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SOVEREIGNS

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ACRA AFFIRMS LT AAA TO SWITZERLAND, OUTLOOK STABLE

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ACRA has affirmed the following ratings to the Swiss Confederation (hereinafter, Switzerland, or the country) under the international scale:

- Long-term foreign currency credit rating at AAA and local currency credit rating at AAA.
- Short-term foreign currency credit rating at S1+ and local currency credit rating at S1+.

The outlook on the long-term foreign currency credit rating is Stable and local currency credit rating is Stable. The Stable outlook assumes that the rating will most likely stay unchanged within the 12 to 18-month horizon.

Positive rating assessment factors

- Very high level of wealth.
- Developed, diversified, innovative and competitive national economy.
- Moderate level of public debt and large domestic financial market.
- Strong banking sector with high level of resiliency to various shocks.
- Comparatively strong external position.
- Developed institutional base.

Negative rating assessment factors

- High level of private debt.
- Large size of the banking sector, which may potentially become a source of contingent liabilities for the government.

CREDIT RATING RATIONALE

Switzerland's AAA sovereign credit rating is based on a developed, diversified, innovative and competitive economic structure, a moderate level of public debt, and a comparatively strong external position. In ACRA's opinion, the risks of a high level of private debt and the large size of the banking sector, which may potentially become contingent liabilities for the government, are balanced by the high level of household assets, as well as the high quality of assets and capital adequacy of Swiss banks.

According to ACRA, the economy of Switzerland, one of the ten richest countries in the world in terms of GDP per capita, is expected to grow by 3.5% in 2021 and 2.9% in 2022 after contracting by around 2.5% in 2020. It is supported by the global recovery, as well as a high vaccination rate, although the number of new COVID-19 cases in the country has surged recently. The risks for this scenario are mutations of the virus (particularly Omicron) and lower resiliency of current vaccines to these variants. Due to recovering domestic demand, ACRA expects positive inflation in the near future. Therefore, the inflation rate is likely to be inside the 0–2% target corridor set by the Swiss National Bank (SNB). The risk of franc appreciation and subsequent deflationary pressures is addressed by the SNB by keeping its policy rate in negative territory and possibility undertaking interventions in the foreign exchange market when necessary.

Unlike many developed countries, after a relatively large anti-crisis package in 2020–21, Switzerland managed to preserve its room to maneuver for countercyclical budget policies in the future. ACRA expects the country's public debt to amount to 42.8% of GDP by the end of 2021, having recorded a modest debt increase compared to the onset of the pandemic — at the end of 2019, general government debt stood at a moderate 39.8% of GDP.

ACRA assumes that the strong fiscal rule at the federal level, which makes up almost a third of GG revenue, and historically good compliance with it, will trigger fiscal consolidation in the near term and gradual reduction of the public debt to its pre-pandemic level. The federal government's fiscal rule mandates balancing the budget throughout the business cycle by allowing for a certain level of deficit during times of recession and mandating surpluses during times of economic growth, while also making exceptions for extraordinary circumstances.

However, in the medium to long term, maintaining public debt at a moderate level may be challenged by the need to increase spending due to the country's population aging. In order to alleviate burden on the pension system, at the end of 2021 the Swiss parliament approved the increase of women's retirement age to 65 making it equal to that of men, and additional value-added tax rates which were introduced for this purpose. However, this reform is subject to public debate, being opposed by trade unions and political left.

Switzerland's external position is comparatively strong, it is supported by persistently high current account surpluses and a very high positive international investment position. However, if the public share were to be excluded from the latter, international investment position would be in negative territory, having consistently downward dynamics due to the attractiveness of the country to foreign investors and a more cautious approach to residents' investments abroad since the 2008 crisis. ACRA assumes Switzerland's export structure, which has a big share of pharmaceutical, chemicals and jewelry exports, will allow the country to maintain a current account surplus in 2021 and beyond in line with pre-pandemic levels.

A relatively high level of external debt coverage and investors' perception of the franc as a reserve currency also support the strength of the country's external position. ACRA notes that investors turn to franc-denominated assets during periods of global economic slowdown and heightened international uncertainty. This triggers appreciation of the franc, which in turn negatively affects Swiss exports due to their increased cost. It also creates deflationary pressure. To prevent this in 2020, the SNB resorted to monetary policy measures aimed at preventing the appreciation of the franc, including injecting francs into the market and accumulating foreign currency liquidity. These measures resulted in international reserves increasing to 144% of GDP at the end of 2020. However, this indicator is expected to amount to around 137% of GDP by the end of 2021 due to smaller volumes of FX purchases with less appreciation pressures on the national currency throughout last year and a higher GDP growth rate. Thus, interventions have been minor in 2021 with no substantial effect on the level of international reserves. The increased level of international reserves improved the outstanding total external debt coverage ratio from 43% at the beginning of 2020 to 47% at the end of Q2 2021 and that of short-term external debt from 83.8% to 87%, respectively.

Unlike the public sector, the debt load of Switzerland's private sector is rather high, which is associated with a prolonged period of low interest rates. By the end of Q2 2021, household debt amounted to 129% of GDP. This is high even when compared to other European countries with similar economic structures. The lion's share (about 90%) of household debt is made up of mortgage loans and only minor part is made up of consumer ones. The fact that mortgage lending is a significant part of portfolios held by some large banks may be problematic for the country's banking sector in the event of a sudden deep real estate price correction, if and when it happens. However, this risk is hedged by the high level of household wealth, which stood at 407% of GDP at the end of Q2 2021.

It is also worth noting that at the end of Q2 2021, the total volume of banking sector assets amounted to about 393% of nominal GDP. The sheer size of the banking sector poses a contingent liability risk and places Switzerland in the group of countries whose economies are highly dependent on the banking sector. The mitigating factors are high capital buffers maintained by the biggest banks and high asset quality. According to the latest Financial Stability Report compiled by the SNB, the Tier 1 capital ratio of the two major national banks, UBS and Credit Suisse, were 19.6 and 17.6, respectively, as of Q1 2021. The recent cases of Archegos and Greensill demonstrate the ability of Credit Suisse to absorb unexpected shocks financially, though reputational damage may take a bit longer to restore.

In ACRA's view, Switzerland can still be considered a "safe haven" due to the highest level of trust in public institutions and the authorities and high quality of public governance. Over the past ten years, Switzerland has had some of the highest and most stable World Governance Indicators (WGIs) as measured by the World Bank. This is a reflection of the high quality of institutional governance and the very favorable environment for allocating resources within the economy. However, the recent developments in negotiations between Switzerland and the EU over the framework agreement, which were halted until November 2021, when it was agreed that the dialogue should be restarted in 2022, create much uncertainty about country's future relationship with its major European partners.

SOVEREIGN MODEL APPLICATION RESULTS

Switzerland has been assigned an AA+ Indicative credit rating in accordance with the core part of ACRA's sovereign model. One of the modifiers in the modifiers part of the model allows the Indicative credit rating to be decreased. This includes the following, which is determined by the Methodology for Credit Rating Assignment to Sovereign Entities under the International Scale:

- Contingent liabilities and the risk of them materializing.

A positive adjustment has been made for the following modifiers:

- Sustainability of economic growth.
- Fiscal policy and budget flexibility.
- Debt sustainability and market access.
- Balance of payments stability.

In view of the abovementioned modifiers, Switzerland's Indicative credit rating has been raised. A Final credit rating of AAA has been assigned. There are no analytical adjustments and limitations that could result in an adjustment of the Final rating. In connection with this, the long-term foreign currency credit rating remains at AAA.

POTENTIAL OUTLOOK OR RATING CHANGE FACTORS

A negative rating action may be prompted by:

- Potentially serious financial shock for Switzerland's banking sector associated with a sudden deep price correction in the real estate market.

- Negative scenario of developments in the negotiations between Switzerland and the EU associated with higher trade costs and impeded cooperation in other spheres.

REGULATORY DISCLOSURE

The sovereign credit ratings have been assigned to the Swiss Confederation under the international scale based on the Methodology for Credit Rating Assignment to Sovereign Entities under the International Scale and the Key Concepts Used by the Analytical Credit Rating Agency Within the Scope of Its Rating Activities.

The sovereign credit ratings of the Swiss Confederation were published by ACRA for the first time on September 10, 2019. The sovereign credit ratings and their outlooks are expected to be revised within 182 days following the publication date of this press release as per the Calendar of sovereign credit rating revisions and publications.

The sovereign credit ratings are based on information from publicly available sources and ACRA's own databases. The sovereign credit ratings are unsolicited. The Swiss government did not participate in the credit rating assignment.

In assigning the credit ratings, ACRA used only information, the quality and reliability of which was, in ACRA's opinion, appropriate and sufficient to apply the methodologies.

ACRA provided no additional services to the Swiss government. No conflicts of interest were discovered in the course of the sovereign credit rating assignment.

The Analytical Credit Rating Agency (ACRA) was founded in 2015, with its 27 shareholders representing major Russian corporate and financial institutions and its authorized capital exceeding RUB 3 bln. ACRA's main objective is to provide the Russian financial market with high-quality rating products. Methodologies and internal documents of ACRA are developed in compliance with Russian legislation and with regard to global rating industry best practices.

The provided information, including, without limitation, credit and non-credit ratings, rating assessment factors, detailed credit analysis results, methodologies, models, forecasts, analytical reviews and materials, as well as other information placed on the ACRA website (further referred to as Information), coupled with the ACRA website software and other applications, are intended for information purposes only. Information must not be modified, reproduced or distributed by any means, in any way or form, either in whole, or in part, in marketing materials, as part of public relations events, in news bulletins, in commercial materials or reports without prior written consent from, and reference to, ACRA. Any use of Information in violation of these requirements or the law is prohibited.

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