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Research Update:

S&PGR Affirms Swiss Canton of Basel-Country At 'AA+/A-1+'; Outlook Stable

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Research Update:

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Overview

- We recognize that the Canton of Basel-Country is making progress on implementing an ambitious cost-saving program, a process designed to sustainably stabilize operating performance and preserve its operating surplus.
- However, with significant ongoing regular capital expenditures and yet another pension fund recapitalization becoming necessary, the canton's already high debt ratio will inevitably display another rise.
- We are nevertheless affirming our 'AA+/A-1+' ratings on Basel-Country.
- The stable outlook reflects our expectation that Basel-Country will continue on its consolidation path, maintain exceptional liquidity and, assuming the absence of further one-off negative effects, stabilize its debt ratio at the (albeit increased and high) 2018 level.

Rating Action

On May 26, 2017, S&P Global Ratings affirmed its 'AA+/A-1+' long- and short-term issuer credit ratings on the Swiss Canton of Basel-Country. The outlook remains stable.

Outlook

The stable outlook reflects our expectation that Basel-Country will maintain exceptional liquidity and continue to display the recently improved performance of its operating budget. Our assessment rests on the canton's ongoing commitment to implementing consolidation measures also over the coming years. In our view, this should allow the canton to implement its capital spending program while posting only moderately negative results after capital accounts. Furthermore, we expect that with one more pension fund recapitalization foreseen for 2018, the canton will discharge practically all legal obligations for such lump sum contributions and will, hence, after one final hike, manage to keep its future debt ratio much more stable than in the past. This new more stable ratio will nevertheless be comparatively high.

Downside Scenario

We might consider a negative rating action if the canton's visible commitment to budget consolidation deteriorated, causing its operating margin to fall again into negative or close to negative territory, in turn producing a markedly weaker overall budgetary performance. The occurrence of large unforeseen extraordinary expenditure needs (e.g., in connection with the cantonal pension fund or its shareholdings and subsidiaries) could also put pressure on the rating if they caused a significant rise in the canton's debt ratio.

Upside Scenario

For us to consider a positive rating action, we would need to see the canton producing sizable surpluses after capital accounts that would be sufficient to quickly and sustainably push the cantonal debt ratio to much lower levels. In addition, we would need to revise up our opinion of financial management. However, we currently consider such a scenario as highly unlikely.

Rationale

We have incorporated Basel-Country's published 2016 results into our analysis, expanded the forecasting horizon by one year and updated our base-case scenario. Our opinion on the canton's expected budgetary performance is now slightly more positive than in our previous review.

The affirmation of the rating reflects our view that, thanks to the implementation of its fairly ambitious cost-saving program, and despite the set-back of yet another pension fund recapitalization becoming necessary, the canton should be able to post better budgetary results and a more stable, although higher, tax-supported debt ratio after 2018.

Strong institutional framework and economy, with the canton's financial management focusing on budget discipline

The canton operates in the wealthy, dynamic, diversified, and internationally integrated economy of the Basel region. Cantonal GDP per capita for 2016 is estimated at Swiss franc (CHF) 67,000 (about $68,000), which is very high in an international comparison. We expect Basel-Country's GDP to increase roughly in line with that of Switzerland. As an export-oriented economy with a high share of wholesaling and chemicals, as well as pharmaceuticals production, the Basel region is, however, exposed to the associated uncertainties that Switzerland generally faces. Among the most relevant are, in our view, foreign exchange-rate developments, the future of EU-Swiss relations, and the risk of more protectionism impacting global trade.

Basel-Country benefits from the advanced institutional framework under which Swiss cantons operate. In 2017, it is one of the 19 recipient cantons in the Swiss financial equalization mechanism. However, with its resource index at 96.2% being so close to the Swiss average, the equalization payments Basel-Country receives amount only to CHF17.6 million. Like all Swiss cantons, Basel-Country can set major tax rates, and these make up more than 60% of cantonal revenues. This has a positive influence on our assessment of budgetary flexibility. However, the cantonal government has publicly committed to raising taxes only as a measure of last resort, which limits the current practical relevance of this flexibility.

Since a Switzerland-wide public referendum rejected the proposed corporate tax reform "USR III" in February 2017, the canton's budget will be spared the associated tax losses of CHF23 million per year that had been planned for 2019 and thereafter. As of today, there is no visibility on the details of a "plan B" for a corporate tax reform, except that no implementation before 2021 is expected.

Our assessment of the canton's financial management is positively influenced by a perceived broad consensus--encompassing administration, parliament, and electorate--for budgetary discipline and the implementation of various significant cost-saving initiatives. We note that, thanks to the cantonal administration's detailed savings plan (132 items for a targeted total volume of CHF188 million), developed at the end of 2015 for the 2016-2019 period, measures worth roughly CHF75 million were already implemented in 2016. For those items recently rejected by the cantonal parliament (e.g., cuts to rural public transportation and limits on certain personal income tax deductibles), the administration is seeking replacements. Furthermore, we understand that through a proposed revision of various laws, the canton's financial administration aims to strengthen the transparency of and its control over the budget execution process, for example, by obtaining more powers to block expenditures, even when they were budgeted.

Basel-Country generally exercises tight control over its subsidiaries, but the targeted hospital consolidation jointly with neighboring Canton of Basel-City is proceeding slowly and is subject to political debate, as is the attempt to save on expenditures for the University of Basel (co-sponsored with Basel-City). The hospitals and the university are the most transfer-intensive cantonal subsidiaries.

Improved underlying operating performance superseded by yet another pension fund recapitalization

Excluding the extraordinary (and non-cash) provision for its pension fund (see below), 2016 marked another year where Basel-Country's operating margin (6.1%) increased materially against the same figure from its 2016 budget (1.2%) and from 2015 (3.7%). This improvement was mainly driven by higher-than-budgeted tax revenues, the receipt of twice the amount budgeted for the Swiss National Bank dividend, and greater proceeds from selling district heating assets. Tight controls over operating costs, for example CHF8 million lower expenditures for personnel versus budgeted amounts, also provided support. Nonetheless, CHF201 million of capital expenditures in 2016 still left the canton with a deficit after capital accounts of slightly over 1%.

For our 2017-2019 base case, we expect the various savings measures implemented to pay off and produce operating margins between 2.5% and 4.5%, sustainably in positive territory. However, with between CHF 240 million and CHF261 million annually in regular capital expenditures (largest items: higher education construction projects), we forecast negative balances after capital accounts (prior to extraordinary items) in the area of -5% to persist in 2017-2019. We consider that, although the canton's various fiscal initiatives help considerably, they might not be able to fully achieve its stated political objective of making Basel-Country capable of self-financing 100% of its capital expenditures solely from operating surpluses by 2020. Nevertheless, as we recognize a departure from the higher deficits of the past, we have revised up our assessment of the canton's underlying budgetary performance.

For 2018, another pension fund recapitalization will dominate operating and regular capital spending. The cantonal pension fund's recent decision to lower its technical interest rate with effect from January 2018 will, as of today and depending on market developments, create approximately CHF300 million of underfunding. Although the canton created an accounting provision already in its 2016 accounts, the cash injection to cure the deficit should actually take place in 2018 and amount to approximately CHF250 million, thanks to a CHF52 million valuation reserve remaining at the pension fund level. We capture the expected payment as additional capital expenditures in our 2018 base-case scenario. On the positive side, we understand that this payment will reduce the canton's "Arbeitgeberbeitragsreserve," effectively a legal obligation to fund shortfalls with cash injections, to near zero. Any future underfunding would then require the currently employed pension plan members and the canton to agree on either raising ongoing contributions or accepting lower future pensions.

Because of the pension fund recapitalization, we expect the canton's tax-supported debt ratio to once more climb significantly, reaching 141.5% of consolidated operating revenues by the end of 2019, which is a comparatively high value for a Swiss canton. However, following this jump and absent any large, new, negative surprises, we forecast a much more stable development thereafter. Nevertheless, Basel-Country will, in our view, have to resort to annual gross borrowing of CHF200 million-CHF400 million annually in 2017-2019, which is more than we previously estimated.

Basel-Country continues to benefit from exceptional liquidity. We calculate that cash of CHF305 million as of year-end 2016 covers 270% of the canton's estimated debt service of CHF71 million for the next 12 months (after accounting for other net liquidity needs). This is augmented by various credit lines, other available liquid financial assets, and excellent access of Basel-Country as an established bond issuer to the deep Swiss capital market for cantonal borrowers.

Next to some other, much smaller items, we consider Basellandschaftliche Kantonalbank (74% owned by Basel-Country, with statutory guarantee) to be the canton's largest contingent liability. However, given our assessment of the bank's stand-alone credit profile at 'a+', we currently regard the likelihood of the guarantee being called as low.

Key Statistics

Table 1

Canton of Basel-Country Key Statistics

	--Fiscal year ending Dec. 31--					
(Mil. CHF)	**2014**	**2015**	**2016**	**2017bc**	**2018bc**	**2019bc**
Selected Indicators						
Operating revenues	2,323	2,490	2,581	2,563	2,620	2,680
Operating expenditures	2,357	2,398	2,424	2,490	2,553	2,561
Operating balance	(34)	93	157	73	67	120
Operating balance (% of operating revenues)	(1.5)	3.7	6.1	2.9	2.5	4.5
Capital revenues	37	21	17	27	29	27

Table 1

Canton of Basel-Country Key Statistics (cont.)

	--Fiscal year ending Dec. 31--					
(Mil. CHF)	**2014**	**2015**	**2016**	**2017bc**	**2018bc**	**2019bc**
Capital expenditures	1,005	829	201	240	516	261
Balance after capital accounts	(1,003)	(716)	(28)	(139)	(420)	(114)
Balance after capital accounts (% of total revenues)	(42.5)	(28.5)	(1.1)	(5.4)	(15.9)	(4.2)
Debt repaid	150	100	50	25	0	150
Gross borrowings	1,200	950	30	200	400	250
Balance after borrowings	47	134	(78)	(13)	(73)	(32)
Modifiable revenues (% of operating revenues)	80.5	81.0	79.0	77.1	77.0	75.7
Capital expenditures (% of total expenditures)	29.9	25.7	7.7	8.8	16.8	9.2
Direct debt (outstanding at year-end)	2,447	3,136	3,117	3,292	3,692	3,792
Direct debt (% of operating revenues)	105.4	125.9	120.7	128.4	140.9	141.5
Tax-supported debt (outstanding at year-end)	2,447	3,136	3,117	3,292	3,692	3,792
Tax-supported debt (% of consolidated operating revenues)	105.4	125.9	120.7	128.4	140.9	141.5
Interest (% of operating revenues)	1.4	2.2	2.0	1.8	1.8	1.8
Local GDP per capita (CHF)	68,537	67,646	67,368	68,028	69,260	70,645
National GDP per capita (CHF)	78,148	77,526	77,229	77,974	79,311	80,825

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. CHF--Swiss franc. bc--Base case: reflects S&P Global Ratings' expectations of the most likely scenario.

Ratings Score Snapshot

Table 2

Canton of Basel-Country Ratings Score Snapshot

Key rating factors	
Institutional framework	Extremely predictable and supportive
Economy	Very strong
Financial management	Strong
Budgetary flexibility	Strong
Budgetary performance	Average
Liquidity	Exceptional
Debt burden	High
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 rating.

Key Sovereign Statistics

- Sovereign Risk Indicators – April 10, 2017. An interactive version is available at http://www.spratings.com/sri.

Related Criteria And Research

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07, 2017
- 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 - October 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Research Update: Switzerland Ratings Affirmed At 'AAA/A-1+'; Outlook Stable - May 19, 2017
- Refinancing Needs Continue To Dominate German, Swiss, And Austrian Local And Regional Government Borrowing In 2017 - February 23, 2017
- Default, Transition, and Recovery: 2016 Annual Non-U.S. Local And Regional Government Default Study And Rating Transitions - May 08, 2017
- Public Finance System Overview: Swiss Cantons- November 03, 2016
- Banking Industry Country Risk Assessment: Switzerland - September 02, 2016
- Full Analysis: Basellandschaftliche Kantonalbank - August 23, 2016
- Research Update: Swiss Canton of Basel-Country 'AA+/A-1+' Ratings Affirmed; Outlook Remains Stable - May 27, 2016
- Institutional Framework Assessments For Non-U.S. Local And Regional Governments - April 21, 2016

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 agreed that budgetary performance had improved. All other key rating factors were unchanged.

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

	Rating	
	To	From
Basel-Country (Canton of)		
Issuer Credit Rating		
Foreign and Local Currency	AA+/Stable/A-1+	AA+/Stable/A-1+
Senior Unsecured		
Local Currency	AA+	AA+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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