Research Update:

Switzerland-Based Bank Cler AG Rated 'A-'; Outlook Stable

October 19, 2020

Overview

- Bank Cler AG operates as a small residential mortgage-focused bank across Switzerland, with a slim branch network and a digital banking app.
- The bank's balancing of a physical and digital presence weighs on its operating efficiency and risk-adjusted profitability, despite improvements from synergies with Basler Kantonalbank.
- We believe that Bank Cler's very strong capitalization offsets its exposure to residential mortgages, in spite of some single-name concentrations.
- We are assigning our 'A-' long-term issuer credit rating to Bank Cler.
- The stable outlook reflects our view that the COVID-19 pandemic will not materially affect the Swiss housing market, and our expectations that Bank Cler will be able to improve efficiency, while retaining its very strong capital buffer in the next two years.

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Rating Action

On Oct. 19, 2020, S&P Global Ratings assigned its 'A-' long-term issuer credit rating to Switzerland-based Bank Cler AG. The outlook is stable.

Rationale

The rating balances our view of Bank Cler's small scale and concentration in Swiss residential mortgages, with its strong collateralization and outstanding capitalization. Its investments into the digital banking app Zak continue to weigh on the bank's operating efficiency and profitability, but position it well to benefit from gradually changing customers preferences in the future. We believe that Bank Cler's ownership by and partial integration into its parent Basler Kantonalbank (BKB; AA+/Stable/A-1+, with a stand-alone credit profile [SACP] of 'a') will lead to some cost synergies and implicit benefits to the bank's risk management and governance. We also expect BKB would provide support under most foreseeable circumstances, although the fact that Bank Cler does not fall under the cantonal guarantee and political implications around this topic raise doubts about the extent of potential group support.

We base our rating on Bank Cler on the 'a-' bank anchor for Swiss domestically focused banks under our Banking Industry Country Risk Assessment, reflecting our assessment of low economic and industry risk in the country.

Our view of Bank Cler's business strength is limited by its small size and market share, and its concentration on mortgage lending, which could make it less resilient in downturns than larger and better diversified peers. Bank Cler operates across Switzerland through a slim branch network of 31 locations and the banking app Zak, with more than 35,000 customers. Despite an increasing digital product range, including free accounts and cards as well as digital wealth management, this area will likely remain a customer acquisition tool for Bank Cler for some time, while it tries to cross sell more complex and profitable mortgage and wealth-management products via its branch network. The conservatism and loyalty of Swiss banking clients will, in our view, also lead to only gradually increasing client numbers and mean more time is required to monetize digital investments. Bank Cler's strong retail focus generates stable interest and fee income from its residential mortgage lending and wealth-management activities. However, the bank's low market share in the retail business and continuing margin pressure from competition and low interest rates will make expanding its mortgage-related revenue difficult. At the same time, we view positively management's efforts to gradually increase fee income from premium services in the banking app and cross sell wealth-management products to mortgage clients, which should ensure stable to slightly rising operating revenue, despite the uncertain environment.

Bank Cler has recently operated with below-average efficiency, mainly spurred by information technology (IT) investments to ramp up its digital banking app. The balancing of its physical and digital presence is reflected in a cost-to-income ratio of 76% in 2019. We expect this to improve to about 72% by 2022 but expect the bank will remain a negative outlier among peers for several years until its digitalization strategy plays out. We expect Bank Cler's earnings buffer, indicating its potential to buffer normalized losses with preprovision operating income, will remain below 50 basis points, a relatively weak level compared with that of similarly rated peers. This low efficiency and risk-adjusted profitability is a rating weakness and limits our view of relative business strength compared with peers.

We consider Bank Cler's capitalization a key rating strength. This takes into account our risk-adjusted capital ratio (RAC) of about 21% as of year-end 2019 and our expectation that it will remain at that level over the next two years. In our forecast, we also assume moderate mortgage growth of 1.5%-3.0% annually, with profitability offset by further reduction in the net interest margin to about 1%. Our base case includes our expectation that rising fee income and the gradual reduction in operating costs from synergies and automation should ensure gradual growth in operating income. This should allow Bank Cler to uphold its very strong capital base, while paying a constant dividend of Swiss franc (CHF) 30 million (about €28 million).

We see the bank's risk profile as largely in line with that of peers operating in Switzerland and other countries with similar economic risks. The assessment reflects our view on the robustness of the Swiss real estate sector and strong collateralization of the bank's lending, which mitigate our concerns over its high sensitivity to potential adverse scenarios. The inherent concentration in Swiss residential mortgages makes Bank Cler susceptible to tail risk. Due to the pandemic-induced recession, we expect Swiss real GDP to drop by 4.3% in 2020, followed by a recovery to 3.9% growth in 2021. We expect unemployment in Switzerland to increase to 3.4% in 2020 from 2.3% in 2019. Nevertheless, the effect on domestic real estate prices will likely be marginal and temporary, such that the trend of moderately increasing nominal house prices will likely persist. Bank Cler's exposure to commercial real estate accounts for less than 10% of the total mortgage book, but we believe it is more susceptible to loan losses in the current environment, despite relatively limited exposure to the hardest hit sectors. The predominance of fixed-rate mortgages makes Bank Cler prone to sudden interest rate increases, although overall sensitivity is in line with peers'.

We consider Bank Cler's asset quality average, given that 99% of its customer loans are conservatively collateralized by real estate. We are mindful of the inherent risk of house price decreases, a relatively larger share of buy-to-let mortgages, and some single-name concentrations. We understand that Bank Cler's largest exposures are predominantly collateralized by real estate portfolios, not single objects, which somewhat mitigates these concentration risks.

We expect Bank Cler to retain a sound funding and liquidity profile, benefitting from a stable customer franchise and low dependence on wholesale funding. It is a largely deposit-funded bank, with a high share of short-term current account and saving deposits, complemented by long-term covered bonds and some minor senior unsecured bonds. With deposit rates effectively floored at zero, we expect an increasing share of covered und unsecured bond funding. Its loan-to-deposit ratio of 129% and stable funding ratio of 106% as of year-end 2019 are largely in line with those of peers.

Liquidity is largely held at the Swiss National Bank. However, Bank Cler's net broad liquid assets (after deduction of wholesale maturities) to short-term customer deposits of 9% at year-end 2019 (9.5% in first-half 2020) is at the lower end of the peer group. To manage liquidity risk, Bank Cler performs daily stress tests for an idiosyncratic, market-wide, and combined stress scenario. We believe that Bank Cler could likely rely on BKB as a contingent funding source in times of short-term liquidity pressure. We expect BKB will preserve its ability to support Bank Cler due to its strong liquidity, which we expect will weather times of stress, since BKB would likely benefit from its cantonal guarantee and flight to quality in a market-wide stress scenario.

BKB bought a majority share in Bank Cler in 2000 and became the 100% owner in 2019, after acquiring Swiss retailer group Coop's stake. Through its full control, BKB benefits from Bank Cler's digital know-how and investments, while at the same time diversifying its concentrated footprint with business growth outside of its restricted home canton. Reflecting the strategic importance of Bank Cler to BKB and partial integration in the parent group, we see Bank Cler as a strategically important subsidiary and would expect some extraordinary support if needed. However, given the relatively strong stand-alone assessment of Bank Cler, we currently see the need for support as unlikely and do not incorporate any uplift in our current rating. At the same time, this expected support could provide a buffer to our rating on Bank Cler in case of a deterioration of the currently strong SACP. We could reflect this potential extraordinary support in rating uplift of up to three notches, capped at one notch below our SACP for BKB of 'a'. To estimate the extraordinary support potential, we look to our SACP on BKB and not the issuer credit rating, since we don't expect that cantonal support to BKB would extend to Bank Cler in case of need. Although BKB would have a strong interest in supporting its subsidiary, we are cautious about the political implications of support that would reduce BKB's stand-alone capitalization. Since Bank Cler does not fall under the cantonal guarantee that benefits BKB, we would expect political discussions that could limit the extent and timeliness of such support.

Outlook

The stable outlook reflects our expectation that the Swiss housing market will emerge largely unscathed from the pandemic-induced recession in 2020 and our expectations that Bank Cler will be able to improve efficiency, while retaining its very strong capital buffer over the coming 12-24 months.

Downside scenario

We consider a negative rating action as remote, since we would likely offset weaker stand-alone creditworthiness with support from BKB, so long as BKB maintains its stand-alone strengths and no doubts arise on the likelihood of support.

However, if we see materially rising credit losses in Bank Cler's mortgage book that would erode its profitability and indicate weaker asset quality than we currently assess, we could revise down the SACP. This could also be the case if operating efficiency does not improve while low interest rates or increasing competition continue to pressure margins.

Upside scenario

We consider an upgrade in the current environment remote. In the longer term, an upgrade could be spurred by successful execution of its digital banking strategy, along with stable growth of its branch-based business that would translate into material and sustainable improvements in operating efficiency and profitability.

We could also consider an upgrade if we revised our SACP on BKB upward, indicating stronger capacity to support Bank Cler if needed.

Ratings Score Snapshot

Issuer Credit Rating	A-/Stable/--
SACP	a-
Anchor	a-
Business Position	Weak (-2)
Capital and Earnings	Very strong (+2)
Risk Position	Adequate (0)
Funding and	Average (0) and
Liquidity	Adequate
Support	0
ALAC Support	0
GRE Support	0
Sovereign Support	0
Group Support	0
Additional Factors	0

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019

- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- Criteria | Financial Institutions | Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 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: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Tech Disruption In Retail Banking: Swiss Banks Are In No Rush To Become Digital Frontrunners, Feb. 13, 2020
- Basler Kantonalbank, Dec. 17, 2019
- Banking Industry Country Risk Assessment: Switzerland, Nov. 20, 2019

Ratings List

New Rating	
Bank Cler AG	
Issuer Credit Rating	A-/Stable/--