S&P Global
Ratings

RatingsDirect®

Research Update:

Canton Of Zurich 'AAA' Ratings Affirmed; Outlook Stable

Primary Credit Analyst:
Thomas F Fischinger, Frankfurt (49) 69-33-999-243; thomas.fischinger@spglobal.com

Secondary Contact:
Michael Stroschein, Frankfurt (49) 69-33-999-251; michael.stroschein@spglobal.com

Table Of Contents

Research Update:

Canton Of Zurich 'AAA' Ratings Affirmed; Outlook Stable

Overview

- We believe the canton is well positioned to weather potential challenges to its budgetary performance.
- We anticipate that the canton will be able to maintain its overall low debt burden despite upcoming deficits after capital accounts.
- We are affirming our 'AAA' ratings on Zurich.
- The outlook is stable.

Rating Action

On Nov. 23, 2018, S&P Global Ratings affirmed its 'AAA' long-term issuer credit ratings on the Swiss Canton of Zurich. The outlook is stable.

We also affirmed our 'AAA' issue rating on Zurich's senior unsecured debt.

Outlook

The stable outlook reflects our expectation that the canton's financial management will successfully keep forecast deficits under control and limit debt intake. We believe that the canton will digest the effects of the imminent corporate tax reform without significant drawbacks to its budgetary performance.

Downside scenario

All other things remaining equal, we could lower the rating if the cantonal bank were to call upon the canton for support. However, we currently view this scenario as unlikely.

Rationale

The ratings on Zurich reflect the extremely predictable and supportive institutional framework for Swiss cantons. Zurich is by far the largest cantonal contributor to the Swiss equalization system. The canton benefits from excellent economic fundamentals, with very high GDP per capita and low unemployment rates compared globally. We regard the canton's financial situation as healthy, with low but rising debt and excellent liquidity. We see the potentially sizable contingent liabilities stemming from its guarantee for practically all liabilities of its cantonal bank Zuercher Kantonalbank (ZKB) as the canton's main credit risk; it is currently mitigated by the bank's high stand-alone creditworthiness.

Accounting for 21% of Swiss GDP, Zurich is an economic heavyweight

The institutional framework under which Swiss cantons operate provides equalization transfers to economically weaker cantons. Zurich is the largest of only seven cantonal contributors to weaker cantons due to its very favorable economic and financial profile. Following a system evaluation, the federal government, together with the cantons, is aiming to reduce the total distributions payable under the equalization system for donor cantons like Zurich by 2020. For 2019, the canton is obliged to pay Swiss franc (CHF) 487 million (about €430 million or equivalent to 3.2% of operating revenues) to other cantons.

The Swiss cantons' institutional framework is mature and extremely predictable, in our view, with major reforms being planned well in advance and widely discussed, notably between the Confederation and the cantons, and among the cantons themselves. The Swiss Confederation is currently preparing a nationwide corporate tax reform (TP17 or STAF, see "Related Research" below), which might take effect by 2020 if approved in a national referendum, likely to take place in May 2019. In short, the reform provides for the discontinuation of certain tax privileges of foreign holdings, domiciliary, and mixed companies. Zurich is less affected by the reform than other cantons as it collects only a negligible amount of taxes from these special-status companies, the canton may therefore predominately be affected by the second-round effects of the reform--that is, when other cantons change their tax codes or rates. In our view, the canton is adequately prepared to handle the reform's impact. Zurich's financial management includes the estimated effects of the tax reform in its financial planning till 2022 with lower tax revenues of about 1.2% of operating revenues, which we deem manageable.

Zurich has a very strong regional economy, with high wealth levels relative to national and international peers. We estimate Zurich's GDP per capita will reach more than CHF100,000 (about €88,000) in 2019, making the canton one of the wealthiest regions globally. The canton is Switzerland's financial center, and it contributes more than one-fifth of national gross value added. Unemployment is very low and declining, with 2.3% unemployed (September 2018), down 1 percentage point year-on-year. In light of the generally resilient economic structure in Switzerland and the canton, we do not expect unemployment rates of the canton to change structurally over the next few years.

All Swiss cantons have the right to set rates for income, wealth, corporate profit, and capital, granting Zurich high revenue flexibility. The canton's overall budgetary flexibility should enable it to weather changes in the medium term. Even though tax competition between cantons, as well as public opposition, might somewhat limit the canton's ability to raise taxes, the medium-term balancing requirement offsets this effect, and we anticipate that the canton's management would use its flexibility, if needed.

Less rosy budgetary times ahead

The canton outperformed its budget in 2017, as it did the year before, and achieved its second consecutive surplus after capital accounts. The actuals benefited from higher-than-budgeted tax revenues and higher dividends but also contained expenditures. We do not believe that the canton will be able to achieve surpluses after capital accounts, but our base-case assumes that the canton will be able to outperform its current financial planning due to its cautious budgeting approach.

We expect the average operating balance to remain below 5% of adjusted operating revenues and a small deficit after capital accounts of about 1% of adjusted total revenues on average over five years in our base-case scenario, up until 2020.
Overall, we view the canton's financial management as very strong, due to its approval-based annual budgeting process and very prudent long-term planning. Zurich's strong commitment to balancing accounts is seen in its medium-term balancing requirement, which calls for an automatic consolidation program if, for the rolling eight-year period of four previous and four future years, the accounts do not balance. The cantonal management does not employ derivatives, but two consolidated cantonal hospitals have signed four derivatives for hedging purposes. The supervisory board (Spitalrat) controls these contracts and has the right to sign potential new contracts without requiring prior approval from the cantonal finance department. We believe that the canton would ultimately bear the risk of such transactions. We view the signing of derivatives as an unusual task for a hospital's supervisory board, given that the members' knowhow and responsibilities are firmly in health care.

We expect Zurich's tax-supported debt ratio to increase slightly to levels just below 50% of operating revenues until 2021. The debt ratio will also depend on the canton's discretionary use of its ample cash reserves. Due to the pension fund's very high coverage ratio, we regard Zurich's unfunded pension liabilities as limited. The canton's cost of debt is very low, with negative interest rates for short-term borrowings and high demand for cantonal debt. As of end-September 2018, the canton has no debt at variable rates or denominated in foreign exchange, but may do so in future depending on management's risk appetite.

The canton has provided a legal guarantee for practically all of ZKB's liabilities, which we view as the canton's main contingent liability. The bank's balance sheet size is nearly 11 times the canton's total revenues, which we believe highlights the heavy impact that significant problems at the bank would have on the canton's creditworthiness. The bank is qualified as systemically important by the Swiss banking supervisory authority and therefore has to fulfill additional reporting and capital requirements. We currently see a very low likelihood that the canton would be called to support the bank, reflected in our assessment of the bank's stand-alone credit profile at 'aa-'. Consequently, we currently assess the canton's contingent liabilities as moderate.

We view Zurich's liquidity as exceptional. Our assessment takes into account the canton's high cash reserves and strong access to Switzerland's deep and liquid capital market. The canton's net free cash and committed credit line covers more than 2x the yearly debt service, benefiting from low debt falling due in 2019. We note that the canton has reduced the amount of liquid assets because cash holdings are costly for the canton due to the current interest rate environment in Switzerland. In our view, the canton has highly predictable cash flows, which form the basis of its liquidity planning. Yearly interest payments are low and stable at about 1% of operating revenues. Zurich plans for a minimum cash position of about CHF500 million, slightly below 4% of operating expenditures. We factor our view of the canton's access to external liquidity as strong into our assessment of its liquidity. This is in line with our favorable view of Switzerland's banking sector (see "Banking Industry Country Risk Assessment: Switzerland," published Nov. 6, 2017, on RatingsDirect).

Key Statistics

Table 1

Zurich (Canton of) Selected Indicators

	Fiscal year end Dec. 31							
CHF mil.	**2015**	**2016**	**2017**	**2018bc**	**2019bc**	**2020bc**	**2021bc**	**2022bc**
Operating revenues	14,175	14,597	15,000	15,193	15,391	15,800	15,805	16,002
Operating expenditures	13,674	13,620	14,004	14,611	14,975	15,163	15,434	15,693
Operating balance	500	978	996	582	416	637	371	309
Operating balance (% of operating revenues)	3.5	6.7	6.6	3.8	2.7	4.0	2.3	1.9
Capital revenues	29	56	41	41	37	39	49	36
Capital expenditures	1,184	729	959	1,004	1,049	1,051	969	953
Balance after capital accounts	(655)	304	78	(381)	(596)	(375)	(549)	(608)
Balance after capital accounts (% of total revenues)	(4.6)	2.1	0.5	(2.5)	(3.9)	(2.4)	(3.5)	(3.8)
Debt repaid	225	500	1,200	207	250	850	175	300
Gross borrowings	0	50	1,725	581	838	1,223	706	905
Balance after borrowings	(807)	119	647	0	0	0	0	0
Modifiable revenues (% of operating revenues)	71.4	73.6	70.5	72.3	71.1	70.6	71.9	73.4
Capital expenditures (% of total expenditures)	8.0	5.1	6.4	6.4	6.5	6.5	5.9	5.7
Direct debt (outstanding at year-end)	5,124	5,737	5,638	6,012	6,600	6,973	7,504	8,109
Direct debt (% of operating revenues)	36.1	39.3	37.6	39.6	42.9	44.1	47.5	50.7
Tax-supported debt (outstanding at year-end)	5,136	5,749	5,650	6,024	6,612	6,985	7,516	8,121

Table 1

Zurich (Canton of) Selected Indicators (cont.)								
	Fiscal year end Dec. 31							
CHF mil.	**2015**	**2016**	**2017**	**2018bc**	**2019bc**	**2020bc**	**2021bc**	**2022bc**
Tax-supported debt (% of consolidated operating revenues)	36.2	39.4	37.7	39.7	43.0	44.2	47.6	50.8
Interest (% of operating revenues)	1.3	0.7	0.7	0.6	0.5	0.5	0.5	0.6
Local GDP per capita (single units)	96,613	96,313	96,727	98,623	100,369	102,216	104,158	109,034
National GDP per capita (single units)	78,569	78,436	78,803	81,353	83,151	84,974	86,827	N.A.

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

Zurich (Canton of) Ratings Score Snapshot	
Key Rating Factors	
Institutional Framework	Extremely predictable and supportive
Economy	Very strong
Financial Management	Very strong
Budgetary Flexibility	Strong
Budgetary Performance	Average
Liquidity	Exceptional
Debt Burden	Low
Contingent Liabilities	Moderate

S&P Global Ratings bases its ratings on local and regional governments on the eight main rating factors listed in the table above. Section A of S&P Global Ratings' "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the foreign currency rating on the government.

Key Sovereign Statistics

- Switzerland Ratings Affirmed At 'AAA/A-1+'; Outlook Stable, Nov. 16, 2018

Related Criteria

- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- Criteria - Governments - International Public Finance: Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- International Public Finance Rating Trends: German, Austrian, And Swiss Local And Regional Governments, Oct. 22, 2018
- Will The Swiss Tax Reform Plan TP 17 Cost Some Cantons More Than Others? Aug. 29, 2018
- Default, Transition, and Recovery: 2017 Annual International Public Finance Default Study And Rating Transitions, June 11, 2018
- Switzerland Ratings Affirmed At 'AAA/A-1+'; Outlook Stable, Nov. 16, 2018
- Considerable Tax Inflows Will Curtail German, Swiss, And Austrian Local And Regional Government Borrowing In 2018, Feb. 22, 2018
- Banking Industry Country Risk Assessment: Switzerland, Nov. 6, 2017
- Institutional Framework Assessments For International Local And Regional Governments, Nov. 6, 2018
- Public Finance System Overview: Swiss Cantons, Nov. 20, 2018
- Sovereign Risk Indicators, Oct. 11, 2018. Interactive version available at http://www.spratings.com/sri

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research').

At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Ratings Affirmed

Zurich (Canton of)	
Issuer Credit Rating	AAA/Stable/--
Senior Unsecured	AAA

Additional Contact:
EMEA Sovereign and IPF; SovereignIPF@spglobal.com