FitchRatings

RATING ACTION COMMENTARY

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

Fri 10 Nov, 2023 - 5:02 PM ET

Fitch Ratings - Frankfurt am Main - 10 Nov 2023: Fitch Ratings has affirmed the Swiss Canton of Zurich's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'AAA' with Stable Outlook. A full list of rating actions is below.

The affirmation reflects Fitch's unchanged assessment of Zurich's Standalone Credit Profile (SCP) at 'aaa', reflecting the canton's 'Stronger' risk profile and 'aaa' debt sustainability under Fitch's Criteria for rating local and regional governments (LRGs).

KEY RATING DRIVERS

Risk Profile: 'Stronger'

Zurich's risk profile reflects the '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 2023-2027 either because of revenue falling short of expectations, spending above expectations, or an un-anticipated 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 44% of Zurich's operating revenue in 2022 and is based on moderately cyclical economic activities. Personal income tax (PIT), the largest single tax item, accounted for 74% of the canton's tax revenue. The other two main sources of the canton's operating revenues are transfers (31%) and fees, fines and other operating revenue (25%).

We assume the canton's operating revenue is moderately cyclical, as proceeds from PIT do not necessarily move in tandem with the economic cycle and have shown consistent growth while transfers and fees have shown only limited volatility. The announced shortfall of dividends from Swiss National Bank (SNB) in 2023 is manageable for Zurich, in Fitch's view, especially in light of the strong capacity to adjust expenditure. The canton used to underperform its investment budget (2022: by 13%), reflecting its fiscal flexibility. Dividends from SNB represented 4% of the canton's operating revenue in 2022.

Zurich is the main contributor to Switzerland's GDP and is showing well above average wealth levels. 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 in times of the financial crisis where banks in the canton faced losses, because taxes are largely driven by PIT.

Revenue Adjustability: 'Stronger'

Fitch assesses Zurich's ability to generate additional revenue in response to possible economic downturn as 'Stronger', supported by its high fiscal autonomy (in line with all Swiss 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 corporate income tax rates. In case of real need, Zurich has 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'

A large part of the canton's main responsibilities is non-cyclical, such as education, healthcare, public safety and public transport. Zurich has a proven record of expenditure restraint. 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 on its budgeted investments. 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. It 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 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 dominantly bonds with bullet repayment and none of its annual debt repayments exceeded 20% of its outstanding debt at end-2022. The canton is not exposed to floating rates and has no foreign-currency debt. Zurich has a strong record of liquidity and its liquidity coverage ratio covered debt servicing by at least 1x over the past years.

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/F1+). This incorporates the bank's liabilities of CHF21.6 billion at end-2022, 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 CHF1.9 billion of contingent liabilities at end-2022, with the bulk of its commitments to its employees.

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. Zurich has further sufficient liquidity, including a committed credit line with ZKB, to cover its annual debt repayment needs.

In severe financial distress, which we deem very unlikely considering the canton's credit strength, we assume the Bund would provide emergency liquidity.

Debt Sustainability: 'aaa category'

Fitch assesses debt sustainability (DS) in the 'aaa' category. The assessment is driven by Zurich's economic liability burden assessed at 13.4%, corresponding to the 'aaa' category, a payback ratio of 7.4x (aa), a synthetic debt service coverage ratio of 1.8x (a) and a fiscal debt burden of 31.8% (aaa).

Fitch views Swiss cantons as a type A LRG 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. Our rating case expects direct debt to increase to CHF7.3 billion by 2027 from CHF5.3 billion in 2022, assuming an operating balance consistently below the last five-year average and annual investments of about CHF1.3 billion on average.

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.

Debt Ratings

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

KEY ASSUMPTIONS

Risk Profile: 'Stronger'

Revenue Robustness: 'Stronger'

Revenue Adjustability: 'Stronger'

Expenditure Sustainability: 'Stronger'

Expenditure Adjustability: 'Stronger'

Liabilities and Liquidity Robustness: 'Stronger'

Liabilities and Liquidity Flexibility: 'Stronger'

Debt sustainability: 'aaa'

Support (Budget Loans): 'N/A'

Support (Ad Hoc): 'N/A'

Asymmetric Risk: 'N/A'

Rating Cap (LT IDR): 'AAA'

Rating Cap (LT LC IDR) 'AAA'

Rating Floor: 'N/A'

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 2018-2022 figures and 2023-2027 projected ratios. The key assumptions for the scenario include:

- Operating revenue to increase 1.2% yoy, including tax revenue growth of 2.6% yoy

- Transfers to grow by 0.8% yoy

- Operating expenditure to increase 1.5% yoy

- Net capital expenditure (average per year) of CHF1,158 million

Quantitative assumptions - Sovereign Related

Figures as per Fitch's sovereign actual for 2022 and forecast for 2023-2027, respectively (no weights and changes since the last review are included as none of these assumptions was material to the rating action):

Liquidity and Debt Structure

Fitch's net adjusted debt comprises short- and long-term debt, amounting to CHF932 million and CHF4,397 million, respectively, at end-2022. We considered CHF251 other Fitch-classified debt and we deducted the canton's cash of CHF1,284 million at end-2022, resulting in net adjusted debt of CHF4,297 million.

Issuer Profile

Zurich is located in the north-east of Switzerland and has around 1.6 million inhabitants, out of 8.8 million for Switzerland overall. 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 material weakening of the secondary metrics, would lead to negative rating action.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

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

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

DISCUSSION NOTE

Committee date: 06 November 2023

There was an appropriate quorum at the committee and the members confirmed that they were free from recusal. It was agreed that the data was sufficiently robust relative to its materiality. During the committee no material issues were raised that were not in the original committee package. The main rating factors under the relevant criteria were discussed by the committee members. The rating decision as discussed in this rating action commentary reflects the committee discussion.

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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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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