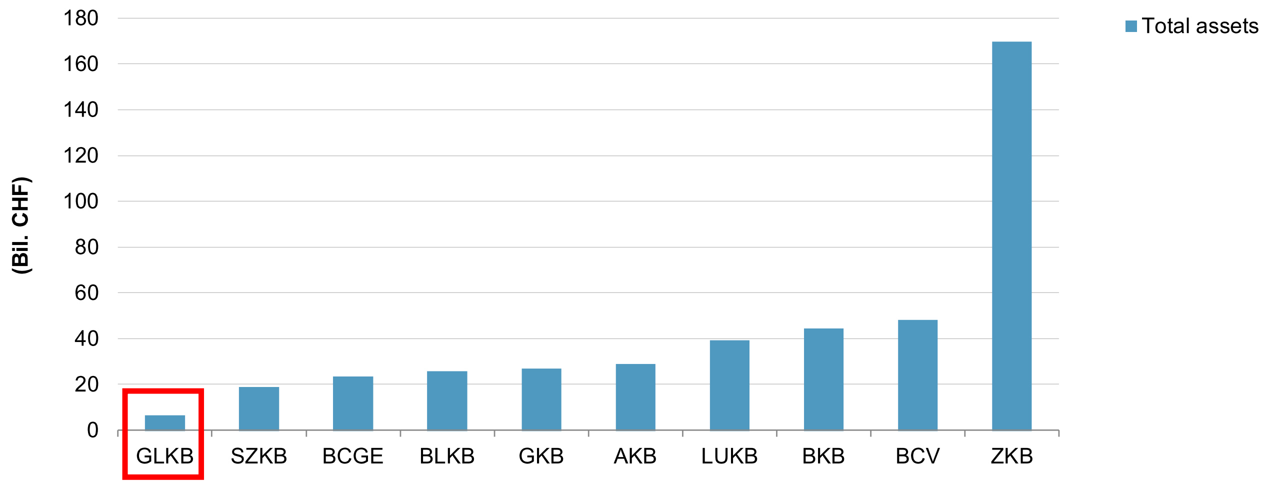
Business position: Strong growth strategy outside home canton weakens business stability

GLKB is a small Swiss cantonal bank (see chart 1) and the leading retail bank in its narrow home canton. It focuses on residential mortgage lending near Glarus and online mortgages in German-speaking Switzerland through its online platform, hypomat.

Chart 1

Size Of Rated Swiss Cantonal Banks

GLKB is the smallest rated Swiss cantonal bank



Source: S&P Global Ratings. Data as of December 2018. CHF--Swiss francs.

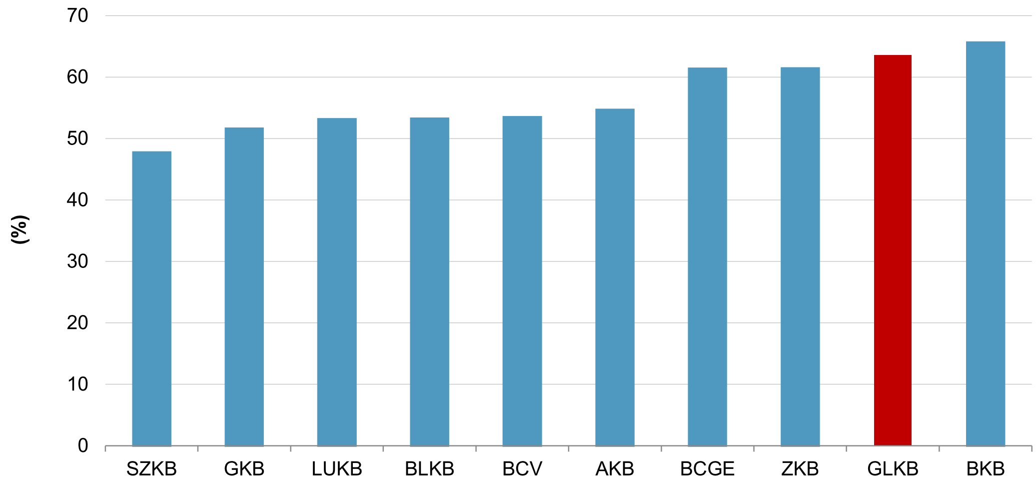
We consider GLKB's franchise weaker than that of peers in Switzerland and European markets with a similar industry risk profile, such as Germany, Austria, and France. This stems from its focus on expanding its loan book outside the home canton. In our view, this results in a more price-sensitive and less stable customer base, in particular during an economic downturn. Conversely, thanks to the cantonal guarantee, we expect the customer base in Glarus will provide the bank with sustainable revenues.

Under current management, GLKB has demonstrated sound and improving profitability with increasing revenues since 2009, and we expect it will continue to do so. While the bank's cost-efficiency has steadily progressed since 2015, that ratio remains high relative to most of its main cantonal peers, with ratios typically at 50%-60% (see chart 2).

Chart 2

Cost-To-Income Ratio

GLKB's cost efficiency remains weaker than most cantonal bank peers'



Cost-to-income ratio is defined as noninterest expense as % of operating revenues. Data relates to FY-2018. AKB--Aargauische Kantonalbank. BCGE--Banque Cantonale de Geneve. BCV--Banque Cantonale Vaudoise. BLKB--Basellandschaftliche Kantonalbank. BKB--Basler Kantonalbank. GLKB--Glarner Kantonalbank. GKB--Graubuendner Kantonalbank. LUKB--Luzerner Kantonalbank. SZKB--Schwyzer Kantonalbank. ZKB--Zuercher Kantonalbank. Source: S&P Global Ratings.

Small corporate banking and asset management activities round out GLKB's franchise. The bank generates additional income by offering administration services for mortgage loans to third parties and selling hypomat licenses. Both initiatives support our view that GLKB is proactively executing strategic measures to cope with the trends in retail banking toward full digitalization and in particular platforms. However, we do not yet consider this business lines significant enough to provide substantial diversification in terms of risk and earnings. We also believe that it might cannibalize the bank's residential mortgage franchise, which could result in fewer growth opportunities than previous years.

Table 2

Glarner Kantonalbank Business Position

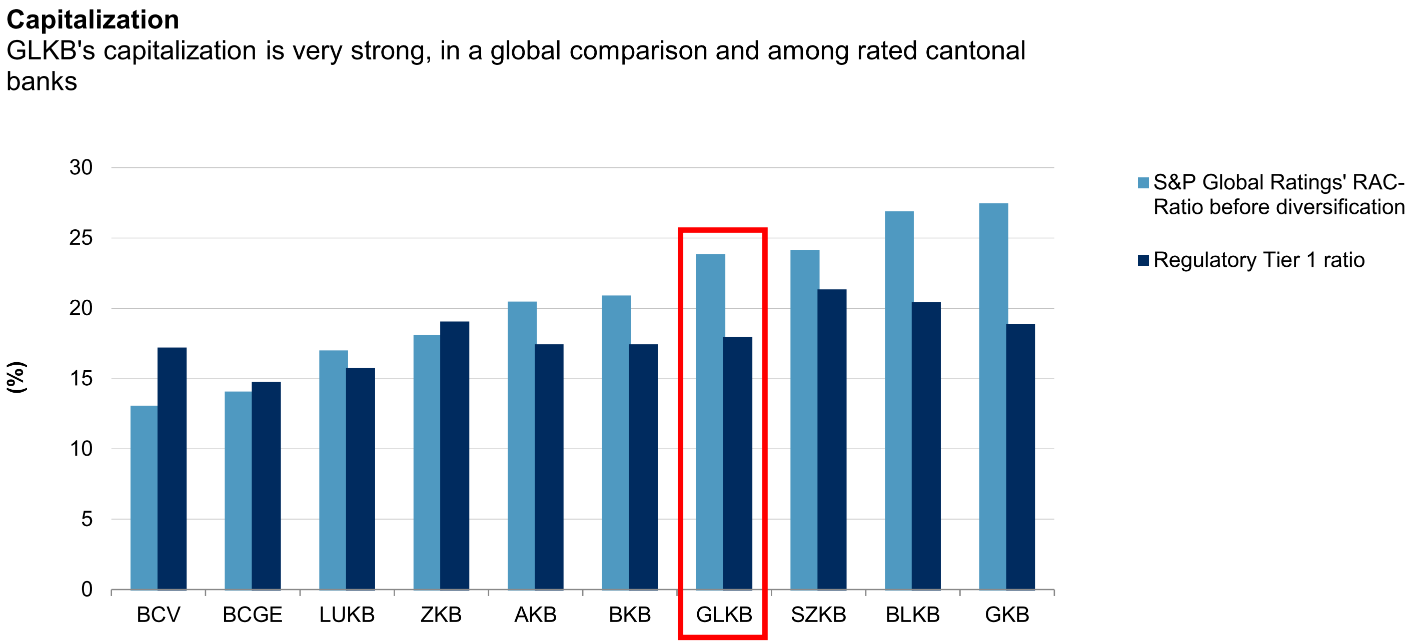
		--Year ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
Loan market share in country of domicile	N/A	0.4	0.4	0.4	0.4
Deposit market share in country of domicile	N/A	0.3	0.3	0.3	0.3
Total revenues from business line (currency in millions)	62.4	79.5	74.5	66.7	64.8
Return on average common equity	7.2	6.9	6.5	5.9	6.9

*Data as of Sept. 30.

Capital and earnings: Very strong capital remains a key rating strength

GLKB's capital is its main rating strength, mirroring our expectation that our RAC ratio will stay in the 22.0%-23.0% range over the next 18-24 months, compared with 23.8% as of Dec. 31, 2018 (see chart 3). The anticipated decrease in the RAC ratio results from expected 4%-7% annual growth in our risk-weighted assets metric for 2019-2021, which will exceed retained earnings over that period.

Chart 3



Ratios as of Dec 2018. AKB--Aargauische Kantonalbank. BCGE--Banque Cantonale de Geneve. BCV--Banque Cantonale Vaudoise. BLKB--Basellandschaftliche Kantonalbank. BKB--Basler Kantonalbank. GLKB--Glarner Kantonalbank. GKB--Graubuendner Kantonalbank. LUKB--Luzerner Kantonalbank. SZKB--Schwyzer Kantonalbank. ZKB--Zuercher Kantonalbank. Source: S&P Global Ratings.

GLKB's regulatory Tier 1 ratio is, at 18.1% at Sept. 30, 2019, comparably lower than its RAC ratio because we apply lower risk weights than the Swiss regulator on Swiss retail loans. Its capital base include of additional Tier 1 hybrid capital instruments totaling Swiss franc (CHF) 200 million. The proportion of hybrid capital instruments in total adjusted capital is higher for GLKB (25%) than most cantonal peers, and we therefore assess the bank's capital quality as slightly weaker. In addition, the bank issued CHF40 million of subordinated convertible loans that could be converted into common equity in 2021, but which we do not include in its total adjusted capital.

In our base-case scenario, we forecast net income under Swiss accounting standards to range from CHF20 million-CHF25 million until 2021 and expect GLKB will maintain its dividend payout ratio at 50%-60%.

The bank is publicly traded with about 31.7% of shares sold to external investors. We expect this to limit its ongoing capital buildup, because it needs to provide its external owners with sufficient dividend payouts. As a risk-mitigating factor, we are confident that the majority owner, Glarus, will continue supporting GLKB's very strong capital position.

Table 3

Glarner Kantonalbank Capital And Earnings

		--Year ended Dec. 31--			
(%)	2019*	2018	2017	2016	2015
Tier 1 capital ratio	18.1	17.9	17.0	17.2	18.4
S&P Global Ratings' RAC ratio before diversification	N/A	23.8	23.0	23.3	N/A
S&P Global Ratings' RAC ratio after diversification	N/A	15.9	16.7	15.0	N/A
Adjusted common equity/total adjusted capital	75.2	75.2	75.2	75.2	75.2
Net interest income/operating revenues	74.3	76.0	75.2	74.0	74.7
Fee income/operating revenues	14.5	13.7	13.7	13.6	15.7
Market-sensitive income/operating revenues	8.0	8.8	9.5	9.2	8.4
Noninterest expenses/operating revenues	63.0	63.6	65.3	69.3	70.6
Preprovision operating income/average assets	0.5	0.5	0.5	0.4	0.4
Core earnings/average managed assets	0.4	0.4	0.4	0.3	0.4

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

Table 4

Glarner Kantonalbank RACF [Risk-Adjusted Capital Framework] Data

(CHF 000s)	Exposure*	Basel III RWA	Average Basel III RW(%)	S&P Global Ratings RWA	Average S&P Global Ratings RW (%)
Credit risk					
Government and central banks	727,501	7,025	1	1,100	0
Of which regional governments and local authorities	28,112	7,025	25	1,012	4
Institutions and CCPs	233,217	178,850	77	42,412	18
Corporate	515,012	371,450	72	339,663	66
Retail	4,554,925	1,934,775	42	1,114,644	24
Of which mortgage	4,418,458	1,814,938	41	1,024,640	23
Securitization§	0	0	0	0	0
Other assets†	0	0	0	0	0
Total credit risk	6,030,655	2,492,100	41	1,497,818	25
Credit valuation adjustment					
Total credit valuation adjustment	--	28,275	--	0	--
Market risk					
Equity in the banking book	9,776	61,100	625	73,320	750
Trading book market risk	--	4,825	--	7,238	--
Total market risk	--	65,925	--	80,558	--
Operational risk					
Total operational risk	--	130,488	--	161,108	--

Table 4

Glarner Kantonalbank RACF [Risk-Adjusted Capital Framework] Data (cont.)

(CHF 000s)	Exposure	Basel III RWA	Average Basel II RW (%)	S&P Global Ratings RWA	% of S&P Global Ratings RWA
Diversification adjustments					
RWA before diversification	--	2,870,525	--	1,739,484	100
Total diversification/concentration adjustments	--	--	--	858,229	49
RWA after diversification	--	2,870,525	--	2,597,713	149

(CHF 000s)	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	S&P Global Ratings RAC ratio (%)
Capital ratio				
Capital ratio before adjustments	513,434	17.9	413,615	23.8
Capital ratio after adjustments‡	513,434	17.9	413,615	15.9

*Exposure at default. §Securitization Exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' 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 2018', S&P Global Ratings.

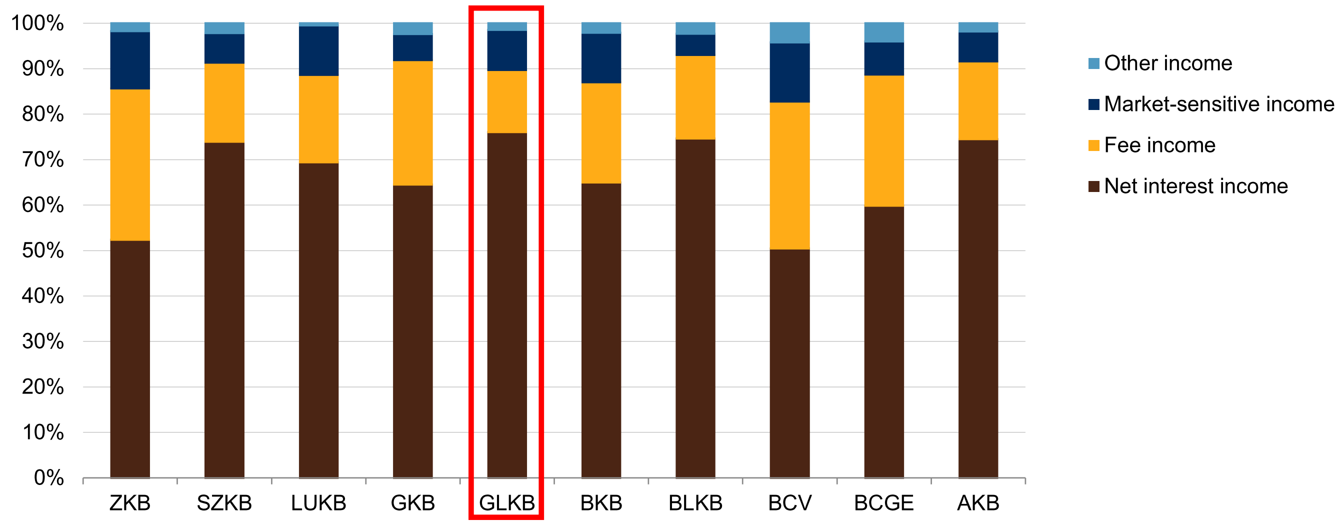
Risk position: Concentration in residential mortgage lending buffered by sound collateralization

GLKB's business model focuses on well-collateralized lending categories, such as mortgages, small and midsize enterprises, and consumer financing, with only minor reliance on market-sensitive business (see chart 4).

Chart 4

Breakdown Of Operating Revenues

GLKB shows highest dependency on interest income among rated peer cantonal banks



Data relates to FY-2018. AKB--Aargauische Kantonalbank. BCGE--Banque Cantonale de Geneve. BCV--Banque Cantonale Vaudoise. BLKB--Basellandschaftliche Kantonalbank. BKB--Basler Kantonalbank. GLKB--Glarner Kantonalbank. GKB--Graubuendner Kantonalbank. LUKB--Luzerner Kantonalbank. SZKB--Schwyzer Kantonalbank. ZKB--Zuercher Kantonalbank. Source: S&P Global Ratings.

The bank's mortgage loan portfolio represents more than 92% of its CHF5.2 billion loan book (as of Sept. 30, 2019), and consists mostly of loans collateralized by residential real estate loans (78% of total loans). Loans backed by commercial real estate account for about 10% of the total loan book.

Growth in customer loans has been significantly above market levels, at an average annual rate of about 6%-7% since 2010, because of GLKB's focus on business opportunities in neighboring regions mainly through online mortgage loans. That said, the bank maintains more restrictive conditions regarding the type of mortgages available on its online platform.

Although GLKB's organic loan growth has slowed down recently, we expect its loan book will continue to expand faster than the market average, also driven by purchases of Swiss mortgages portfolios from domestic insurance companies.

Despite offering online mortgages nationwide, the bank's regional concentration in mortgage lending remains significant, especially when accounting for exposure to the nearby Canton of Zurich and Glarus' direct neighbors. We believe it exposes GLKB to concentration risks, which are partially offset by high collateralization of the mortgage loan portfolio (estimated average loan-to-value ratio of 52% for mortgage loans).

We think that the housing price increases in Switzerland in the past heightened the risk of correction and subsequently could hamper GLKB's sound asset quality. Positively, the bank mostly avoids complex products, and we expect it to maintain its sound underwriting practices in new mortgage lending, helping it continue reporting low levels of nonperforming loans (NPL; 90 days past due) in its loan book (about 0.1% of the total at Dec. 31, 2018). This supports our estimate that the cost of risk remain below 20 basis points over the next two years, slightly below our estimate for Swiss market. GLKB has limited market risk, including mainly interest rate risk from mismatches in asset-liability management activities, but these are adequately hedged, in our view.

Table 5

Glarner Kantonalbank Risk Position

		--Year ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
Growth in customer loans	7.5	3.2	4.2	7.2	9.5
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	49.3	37.5	54.5	N/A
Total managed assets/adjusted common equity (x)	19.8	19.2	18.7	18.1	17.5
New loan loss provisions/average customer loans	0.1	0.1	0.0	0.0	0.0
Gross nonperforming assets/customer loans + other real estate owned	0.0	0.1	0.0	0.0	0.1

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

Funding and liquidity: Below-average metrics, but funding stability is aided by the cantonal guarantee

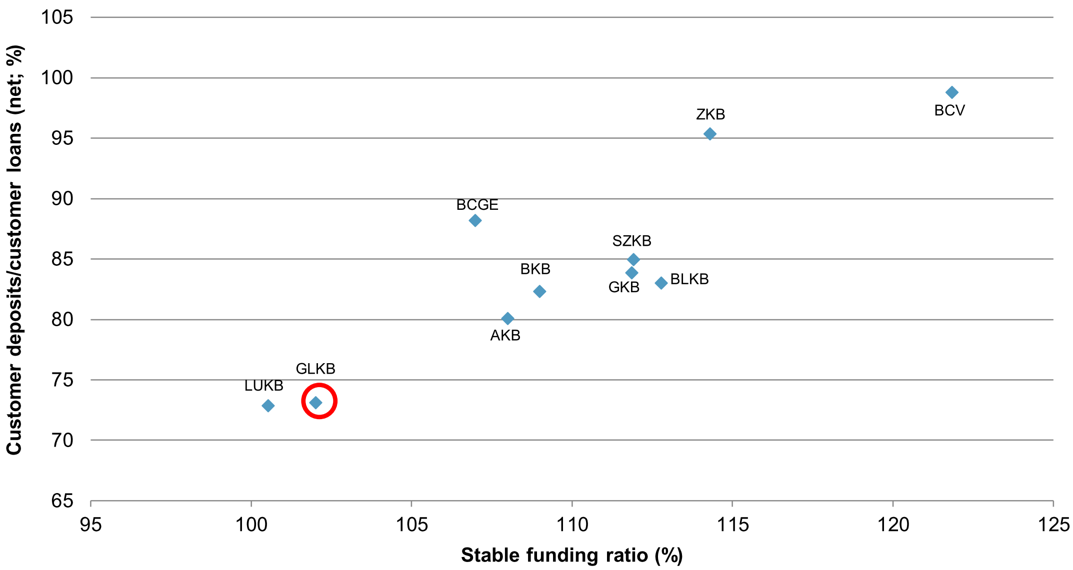
We view GLKB's funding profile as weaker compared with that of most domestic peers, because the bank has a high dependency on wholesale funding sources mainly through interbank and capital market funding (see chart 5). This is owing to a lack of sufficient customer deposits to fund ongoing strong balance sheet growth. Its ratio of customer loans to customer deposits will remain materially weaker than the average of rated peers, with the ratio hovering near 140%-145% over the coming years. This exposes the bank to the risk of not being able to replace maturing debt with new issuances during times of stress.

GLKB's core customer deposits account for 66% of its funding base. However, due to the cantonal guarantee, we expect this to remain very stable. We expect the bank's stable funding ratio will remain below 100% over the next few years--a level at the lower end compared with metrics of other rated cantonal banks.

Chart 5

Swiss Cantonal Banks' Funding Profile

GLKB is among the rated cantonal banks with the weakest funding metrics



BLAST ratio is calculated as broad liquid assets divided by short-term wholesale funding. Ratios as of Dec. 2018. AKB--Aargauische Kantonalbank. BCGE--Banque Cantonale de Geneve. BCV--Banque Cantonale Vaudoise. BLKB--Basellandschaftliche Kantonalbank. BKB--Basler Kantonalbank. GLKB--Glarner Kantonalbank. GKB--Graubuendner Kantonalbank. LUKB--Luzerner Kantonalbank. SZKB--Schwyzer Kantonalbank. ZKB--Zuercher Kantonalbank. Source: S&P Global Ratings.

GLKB benefits from its close ties with and the guarantee provided by Glarus. We expect the bank's access to liquidity to potentially benefit from a "flight to quality" effect in more challenging economic conditions. We see as supporting liquidity the bank's loyal customer deposit base, and we do not expect deposits will be withdrawn in large amounts in times of stress.

We expect the bank to maintain an adequate coverage of short-term wholesale funding sources of total funding by liquid assets (BLAST ratio) (1.1x). However, most peer cantonal banks demonstrate materially stronger metrics and GLKB's weaker liquidity ratio mirrors the bank's relatively lower amounts of cash reserves held at central banks and, in our view, a smaller and less liquid security portfolio than some peers. We also consider the risk that maturing debt issuances could drain a significant portion of GLKB's liquidity in a stress scenario. We see this risk as more pronounced than for peers, given the bank's small size but significant wholesale funding activities. Overall, we expect GLKB could operate for more than six months without access to market funding in an adverse scenario.

Table 6

Glarner Kantonalbank Funding And Liquidity

		--Year ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
Core deposits/funding base	62.9	66.5	66.2	68.3	70.0
Customer loans (net)/customer deposits	145.2	136.8	141.3	141.5	137.0
Long-term funding ratio	85.9	89.2	86.0	88.0	90.4
Stable funding ratio	97.8	102.0	96.3	95.2	98.2
Short-term wholesale funding/funding base	15.4	11.8	15.4	13.2	10.6
Broad liquid assets/short-term wholesale funding (x)	0.9	1.3	0.8	0.7	1.0
Net broad liquid assets/short-term customer deposits	(1.9)	5.1	(4.3)	(5.5)	(0.4)
Short-term wholesale funding/total wholesale funding	37.9	31.8	41.4	37.3	31.4
Narrow liquid assets/three-month wholesale funding (x)	3.3	4.8	1.6	1.5	1.8

*Data as of Sept. 30.

External support: Extremely high likelihood of extraordinary local government support

We consider GLKB a GRE. The long-term rating on the bank is four notches above the SACP, reflecting our view that there is an extremely high likelihood of timely and sufficient extraordinary support from Glarus, if needed. We base this on our view of the bank's integral link with and very important role for the canton, despite Glarus' reduced shareholding in GLKB after the IPO, and potential further dilution due to convertible bonds outstanding. According to cantonal law, the canton must hold more than 50% of shares and voting rights.

Our view on the likelihood of support is mainly based on GLKB's importance to Glarus' regional economy and the cantonal guarantee on all of the bank's liabilities, provided by law. We think a default by GLKB would have a significant systemic impact on the local economy.

Glarus' government has started the regular process to review the bank's ownership structure and strategy over its legislature period until 2022. We do not expect a proposal on the strategy before mid-2020 and note that any proposed change to the cantonal bank law, for instance, giving up majority ownership or the removal of the cantonal guarantee, would need to be approved by the people through vote. In our base-case scenario, we do not anticipate any material changes to the ownership structure or cantonal guarantee. That said, if material changes happen, we could decide to lower or remove the GRE status of the bank, if we conclude that it weakened the ties to the canton.

Additional rating factors: None

No additional factors affected the ratings.

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Hybrid Capital: Methodology And Assumptions, July 1, 2019
- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017

- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Banking Industry Country Risk Assessment Update: October 2019, Oct. 29, 2019
- Summary: Switzerland, Aug. 23, 2019
- Swiss Cantonal Banks: Ratings As High As The Alps, Jan 31, 2019

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 January 17, 2020)*	
Glarner Kantonalbank	
Issuer Credit Rating	AA/Stable/A-1+
Issuer Credit Ratings History	
09-Mar-2017	AA/Stable/A-1+
Sovereign Rating	
Switzerland	AAA/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and

Ratings Detail (As Of January 17, 2020)*(cont.)

debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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