FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Canton of Zurich at 'AAA'; Outlook Stable

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Fitch Ratings - Frankfurt am Main - 18 Nov 2022: Fitch Ratings has affirmed the Swiss Canton of Zurich's Long-Term Foreign and Local Issuer Default Ratings (IDRs) at 'AAA' with Stable Outlook. A full list of rating actions is below.

Under its criteria for rating local and regional governments (LRGs), Fitch assesses Zurich's Standalone Credit Profile (SCP) at 'aaa', reflecting the canton's unchanged 'Stronger' risk profile and 'aaa' debt sustainability.

KEY RATING DRIVERS

Risk Profile: 'Stronger'

Zurich's risk profile reflects a 'Stronger' assessment of all six key risk factors. The 'Stronger' risk profile reflects a very low risk relative to international peers that the canton may see its ability to cover debt service by its operating balance weaken unexpectedly over 2022-2026 either because of revenue falling short of expectations, spending above expectations, or an unanticipated rise in liabilities or debt-service requirements.

Revenue Robustness: 'Stronger'

The canton's revenue sources are stable with growth prospects in line with national GDP growth. Tax revenue accounted for 42% of Zurich's operating revenue in 2021 and is based on moderately cyclical economic activities. Personal income tax (PIT), the largest single tax item, accounted for 73% of the canton's tax revenue. The other two main sources of the canton's operating revenue are transfers (33%) and fees, fines and other operating revenue (24%).

We assume all of the canton's operating revenue to be moderately cyclical, as proceeds from PIT do not necessarily move in tandem with the economic cycle while transfers and fees have shown only limited volatility in the past.

Zurich's operating revenue growth has been consistently in line with national nominal and deflated GDP growth. Zurich is the main contributor to Switzerland's GDP and has wealth levels materially above the average. The canton's GDP base is largely driven by the services and financial sectors, in particular banking, insurance and real estate. Operating revenue has been stable, even during the global financial crisis when banks in the canton suffered losses, as its taxes are largely driven by PIT.

Zurich can rely on a stable tax base, consisting of PIT and corporate income tax (CIT), transfers and fees. Both tax items show little volatility and have shown consistent growth. Charges and fees as well as transfers received have also shown a stable trend in line with cantonal GDP growth.

Revenue Adjustability: 'Stronger'

Fitch assesses Zurich's ability to generate additional revenue in response to possible economic downturn as 'Stronger', supported by the canton's high fiscal autonomy (in line with all Switzerland cantons) and particularly its tax leeway.

Swiss cantons have a high degree of autonomy and are independent from the central government. Cantons have some leeway in adjusting PIT and CIT rates. In the case of real need, Zurich has the theoretical leeway to adjust taxes as it is currently applying below-average PIT rates. However, we do not expect the canton to use this headroom unless it was to avoid a default.

Expenditure Sustainability: 'Stronger'

Zurich has a proven record of expenditure restraint. Spending growth is generally below revenue growth. A large part of the canton's main responsibilities is non-cyclical, such as education, healthcare, public safety and public transport.

Zurich's operating expenditure growth has generally been in line with that of operating revenue, resulting in an operating surplus. Zurich has effective budget rules in place and commits itself to a medium-term balanced budget over eight years. This is subject to review and if the medium-term surplus is not met, the cantonal government can call on all departments to review their operating expenditure and recommend savings.

Zurich has also had a good record of adjusting capex in case of need. The canton usually underspends its budgeted investments (2021: by 37%). We assume Zurich will cut capex in response to revenue decline and the canton has previously shown strong affordability of cutbacks.

Expenditure Adjustability: 'Stronger'

We assess the canton's ability to reduce spending in response to shrinking revenue as 'Stronger'. This is due to effective balanced-budget rules. Despite the canton's tax leeway, Zurich would first adjust operating spending to cope with a revenue decline. The canton has a strong record of cutting spending to achieve a medium-term balanced budget. The canton also has some leeway for smaller adjustments to cope with cyclical swings of revenue and the canton used to underperform its investment budget. For instance, based on financial data for 2019-2021, capex realised was on average been 19% below budget, reflecting the canton's fiscal flexibility.

Liabilities & Liquidity Robustness: 'Stronger'

Zurich has prudent debt management and established access to the capital market. Its debt is predominantly bonds with bullet repayment and none of its annual debt repayments exceeded 20% of its outstanding debt at end-2021. The canton is not exposed to floating rates and has no foreign-currency debt.

Zurich has a strong record of liquidity and its liquidity ratio covered debt servicing by at least 1x over the past decade. Zurich has high working-capital needs at the beginning of each budgetary year and therefore increases its short-term debt (to 10% of its total debt at end-2021), which usually declines to zero during the year.

The canton is exposed to contingent liabilities, which Fitch views as moderate risk. The largest single contingent liability stems from the guarantee Zurich provided to its fully-owned cantonal bank, Zuercher Kantonalbank (ZKB; AAA/Stable). This incorporates the bank's liabilities of CHF34.2 billion at end-2021, but we assume the canton would support the bank through capital measures to prevent a default. Furthermore, the bank is supervised by the canton and its business profile is of limited risk.

In addition to ZKB, the canton had CHF1.6 billion of contingent liabilities at end-2021, with the bulk of it commitments to its employees. The canton also has a 100% share in two entities, with a moderate CHF214 million of liabilities at end-2021, which are of low risk.

Liabilities & Liquidity Flexibility: 'Stronger'

This assessment is based on Zurich's established access to funding in capital markets as a frequent bond issuer in the domestic market. Zurich is not focused on international placements, as demand for its debt is fully satisfied in the domestic market with its most recent bonds placed at negative rates. Zurich has sufficient liquidity, including a committed credit line with ZKB, to usually cover annual debt repayment needs. In severe financial distress, which we deem to be very unlikely considering the canton's credit strength, we assume the Bund would provide emergency liquidity.

Debt Sustainability: '
DS is recommended to be assessed in the 'aaa' category

The assessment of the Canton of Zurich is driven by its ELB assessed at 17.1%, corresponding to the 'aaa' category, a debt payback of 8.8x (aa), SDCR of 1.5x (a) and a FDB of 33.2% (aaa).

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Fitch views Swiss cantons as a type A LRGs under its criteria, given that their main spending responsibilities cover health, education and social spending, with a material share of general government expenditure and debt, and fiscal imbalances. Consequently, their primary debt sustainability metric is the economic liability burden, which is strongly related to central government debt.

In Fitch's rating case, Zurich's economic liability burden will slightly increase to 17.1% in 2026, corresponding to a 'aaa' assessment, from 16.5% in 2021. Debt payback is expected to increase to 8.8x in 2026 from 5.2x in 2021, the synthetic debt service coverage ratio (DSCR) to decline to 1.5x from 2.7x and the fiscal debt burden to increase to 33.2% from 24.8%.

Our rating case expects debt to increase to almost CHF8.1 billion by 2026 from CHF5.0 billion in 2021, assuming an operating balance consistently below the last five-year average and large annual investments of about CHF1.4 billion per year on average during the same period. This would lead to a slight increase in the canton's economic liability burden.

DERIVATION SUMMARY

Zurich's SCP is 'aaa', based on a 'Stronger' risk profile and 'aaa' debt sustainability under our rating case. The IDRs are not capped by Switzerland's ratings and are not affected by rating factors other than those mentioned above.

Debt Ratings

Fitch rates Zurich's senior unsecured debt at 'AAA'.

Qualitative assumptions:

Risk Profile:

Revenue Robustness:

Revenue Adjustability:

Expenditure Sustainability:

Expenditure Adjustability:

Liabilities and Liquidity Robustness:

Liabilities and Liquidity Flexibility:

Debt sustainability:

Support (Budget Loans):

Support (Ad Hoc):

Asymmetric Risk:

Sovereign Cap:

Sovereign Floor:

Quantitative assumptions - Issuer Specific

Fitch's rating case is a "through-the-cycle" scenario, which incorporates a combination of revenue, cost and financial risk stresses. It is based on 2017-2021 figures and 2022-2026 projected ratios. The key assumptions for the scenario include:

- Tax revenue to grow by 2.6% in 2022-2026

- Transfers to decrease by 2.2% in 2022-2026, as we assume this revenue item to scale back to the levels seen prior to the pandemic

- Fees, fines and other operating revenue to increase in line with the last five-year average growth rate

- Operating expenditure to increase 0.8% in 2022-2026

- Direct debt to increase CHF636.8 million

Liquidity and Debt Structure

Fitch's net adjusted debt comprises short- and long-term debt, amounting to CHF450 million and CHF4,237 million, respectively, at end-2020. We considered CHF264 million other Fitch-Classified Debt and we deducted the canton's cash of CHF510 million at end-2021, resulting in net adjusted debt of CHF4,441 million.

Issuer Profile

Zurich is located in the north-east of Switzerland and has around 1.6 million inhabitants, out of Switzerland's 8.8 million. It is the largest economy in Switzerland by far and its wealth level is well above the national average.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Given the canton's tax dynamics and tax-raising potential, a downgrade is unlikely. However, materialisation of the canton's contingent liabilities, or capital injections into its government-related entities raising the economic liability burden consistently above 40% and a corresponding weakening of the secondary metrics to below current levels, would lead to negative rating action.

Significant changes in the canton's financial leeway in either the intra- or inter-cantonal context, could also be rating negative.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The ratings are the highest level on Fitch's scale and cannot be upgraded.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Zurich's ratings are credit-linked to Switzerland's ratings (AAA/Stable/F1+).

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

References for Substantially Material Source Cited as Key Driver Rating

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Zurich, Canton of	LT IDR	AAA Rating Outlook Stable	Affirmed	AAA Rating Outlook Stable
	ST IDR	F1+	Affirmed	F1+
	LC LT IDR	AAA Rating Outlook Stable	Affirmed	AAA Rating Outlook Stable
senior unsecured	LT	AAA	Affirmed	AAA

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

International Local and Regional Governments Rating Criteria (pub. 03 Sep 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Zurich, Canton of	EU Issued, UK Endorsed

UNSOLICITED ISSUERS

Zurich, Canton of (Unsolicited)

With Rated Entity or Related Third Party Participation	Yes
With Access to Internal Documents	Yes
With Access to Management	Yes

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UNSOLICITED ISSUERS

ENTITY/SECURITY	ISIN/CUSIP	RATING TYPE	SOLICITATION STATUS
Zurich, Canton of CHF 190 mln 1.375% bond/note 06-Dec-2023	CH0224761533	Long Term Rating	Unsolicited
Zurich, Canton of CHF 300 mln 0.25% bond/note 12-Jul-2039	CH0484360380	Long Term Rating	Unsolicited
Zurich, Canton of CHF 450 mln Fixed bond/note 10-Nov-2033	CH1101096621	Long Term Rating	Unsolicited
Zurich, Canton of	-	Long Term Issuer Default	Unsolicited

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International Public Finance Supranationals, Subnationals, and Agencies Europe

Switzerland