Research Update:

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

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PRIMARY CREDIT ANALYST

Michael Stroschein
Frankfurt
(49) 69-33-999-251
michael.stroschein@spglobal.com

SECONDARY CONTACTS

Stefan Keitel
Frankfurt
(49) 69-33-999-254
stefan.keitel@spglobal.com

Michelle Bozem
Frankfurt
michelle.bozem@spglobal.com

ADDITIONAL CONTACT

EMEA Sovereign and IPF
SovereignIPF@spglobal.com

Overview

- Although COVID-19-related effects will weigh on the Canton of Basel-Country's budgetary performance in 2020, the impact will be mitigated by the canton's relatively pandemic-resilient economy, and a taxation system that partially delays the expected dip in tax revenue to 2021.
- We anticipate fiscal outcomes will pick up again from 2022, but tax reform projects and capital expenditure (capex) will likely prevent the canton from achieving the very strong performance seen in the past three years.
- Overall, we forecast the canton will report only minor deficits after capex over 2020-2023.
- We are affirming our 'AA+/A-1+' ratings on Basel-Country. The outlook is stable.

Rating Action

On Nov. 6, 2020, 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.

We also affirmed our 'AA+' issue rating on the canton's senior unsecured debt.

Outlook

The stable outlook reflects our expectation that Basel-Country will incur only minor deficits after capex over our 2020-2023 forecast horizon, despite a temporary drop in results due to the fallout from COVID-19 and tax reform projects structurally weighing on performance. We anticipate the canton's ratio of direct debt to operating revenue will continue its very gradual decline. However, COVID-19's impact on revenue and a small amount of precautionary funding will mask this trend in 2020-2021.

Downside scenario

We could lower our ratings if Basel-Country's average budgetary performance deteriorated markedly beyond our current expectations, either because of weaker fiscal discipline or very adverse macroeconomic conditions persisting for longer than currently expected. This, together with any large unforeseen one-time expenditure, could constrain the ratings if it also caused a lasting rise in Basel-Country's debt.

Upside scenario

We might consider a positive rating action if the canton achieved structural surpluses after capital accounts. This could reflect stronger financial management and might eventually lead to a material reduction of the canton's debt.

Rationale

The immediate negative impact of the pandemic on Basel-Country's budgetary performance will be mitigated and spread over 2020 and 2021, thanks to the canton's taxation system partially delaying the expected dip in tax revenue. We anticipate fiscal recovery from 2022, but believe it will likely be muted by structural factors. These include the recent Swiss corporate tax reform, an intended realignment of the taxation of individuals, and planned capex. Overall, we forecast the canton to experience minor deficits after capex over 2020-2023.

Basel-Country displays a moderate-but-higher debt burden than most of its equally rated Swiss peers. This is largely the result of past capital injections into its now fully funded pension fund. Contingent liability risk, which includes majority ownership of and a statutory guarantee for Basellandschaftliche Kantonalbank (BLKB), weighs on our overall debt assessment.

Our ratings on Basel-Country are also underpinned by the canton's excellent liquidity, the general strength of its economy, with comparatively high resilience to the effects of the COVID-19 pandemic, and the supportiveness of the institutional framework for Swiss cantons.

Basel-Country is pursuing various structural reforms with attached costs, despite COVID-19 straining its economy

We expect Basel-Country's economy, and that of Switzerland, to weaken from the pandemic, but remain more resilient than many other European countries'. S&P Global Ratings' economists currently forecast Swiss national real GDP falling by 4.3% in 2020, before rebounding by 3.9% in 2021. However, our updated forecast also points out that new restrictions to combat a second wave of COVID-19 infections could weigh on the recovery (see "European Economic Snapshots: A Second COVID-19 Wave Is Dampening The Recovery," published Oct. 14, 2020, on RatingsDirect). Given that we forecast national GDP per capita exceeding Swiss franc (CHF) 80,000 (about $85,000) in 2020, Switzerland will, in any case, maintain a very strong economy.

We note several socioeconomic features of Basel-Country that should help render the canton's fiscal performance less susceptible to negative implications from the pandemic. First and foremost, this is the high relevance of pharmaceutical-related services and employment in Basel-City, which have not been materially hampered by COVID-19. As a residential canton, Basel-Country's tax revenue is made up of a higher share of taxes sourced from individuals, which tend to be more stable than corporate taxes, than almost any other Swiss canton.

Switzerland's economic assistance programs to mitigate the impact of COVID-19 are almost exclusively financed at the federal level, which, in our view, documents the strong supportiveness of the existing institutional framework for cantons. Primarily consisting of compensation for reduced working hours ("Kurzarbeitsentschädigung") and of federal guarantees for new bank loans to corporates, these programs amount to about CHF72 billion. Although they benefit indirectly, cantons are not required to contribute any financial resources to the federal programs. We understand that Basel-Country's own supplemental and self-funded local assistance program amounts to just CHF50 million of loan guarantees, of which only a fraction has actually been paid out; and another CHF50 million of nonrepayable budgetary funds, which have been disbursed almost fully.

The canton's financial management continues to pursue reforms designed to improve its economic competitiveness, despite related costs and COVID-19 weighing on the budget. Basel-Country has implemented the Swiss corporate tax reform TRAF (Federal Act on Tax Reform and AHV Financing) by starting to gradually reduce its general corporate tax rate, to 13.45% from 20.7% previously, until 2025, and by granting other tax breaks. Furthermore, we understand that the administration plans to realign the taxation of individuals' income by 2023 to make the canton a more attractive place of residence for higher-earning taxpayers. Overall, we expect Basel-Country's management to carefully balance long-term strategic initiatives with budgetary constraints.

Overall deficits should be very limited, despite weaker performance, changes in taxation, and capex

In our view, Basel-Country's budgetary results will drop significantly in 2020, and likely bottom out in 2021, before displaying a muted recovery from 2022. We moderately improved our forecast from earlier this year (see "Swiss Canton of Basel-Country 'AA+/A-1+' Ratings Affirmed; Outlook Stable ", published May 8, 2020) to incorporate the stronger-than-expected resilience of the canton's economy to the pandemic.

For 2020, we anticipate the canton's operating margin will fall by more than 7 percentage points when compared with 2019, mainly due to COVID-19-related effects. While this year's elevated Swiss National Bank profit distribution payment exceeded the budgeted amount by CHF67 million, it is unlikely to fully offset lower tax revenue and additional operating expenditure, for example on crisis management and pandemic-related economic assistance. Tax revenue for 2021 will likely be hit harder by COVID-19 than the previous year, due to collection and assessment mechanics. Tax prepayments for 2020, which were fixed ahead of the pandemic and hence too high, will be settled only in 2021 or even later. Effectively, this delays a large part of the impact of COVID-19 on the canton's revenue by about a year. We therefore predict Basel-Country's budgetary performance will mark its low point in 2021, with an operating margin of 4.4% and a deficit after capital accounts of 2.3% of revenue.

From 2022, we expect a muted recovery of Basel-Country's budgetary performance. In our view, the positive effects of better underlying economic growth will be damped by revenue losses from the tax reforms and a renewed focus on infrastructure investments. We understand that the TRAF corporate tax reform and plans to adjust individuals' taxation might eventually cause a joint structural revenue loss of up to CHF60 million per year. Still, we anticipate the canton will manage to limit deficits after capital accounts and return to practically balanced accounts at the end of our 2020-2023 forecast horizon.

The canton started 2020 with almost CHF350 million of cash and cash-like assets, no long-term debt maturities in 2020, and only CHF85 million due in 2021. Despite adding an assumed maximum outstanding volume of CHF200 million of occasional intrayear, short-term borrowing to our modelling, we continue to assess Basel-Country's liquidity as exceptional. This is significantly influenced by the volume of committed and uncommitted credit lines the canton has established with financial institutions, and its, in our view, strong access to the deep capital market for Swiss cantonal borrowers. The canton tapped an outstanding bond for CHF50 million in June 2020 to bolster reserves. We understand that the treasury management intends to liquidate its significant withholding tax receivables position with the central government, before returning to long-term capital market funding only in 2022.

We assume Basel-Country will maintain a moderate ratio of debt to operating revenue, before our adjustment for contingent liability risk. However, the canton's debt exceeds that of its equally rated domestic peers. A large part stems from past capital injections into the canton's pension fund, which is now fully funded. Reflecting our assumption of almost balanced accounts and revenue growth, we anticipate Basel-Country's debt will slowly decline toward 100% of operating revenue by 2023, after a small, COVID-19-related uptick in 2020. The canton follows a conservative debt-management approach, with predominantly fixed-rate, long-dated funding instruments and no foreign currency exposure.

Basel-Country's combined exposure to contingent liability risk weighs on our overall assessment of indebtedness. Although profitable and well capitalized, Basellandschaftliche Kantonalbank (BLKB) remains a key element of our contingent liability analysis, primarily due to its balance sheet size of almost 10x Basel-Country's operating revenue and the canton's statutory guarantee for practically all liabilities of BLKB. Other contingent liabilities are, in our view, of secondary importance from a cash flow perspective.

Key Statistics

Table 1

Canton of Basel-County -- Selected Indicators

	--Year ending Dec. 31--					
(Mil. CHF)	**2018**	**2019**	**2020bc**	**2021bc**	**2022bc**	**2023bc**
Operating revenues	2,772.8	2,843.8	2,755.1	2,766.6	2,760.5	2,782.0
Operating expenditures	2,489.5	2,477.3	2,612.4	2,643.5	2,587.7	2,597.9
Operating balance	283.4	366.5	142.7	123.1	172.8	184.1
Operating balance (% of operating revenues)	10.2	12.9	5.2	4.4	6.3	6.6
Capital revenues	28.0	20.5	18.3	18.1	29.7	24.0
Capital expenditures	320.1	183.1	186.0	205.5	206.8	227.5
Balance after capital accounts	(8.8)	203.9	(25.0)	(64.3)	(4.3)	(19.4)
Balance after capital accounts (% of total revenues)	(0.3)	7.1	(0.9)	(2.3)	(0.2)	(0.7)
Debt repaid	267.0	460.0	270.0	285.0	740.0	200.0
Gross borrowings	294.1	271.9	250.0	200.0	680.4	200.0
Balance after borrowings	(9.1)	3.9	(39.9)	(144.3)	(58.9)	(14.4)
Direct debt (outstanding at year-end)	3,075.1	2,887.6	2,937.6	2,852.6	2,792.6	2,792.6
Direct debt (% of operating revenues)	110.9	101.5	106.6	103.1	101.2	100.4
Tax-supported debt (outstanding at year-end)	3,095.6	2,901.6	2,976.6	2,885.1	2,833.7	2,835.9
Tax-supported debt (% of consolidated operating revenues)	110.4	100.8	106.6	102.9	101.3	100.6

Table 1

Canton of Basel-County -- Selected Indicators (cont.)

	--Year ending Dec. 31--					
(Mil. CHF)	2018	2019	2020bc	2021bc	2022bc	2023bc
Interest (% of operating revenues)	1.3	1.2	1.2	1.1	1.1	1.0
Local GDP per capita (single units)	73,189.5	73,401.8	69,812.4	72,723.6	75,174.4	77,038.7
National GDP per capita (single units)	84,219.3	84,466.4	80,338.1	83,712.9	86,553.2	88,714.6

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 -- Rating Score Snapshot

Key rating factors	
Institutional framework	1
Economy	1
Financial management	2
Budgetary perfomance	2
Liquidity	1
Debt burden	4
Stand-alone credit profile	aa+
Issuer credit rating	AA+

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Key Sovereign Statistics

- Sovereign Risk Indicators, Oct. 12, 2020. Interactive version available at http://www.spratings.com/sri

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- European Economic Snapshots: A Second COVID-19 Wave Is Dampening The Recovery, Oct. 14, 2020
- Institutional Framework Assessments For International Local And Regional Governments, Sept. 25, 2020
- Switzerland 'AAA/A-1+' Ratings Affirmed; Outlook Stable, Aug. 21, 2020
- Comparative Statistics: European Local And Regional Government Risk Indicators, June 30, 2020
- COVID-19 Will Test The Financial Flexibility Of LRGs In Germany, Switzerland, And Austria, April 27, 2020
- Swiss Cantons Will Receive Greater Payouts From SNB, But Will It Last?, March 3, 2020
- Local Government Debt In Germany, Switzerland, And Austria For 2020, March 2, 2020
- Basellandschaftliche Kantonalbank, Dec. 16, 2019
- Banking Industry Country Risk Assessment: Switzerland, Nov. 20, 2019
- Public Finance System Overview: Swiss Cantons, Nov. 20, 2018

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	
Basel-Country (Canton of)	
Issuer Credit Rating	AA+/Stable/A-1+
Senior Unsecured	AA+