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Research Update:

Swiss Canton of Basel-Country 'AA+/A-1+' Ratings Affirmed; Outlook Remains Stable

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Overview

- Assuming a stable economic environment and recognizing the beneficial effects of past years' cost reductions as well as structural reforms, we now forecast moderately stronger operating surpluses and a progression toward balanced accounts after capital revenues and expenditures for the Canton of Basel-Country in 2018-2021.
- Thanks to improved budgetary performance, and with a smaller recapitalization requirement for its pension fund in 2019 than previously expected, we believe that the canton will be able to avoid net new borrowings until at least 2022, but instead make small debt repayments.
- We are affirming our 'AA+/A-1+' ratings on Basel-Country.
- The outlook remains stable.

Rating Action

On May 25, 2018, 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

Our stable outlook reflects the view that Basel-Country will, with the exception of 2019, display roughly balanced accounts after capital revenues and expenditures. The outlook factors in a reduced recapitalization requirement for the canton's pension fund and assumes no net new borrowing until at least 2022. Additionally, we expect the canton's administration to keep focusing on budgetary discipline, backed by electoral support for example in fiscally-related referendums.

Downside Scenario

We could lower our ratings on the canton if its operating margins reduced markedly, either as a result of a weaker commitment to fiscal discipline or due to adverse changes in the economic environment, which would lead to more negative balances after capital accounts and possibly rising debt levels. Additionally, large unforeseen expenditures (for instance in connection with the cantonal pension fund or its shareholdings and subsidiaries) could also put pressure on the ratings if they caused a significant rise in Basel-Country's debt ratio.

Upside Scenario

We might consider a positive rating action if the canton managed to repeat positive results after capital accounts, and this led to a faster reduction in the canton's debt ratio than we currently envisage. We would expect such improved performance to be also the result of stronger management practices. Additionally, we would require evidence that the canton had concluded the pension fund's recapitalization in a fiscally benign and sustainable way.

Rationale

We have analyzed Basel-Country's exceptionally strong recently-published 2017 results. While probably not repeatable to the same extent, we nonetheless recognize the beneficial impact of a strong economic backdrop and the sustainable effects of the various cost reduction and structural reform measures of recent years. We have accordingly improved our 2018-2021 forecast for budgetary performance.

With a more balanced budget, and under the assumption of a smaller pension fund recapitalization payment in 2019 than previously expected, we now believe that Basel-Country will manage to avoid the incurrence of net new debt until at least 2022, but instead make small repayments. We believe this to be well supported by the canton's current exceptional liquidity position.

The expected changes to the institutional framework for Swiss cantons from 2020 onward, namely the SV 17 tax reform proposal and a modification of the national fiscal equalization scheme, will create insignificant fiscal headwinds for Basel-Country, in our view.

Consolidation efforts are supported by the economic environment and institutional framework

Very similar to the Swiss national economy, we expect Basel-Country to experience an acceleration in real GDP growth to above 2% in 2018. GDP per capita should rise to about CHF70,000 ($70,000 equivalent), signaling the outstanding strength of the regional economy in an international comparison.

Structurally, Basel-Country's economy is characterized by the importance of its wholesaling, logistics, and chemicals and pharmaceutical sectors. The latter is responsible for over 90% of exported goods. However, with the headquarters of multinational pharmaceutical companies located in the neighboring Canton of Basel-City, Basel-Country actually relies on the income of individuals for over 70% of its aggregated tax base. This represents a higher proportion than in any other Swiss canton, but it should mitigate the effect of any business cycle fluctuations and the pending changes to corporate taxation rules on cantonal revenues.

We continue to consider increased global protectionism, failure to align the Swiss tax system with OECD rules and EU demands, and the potential of a sudden Swiss franc appreciation in response to external, non-Swiss events, to be the most relevant near-term risks to Basel-Country's economic performance.

The very beneficial and stable institutional framework for Basel-Country and the other Swiss cantons will likely witness two important changes over the coming years—namely the SV 17 tax proposal and a planned evolution of the Swiss national fiscal equalization scheme.

Subject to national parliamentary approval and likely a subsequent popular referendum on the topic, SV 17 (the successor to the USR III reform proposal that was rejected in a referendum in 2017) aims to preserve the attractiveness of Switzerland's corporate tax regime while maintaining compliance with OECD rules and EU demands. To do so, the current preferential tax treatment for special status companies will be abolished, but all the cantons have already announced that they will lower their general corporate tax rates (to varying degrees) from 2020 onward. Proposing to reduce the cantonal tax rate on corporate profits from up to 20.7% to uniformly 13.45%, and factoring in a higher share in federally collected taxes as partial compensation, Basel-Country's administration forecasts net tax revenue losses from the adoption of SV 17 to reach up to no more than CHF30 million per year.

As Basel-Country is only a marginal recipient of fiscal equalization payments (CHF18 million in 2017), we consider the targeted modification of the national fiscal equalization framework in 2020 to have only an insignificant impact on the canton's fiscal situation. Depending on which variant of the currently discussed reform proposal is implemented, the canton stands to lose or gain less than CHF10 million annually from the changes.

Our assessment of the canton's financial management is positively influenced by Basel-Country's demonstrated focus on cost containment, structural reforms, and efficiency gains over the past few years. For example, the canton managed to cut spending on personnel and health care between 2016 and 2017 by CHF4 million and CHF20 million, respectively. It agreed with neighboring Basel-City to create a joint hospital group to capture synergies and introduced new legal instruments to improve control over actual expenditure. Overall, the implementation of the cantonal administration's 132-item savings plan for 2016-2019 has already generated budgetary improvements of CHF103 million.

Beyond the various reform measures affecting spending, we positively note the canton's ability to alter applicable tax rates and multipliers. With revenues from cantonal taxes representing in excess of 60% of operating revenues, we consider Basel-Country's budgetary flexibility to be comparatively strong.

We believe that the electoral backing endures for the canton's chosen frugal path, although a referendum in March saw the transfer of CHF30 million to the canton's municipalities, and an initiative to cap health insurance premiums relative to income would, if accepted by the electorate on Nov. 25, 2018, cost the canton an additional CHF75 million annually.

Better operating margins and no new borrowings expected

Basel-Country's exceptional 2017 budgetary performance surprised positively. With, according to our cash-focused calculation methodology, an operating surplus of 11% and a positive balance after capital accounts of 6%, the canton clearly and significantly outperformed its own budgetary planning by several percentage points. We attribute this outperformance to the combined effect of a positive economic backdrop, various one-off events partially outside of the canton's direct control, and the past years' cost reduction measures bearing fruit. Tax revenues exceeding budgetary planning by CHF175 million and CHF82 million in budgeted capital expenditure not being executed in 2017 constitute the largest items in this respect.

Assuming the regional economy will remain strong and recognizing the permanent, structural nature of various reforms, we have improved our assessment of the canton's future budgetary performance moderately and now predict operating surpluses of 7%-8% over 2018-2021. This should allow the canton to achieve roughly balanced accounts after capital revenues and expenditures over the forecast horizon, except for 2019, when a recapitalization payment to the canton's pension fund will likely generate a deficit (on a modified-cash basis, i.e. with utilization of provisions not recognized).

We have modified our expectations concerning the timing and size of the required recapitalization of Basel-Country's pension fund. While previously we assumed a payment of about CHF250 million would still take place in 2018 (see "S&PGR Affirms Swiss Canton of Basel-Country At 'AA+/A-1+'; Outlook Stable," published May 26, 2017) we now understand that such a payment will only occur in 2019 and will likely be much smaller. This is the result of the pension fund's very strong 2017 performance (+8.2%). The exact recapitalization amount required will, however, only be determined by the fund's 2018 yield.

Basel-Country's improved budgetary performance and lower funding requirement for its pension fund will positively affect the canton's forecast debt ratio. We now assume that Basel-Country will not need to incur any net new borrowing until at least 2022. Rather, we expect small debt repayments to take place, partially funded by a reduction of the canton's currently elevated liquidity holdings. Accordingly, the absolute amount of outstanding debt should decrease marginally, while thanks to operating revenue growth its tax-supported debt ratio should start to fall toward about 110%.

The canton's liquidity position remains exceptional, in our view. We calculate that existing liquidity of CHF611 million as of end-March (consisting about evenly of cash in bank accounts and a credit balance with the Swiss Confederation) more than fully covers the next 12 months of debt service payments of CHF190 million. This is supported further by various existing counterparty credit lines as well as Basel-Country's established access to the deep Swiss bond market for cantonal borrowers.

We continue to regard Basellandschaftliche Kantonalbank (74% owned by Basel-Country, with a statutory guarantee and a stand-alone credit profile of 'a+') as the canton's most relevant contingent liability, primarily due to its balance sheet size relative to cantonal operating revenues. We also note in this context that the canton currently still has a legal obligation to assume any future funding shortfalls at its pension fund up to CHF329 million.

Key Statistics

Table 1

Canton of Basel-Country Key Statistics

	—Fiscal year end Dec. 31—						
(Mil. CHF)	**2015**	**2016**	**2017**	**2018bc**	**2019bc**	**2020bc**	**2021bc**
Operating revenues	2,490	2,579	2,763	2,669	2,683	2,675	2,697
Operating expenditures	2,392	2,424	2,449	2,484	2,492	2,478	2,471
Operating balance	98	155	314	184	192	197	226
Operating balance (% of operating revenues)	3.9	6.0	11.4	6.9	7.1	7.3	8.4
Capital revenues	20	17	15	24	47	76	60
Capital expenditures	829	201	161	245	333	279	270
Balance after capital accounts	(711)	(30)	168	(37)	(94)	(7)	15
Balance after capital accounts (% of total revenues)	(28.3)	(1.2)	6.1	(1.4)	(3.5)	(0.3)	0.6
Debt repaid	100	50	181	0	150	0	85
Gross borrowings	950	30	75	0	0	0	50
Balance after borrowings	130	(80)	26	(51)	(236)	4	(4)
Modifiable revenues (% of operating revenues)	78.9	77.8	75.6	75.7	76.6	77.1	78.3
Capital expenditures (% of total expenditures)	25.7	7.7	6.2	9.0	11.8	10.1	9.9
Direct debt (outstanding at year-end)	3,136	3,117	3,086	3,086	2,936	2,936	2,901
Direct debt (% of operating revenues)	125.9	120.9	111.7	115.6	109.4	109.8	107.6
Tax-supported debt (outstanding at year-end)	3,156	3,157	3,127	3,127	2,984	2,992	2,965
Tax-supported debt (% of consolidated operating revenues)	125.5	121.3	112.1	116.1	110.2	110.8	109.0
Interest (% of operating revenues)	1.9	1.8	1.5	1.5	1.3	1.2	1.2
Local GDP per capita (CHF)	68,730	68,517	68,812	70,161	71,402	72,716	74,098
National GDP per capita (CHF)	78,507	78,268	78,771	80,400	82,153	83,918	85,778

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. CHF—Swiss franc.

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	Strong
Liquidity	Exceptional
Debt burden	Moderate
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

- Sovereign Risk Indicators – April 10, 2018. An interactive version is available at http://www.spratings.com/sri.

Related Criteria And Research

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

Related Research

- Research Update: Switzerland Ratings Affirmed At 'AAA/A-1+'; Outlook Stable - May 18, 2018
- Considerable Tax Inflows Will Curtail German, Swiss, And Austrian Local And Regional Government Borrowing In 2018 - February 22, 2018
- Default, Transition, and Recovery: 2016 Annual Non-U.S. Local And RegionalGovernment Default Study And Rating Transitions - May 08, 2017
- Public Finance System Overview: Swiss Cantons- November 03, 2016
- Banking Industry Country Risk Assessment: Switzerland - November 06, 2017
- Basellandschaftliche Kantonalbank - November 02, 2017
- Research Update: S&PGR Affirms Swiss Canton of Basel-Country At 'AA+/A-1+'; Outlook Stable - May 26, 2017
- Institutional Framework Assessments For Non-U.S. Local And Regional Governments - September 21, 2017

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

	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.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website 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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