S&P Global Ratings

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Glarner Kantonalbank

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Glarner Kantonalbank

SACP	a-

\+

Support	+4

\+

Additional Factors	0

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

ALAC Support	0
GRE Support	+4
Group Support	0
Sovereign Support	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. • Strong and stable retail banking franchise in the Canton of Glarus and a high quality loan book dominated by well-collateralized residential mortgages. • Very strong capitalization.	• Concentration risk because of a focus on residential mortgage lending in the home region and neighboring economic area, as well as less stable relationships with customers outside the home canton. • Weaker cost efficiency and profitability than cantonal peers. • Stronger reliance on wholesale funding activities than the rated cantonal peer group.

Outlook: Stable

The stable outlook on Swiss bank Glarner Kantonalbank (GLKB) reflects S&P Global Ratings' view that GLKB continues to benefit from being a government-related entity (GRE) with an extremely high likelihood of receiving support from the canton of Glarus over the next two years, if needed. Moreover, we consider that GLKB's capital and earnings offer a substantial buffer against potential domestic financial risks.

The likelihood of a downgrade is remote because, in the event of a multiple-notch deterioration of the stand-alone credit profile (SACP), the ratings would be cushioned by additional extraordinary support from the canton, assuming everything else remained equal. Nevertheless, a negative rating action may be triggered by a downward revision of our assessment of GLKB's role for or link with the canton of Glarus, or changes in the statutory guarantee, which may lead to our reassessment of GLKB's status as a GRE. However, we currently 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 revise downward our assessment of Glarus' creditworthiness.

An upgrade of GLKB could result if we revised upward the SACP by two notches, to 'aa-'. However, we regard this as a remote scenario, given the bank's comparatively concentrated business profile and its strong reliance on wholesale funding. In addition, all else remaining equal, we could raise the ratings on GLKB if we revised upward our assessment of Glarus' creditworthiness.

Rationale

Our ratings on GLKB reflect our 'a-' anchor for pure domestic Swiss banks, GLKB's moderate business position, very strong capital and earnings, adequate risk position, below average funding, and adequate liquidity. The SACP is at 'a-'. We consider GLKB to be a GRE with an extremely high likelihood of receiving timely and sufficient extraordinary support from canton of Glarus if needed. We base this opinion on GLKB's very important role for, and integral link with, the local government, the canton of Glarus. This provides a four-notch uplift to our assessment of GLKB's SACP, leading to the long-term rating of 'AA'. In our view, the Swiss bank resolution regime that came into effect on Jan. 1, 2016, does not impede cantonal owners' ability to provide extraordinary support to banks, like GLKB, that we consider to be GREs.

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

The anchor reflects GLKB's Swiss headquarters and its credit exposures, which are almost exclusively to Swiss-domiciled counterparties.

Our 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 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, it also reflects that risks have increased, owing to the cumulative rise in Swiss house prices and domestic lending over the past several years. Although these imbalances are still low in a global context, they have also led the regulator to enact macroprudential measures to rein in robust growth in mortgage indebtedness. We recognize that house price and lending growth have cooled since the beginning of 2014. However, in our view, house prices and household indebtedness remain historically high, in particular when considering the low rate of home ownership in Switzerland. The very high mortgage debt level is 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's stability and high share of deposit funding. Banks' net interest margins continue to decline gradually, given the pressure on deposit margins from the negative yield environment. This is partly offset, however, by higher margins on lending products, fee income from investment advisory-related activities, and cost management. As a result, banks are still able to generate returns on core banking products that are adequate to meet their cost of capital. Moreover, in our view, the Swiss regulator's regulatory initiatives are more stringent than those in other European banking industries.

Table 1

Glarner Kantonalbank Key Figures					
	--Year-ended Dec. 31--				
(Mil. CHF)	**2016**	**2015**	**2014**	**2013**	**2012**
Adjusted assets	5,276.7	4,987.0	4,475.4	4,014.2	3,669.6
Customer loans (gross)	4,570.8	4,297.9	3,926.8	3,634.4	3,282.1
Adjusted common equity	293.3	285.7	276.0	227.3	219.9
Operating revenues	65.8	61.7	57.0	52.8	49.2
Noninterest expenses	45.6	43.6	39.6	38.2	38.0
Core earnings	16.8	17.1	15.6	12.9	10.5

CHF--Swiss franc.

Business position: Stable franchise in Glarus but less stable client relationships outside its home area

We consider GLKB's business position to be moderate compared with that of other domestically focused Swiss banks.

GLKB is one of the smaller Swiss cantonal banks, with total assets of Swiss franc (CHF) 5.3 billion (€4.9 billion) as of Dec. 31, 2016. Like most of the other Swiss cantonal banks, GLKB is the leading commercial bank in its home canton. It mainly operates in residential mortgage lending in the canton of Glarus and neighboring economic areas, but also offers online mortgages in German-speaking Switzerland through its online platform, hypomat.

Given the canton of Glarus' smaller size and the bank's therefore limited business growth opportunities, the concentration of GLKB's mortgage book on its home canton is lower compared with peers but still significant, especially when also considering the exposure to the nearby canton of Zurich and Glarus' direct neighbors St. Gallen and Schwyz. We acknowledge that the bank has improved its regional diversification by offering online mortgages based on selective criteria, but the bank's geographic concentration still significantly exposes the bank's earnings to economic swings in the small economy of Glarus and its neighboring regions.

In our view, GLKB's primary focus on customer loan growth outside its home canton could lead to more price-sensitive and therefore less stable client relationships, compared with the very stable and long-standing customer base in Glarus, which, thanks to the guarantee from the canton, we expect to continue to provide GLKB with a sustainable source of revenues.

GLKB demonstrates slightly lower profitability ratios than peers and we consider that this is partly a consequence of the rapid strategy change following the bank's crisis in 2008, when under the new management team the bank replaced more risky uncollateralized corporate exposure by lower risk and lower yield assets. The bank also shows low and stagnating proportions of fee income and a high reliance on net interest income, to some extent still driven by significant drains of customer funds at that time. We also anticipate that GLKB's cost-efficiency ratio will hover at 67%-69% for the next two years, which is weaker than those of its main cantonal peers, with ratios typically at 50%-60%. We note that the bank accounts for coupon payments on its additional Tier 1 (AT1) capital as interest expense, which negatively distorts the ratio by about 5% compared with peers that have not issued such instruments.

On the positive side, under its new management GLKB has demonstrated sound profitability and increasing revenues since 2009, and we expect it will continue to do so. Net interest income currently accounts for 74% of operating revenues, followed by fee income (14%), market-sensitive income (9%), and other income (3%), a distribution of revenues that we expect the bank to maintain in the coming years.

GLKB is also engaging as a vendor of its self-developed online mortgage platform solution, which comprises different modules including elements for granting and administration of mortgages. While we consider this as positive evidence that the bank is proactively executing strategic initiatives in order to cope with the changing landscape in the retail banking industry, we currently do not consider this business as sufficient to provide substantial diversification in terms of risk and earnings. We also believe that this initiative might cannibalize the bank's own online mortgage offerings to some extent, which could result in lower growth opportunities compared with previous years.

GLKB went public via an IPO in 2014 and the canton of Glarus currently holds 68.3% of shares and voting rights. According to cantonal laws, the canton needs to keep more than 50% of shares and voting rights, and we therefore believe that the majority shareholder still provides the bank with some business stability. However, we also believe that it puts the bank under slightly more pressure to report sufficient returns on equity to satisfy its external owners.

Table 2

Glarner Kantonalbank Business Position					
	--Year-ended Dec. 31--				
(%)	2016	2015	2014	2013	2012
Total revenues from business line (mil. CHF)	66.7	64.8	57.1	52.8	49.7
Other revenues/total revenues from business line	100.0	100.0	100.0	100.0	100.0
Return on equity	5.9	6.9	6.1	5.6	5.0

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

We assess GLKB's capital and earnings as very strong compared with banks we rate globally. This is based on our expectation that GLKB's risk-adjusted capital ratio (RAC) will stay in the range of 20%-22% over the next 18-24 months, compared with 21.7% as of Sept. 30, 2016. The anticipated decrease in the RAC ratio mainly results from our expectation of 5%-7% annual growth in our risk-weighted assets metric in 2017-2018, which will exceed capital build up through retained earnings over that period. However, this will still allow the bank to maintain a RAC ratio that is very strong in a global comparison.

GLKB's regulatory core equity Tier 1 ratio stood at 17.4% at end-September 2016. In the recent past, the bank has improved its capital base by several means to support expected business growth over the coming years. GLKB issued two AT1 hybrid capital instruments totaling CHF170 million (notional) in 2012 and 2015. In 2011, GLKB also issued CHF40 million of subordinated convertible loans that can be converted into common equity in 2021, but which we do not currently take into account in our calculation of GLKB's total adjusted capital (TAC). In 2014, GLKB increased its capital by a further CHF35 million and went public via an IPO. The canton of Glarus sold about 31.7% of shares to external investors.

We assess the quality of capital mainly through the proportion of AT1 hybrid capital instruments in TAC. This proportion is higher for GLKB (25%) compared with most cantonal peers and we therefore assess GLKB's capital quality as lower. At most peer cantonal banks, TAC consists solely of share capital, share surplus, and reserves, which we consider of better quality.

We expect GLKB to maintain a conservative dividend payout ratio of about 50% and therefore to generate some internal capital to mitigate the negative impact on the RAC ratio from ongoing customer loan growth. We understand, however, that, unlike other cantonal banks, GLKB faces constraints in its ongoing buildup of capital, because it needs to provide its external owners with reasonable dividend payouts. However, we are confident that the majority owner, the Canton of Glarus, will remain supportive of GLKB's very strong capital position.

In addition, we take into account the quality of the bank's earnings, supported by its stable return on assets and its likely stable earnings buffer, which measures the capacity for a bank's earnings to cover normalized losses. We estimate the earnings buffer at about 60 basis points of its risk-weighted assets. We expect the earnings buffer will remain at this level over the medium term, which is lower than the average for cantonal banks we rate.

Table 3

Glarner Kantonalbank Capital And Earnings

	--Year-ended Dec. 31--				
(%)	2016	2015	2014	2013	2012
Tier 1 capital ratio	17.2	18.4	15.0	N/A	N/A
S&P RAC ratio before diversification	21.7	N.M.	N.M.	N.M.	N.M.
S&P RAC ratio after diversification	16.3	N.M.	N.M.	N.M.	N.M.
Adjusted common equity/total adjusted capital	75.2	75.2	79.8	100.0	100.0
Net interest income/operating revenues	74.0	74.7	75.9	73.4	72.9
Fee income/operating revenues	13.6	15.7	17.9	19.3	18.5
Market-sensitive income/operating revenues	9.2	8.4	6.0	6.7	7.6
Noninterest expenses/operating revenues	69.3	70.6	69.5	72.5	77.2
Preprovision operating income/average assets	0.4	0.4	0.4	0.4	0.3
Core earnings/average managed assets	0.3	0.4	0.4	0.3	0.3

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Table 4

Glarner Kantonalbank 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	476,108	4,738	1	14,379	3
Institutions	192,369	122,888	64	37,833	20
Corporate	664,314	499,225	75	475,882	72
Retail	4,057,126	1,766,900	44	995,931	25
Of which mortgage	4,004,160	1,713,938	43	960,998	24
Securitization§	0	0	0	0	0
Other assets	0	0	0	0	0
Total credit risk	5,389,917	2,393,750	44	1,524,025	28
Market risk					
Equity in the banking book†	18,308	96,913	529	125,868	688
Trading book market risk	--	1,650	--	2,475	--
Total market risk	--	98,563	--	128,343	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	110,038	--	127,868	--
(CHF 000s)		**Basel III RWA**		**S&P Global Ratings RWA**	**% of S&P Global Ratings RWA**
Diversification adjustments					
RWA before diversification		2,615,075		1,780,235	100
Total Diversification/Concentration Adjustments		--		594,016	33
RWA after diversification		2,615,075		2,374,251	133
(CHF 000s)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		455,996	17.4	386,879	21.7
Capital ratio after adjustments‡		455,996	17.4	386,879	16.3

*Exposure at default. §Securitisation exposure includes the securitisation 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 Sept. 30, 2016, S&P Global Ratings.

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

We consider GLKB's risk position to be adequate, owing to its business model, which focuses mainly on low-risk collateralized residential mortgage lending, and to a lesser extent on lending to small and midsize companies and consumer financing based on prudential underwriting standards.

GLKB's loan book of CHF4.6 billion at end-December 2016, which is dominated by residential real estate loans in the Canton of Glarus and neighboring regions, will, in our view, continue to show strong asset quality. GLKB's mortgage loan portfolio represents more than 92% of the loan book and consists mostly of loans collateralized by residential real estate loans (77% of total loans). Loans backed by commercial real estate account for about 15% of the total loan book.

Growth in customer loans has been significantly above the market at an average annual rate of about 7% since 2010, also due to GLKB's increased focus on business opportunities in neighboring regions and its countrywide offering of selective online mortgage loans. We expect the loan book will continue to expand faster than the market average but at a somewhat slower pace than in previous years. We also acknowledge that the bank has more conservative underwriting standards in new mortgage lending outside its home economic area and more restrictive conditions regarding the type of mortgages available on its online platform.

We consider that the regional focus of the loan book exposes the bank to concentration risks, which are partly offset by high collateralization of the mortgage loan portfolio (estimated average loan-to-value ratio of 55% for mortgage loans). We think that the housing price increases in Switzerland over the past several years will likely heighten the risks of correction and subsequently could hamper GLKB's current sound asset quality. Residential real estate price increases in Glarus have been lower than the Swiss average in the past but are now catching up to some extent. GLKB is also exposed in Swiss hot spots like the canton of Zurich, and we also believe that there exists some positive correlation between the housing markets in Glarus and Zurich, given their proximity.

Positively, GLBK mostly avoids complex products and we expect the bank to maintain its conservative underwriting practices in new mortgage lending, helping it to continue reporting low levels of nonperforming loans in its loan book (0.1% as of end-2015). This supports our estimate that the cost of risk will be less than 5 bps over the next two years, which we expect to be slightly below the industry average. GLKB has limited market risk comprising 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--				
(%)	**2016**	**2015**	**2014**	**2013**	**2012**
Growth in customer loans	6.3	9.5	8.0	10.7	8.8
Total managed assets/adjusted common equity (x)	18.0	17.5	16.2	17.7	16.7
New loan loss provisions/average customer loans	N/A	0.0	0.0	0.0	0.0
Gross nonperforming assets/customer loans + other real estate owned	N/A	0.1	0.2	0.3	0.7

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Funding and liquidity: Below average metrics, but supported by the cantonal guarantee

We assess GLKB's funding as below average and the bank's liquidity is adequate, in our opinion.

We expect that the amount of customer loans will continue to exceed deposits, with the ratio staying between 135% and 140%, which is significantly higher than that of rated peers and indicates GLKB's stronger dependency on wholesale funding and a lack of sufficient stable customer deposits to fund ongoing balance-sheet growth. This significantly exposes the bank to the risk that maturing debt cannot be adequately replaced by new issuances during times of stress. The bank's core customer deposits account for 68% of its funding base. Due to the cantonal guarantee, we expect GLKB's customer deposits in its home canton will remain very stable.

The remainder of the funding mix is mainly interbank funding and capital market funding, via secured and unsecured instruments. We expect GLKB's stable funding ratio--S&P Global Ratings' measure of available long-term funding relative to long-term funding needs--will remain close to 100% over the next few years, which is at the lower end compared with metrics of other rated cantonal banks.

Our assessment of GLKB's liquidity as adequate, which is weaker than for most Swiss cantonal banks, reflects our estimate of the bank's sufficient but significantly lower ratio of broad liquid assets to short-term wholesale funding. This ratio was 1.0x for GLKB at year-end 2015. The liquidity ratio is weaker because of the bank's lower amounts of cash reserves held at central banks and, in our view, a smaller and less liquid security portfolio compared with peers. We also consider the risk that maturing debt issuances could drain a significant portion of GLKB's liquidity in a stress scenario, which we see as more material than for peers, given the bank's small size but significant wholesale funding activities.

However, we see as positive the bank's loyal customer deposit base; we do not expect deposits will be withdrawn in large amounts in times of stress. Moreover, we would expect GLKB to profit from any erosion of confidence at other Swiss financial institutions, given its close ties with and guarantee from the canton. We therefore expect it 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--				
(%)	**2016**	**2015**	**2014**	**2013**	**2012**
Core deposits/funding base	68.3	70.0	72.3	69.1	69.0
Customer loans (net)/customer deposits	141.5	137.0	133.8	141.0	140.6
Long term funding ratio	87.9	90.4	93.0	91.4	92.2
Stable funding ratio	95.2	98.6	N/A	N/A	N/A
Short-term wholesale funding/funding base	13.3	10.6	7.6	9.1	8.3
Broad liquid assets/short-term wholesale funding (x)	N/A	1.0	N/A	N/A	N/A
Net broad liquid assets/short-term customer deposits	(5.5)	0.2	N/A	N/A	N/A
Short-term wholesale funding/total wholesale funding	37.6	31.4	25.9	29.4	26.9
Narrow liquid assets/3-month wholesale funding (x)	1.3	1.8	N/A	N/A	N/A

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

External support: Extremely high likelihood of extraordinary local government support

We consider GLKB to be 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 its major shareholder, the Canton of Glarus, if needed. We base this on our view of the bank's integral link with and very important role for the canton, despite the canton's reduced shareholding in GLKB as a result of the recent IPO, and potential further dilution due to outstanding convertible bonds. According to cantonal law, the canton must hold more than 50% of shares and voting rights. Changes to the law would need to be approved through a referendum.

Our view on the likelihood of support is mainly based on GLKB's importance to the regional economy of the Canton of Glarus and the cantonal guarantee on all of the bank's liabilities, provided by cantonal law. We think a default by GLKB would have a significant systemic impact on the local economy. We do not anticipate any change to the bank's current integral link with and very important role for the canton in the medium term.

We believe that the prospect of extraordinary government support for Swiss banks is now uncertain, because Switzerland has implemented several legislative measures in recent years to address the "too big to fail" issue and has established a functioning resolution regime. However, we generally believe that resolution frameworks are less likely to impede the state owners' willingness to provide extraordinary support to GRE banks, including GLKB. Despite the reduced predictability of government support to systemically important commercial banks, we expect that the canton's government will remain highly supportive of GLKB. Furthermore, we believe the government has sufficient financial resources to support GLKB.

We don't expect that additional loss-absorbing capacity (ALAC) will result in uplift to our rating on the bank, as we see a resolution scenario for GLKB as unlikely because of its GRE status and its low systemic importance. Generally, we view the Swiss resolution regime as effective under our ALAC criteria as, among other factors, we believe it contains a well-defined bail-in process, under which authorities would permit nonviable systemically important banks to continue critical functions as going concerns following a bail-in of eligible liabilities.

Additional rating factors: None

No additional factors affect this rating.

Related Criteria And Research

Related Criteria

- 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: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 09, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 09, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions, Dec. 06, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- Banking Industry Country Risk Assessment: Switzerland, Sept. 2, 2016

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 March 9, 2017)

Glarner Kantonalbank	
Counterparty Credit Rating	AA/Stable/A-1+
Counterparty Credit Ratings History	
09-Mar-2017	AA/Stable/A-1+
Sovereign Rating	
Swiss Confederation	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 debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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