Research Update:

Swiss Canton of Basel-City 'AAA/A-1+' Ratings Affirmed; Outlook Stable

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Overview

- In 2022, the Canton of Basel-City recorded a significantly above-budget operating margin but, once reported figures are adjusted for more than Swiss franc (CHF)450 million of real estate purchases, it also experienced a pronounced spike in capital expenditure.
- We anticipate operating margins will soften slightly, reflecting recent local tax policy decisions and current economic headwinds.
- Basel-City's capital expenditure plans, particularly on greener infrastructure and housing assets, imply moderate deficits after capital accounts for 2023-2025, and a debt burden that will rise slightly from the low point at year-end 2022.
- We have affirmed our 'AAA/A-1+' ratings on Basel-City and maintained the stable outlook.

Rating Action

On May 5, 2023, S&P Global Ratings affirmed its 'AAA/A-1+' long- and short-term issuer credit ratings on the Swiss Canton of Basel-City. The outlook remains stable.

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

Outlook

The stable outlook reflects our view that Basel-City will continue to achieve sound operating performance over the next few years, despite current economic headwinds, and contain the deficits that we anticipate will result from its capital expenditure program.

Downside scenario

We could lower the rating if the canton's management fails to exercise budgetary discipline and loosens its grip on financial performance more than we currently assume. This could include significantly elevated capital expenditure volumes, for example repeated, sizable (in relation to the canton's overall budget) real estate purchases for the canton's financial account, that cause a deterioration in budgetary performance and put the canton on a trajectory for a markedly higher debt burden. In addition, pressure on the rating would build if the cantonal bank calls on Basel-City for support.

Rationale

The ratings on Basel-City continue to reflect the extraordinary strengths of both the local and national economy and tax base, the beneficial institutional framework under which cantons operate, and the canton's experienced financial management. In our view, Basel-City retains exceptional access to funding and liquidity via a credit line with the cantonal bank and its status as an established issuer in the Swiss bond market. This allows the canton to pursue a substantial volume of capital expenditure and fund the associated moderate deficits after capital accounts, while maintaining its debt burden at a moderate level.

A supportive economy and institutional framework allow for an ambitious investment program

Our forecast for the Swiss economy remains muted, although we expect it to fare comparatively better than most neighbors. S&P Global Ratings currently expects national real GDP growth of 0.6% for 2023, recovering to 1.2% in 2024 and 1.7% in 2025. Inflation, even if currently high by Swiss standards, will likely only amount to 2.5% in 2023. We then expect it will level off further to 1.5% in 2024 and 2025. With an estimated national GDP per capita of about CHF89,000 (equivalent to about US$97,000) for 2023, Switzerland will remain one of the world's strongest economies in any case.

The pharmaceutical industry continues to form the backbone of Basel-City's extraordinary local economic strength. Comprising companies like Roche, Novartis, and Lonza (all headquartered in Basel-City) the sector is responsible for more than 40% of gross value added in the canton and a significant contributor to Basel-City's local GDP per capita of above CHF210,000 (almost US$230,000). We do not reflect the canton's exposure to the pharmaceutical industry as a source of volatility or concentration risk, as the sector has remained extremely resilient throughout all recent crises. Even if we disregarded pharmaceutical companies' contribution entirely, Basel-City would remain a very strong economy in an international comparison.

Basel-City will likely be one of the largest beneficiaries of the planned implementation of the OECD minimum tax rate in Switzerland from 2024. If the national referendum scheduled for June 18, 2023, adopts the central government's proposed revenue split of 75:25 between cantons and the central government, the canton could possibly gain up to CHF300 million per year, according to media reports. That said, alternative proposals would lead to much lower revenue, and we understand that the canton plans to largely plow any additional revenue back into its local economy and infrastructure to keep it competitive and attractive. The general economic impulse created from the tax floor could therefore be more important than its net impact on financial results.

Switzerland's still-pending reform of the subsidization scheme for medical insurance premiums for the less affluent will not significantly affect the supportiveness of the Swiss institutional framework for Basel-City, in our view. The reform is currently stuck in the national parliament, where different proposals that would shift the fiscal burden--either more on the cantons or more on the federal level--are competing for adoption. We trust that the cantons' representation in the second chamber of parliament and the possibility of a referendum give them sufficient power to prevent extremely detrimental legislative changes. In any case, we infer from Swiss federal calculations that Basel-City's above-average premium subsidization level would, even if the most fiscally adverse proposal is adopted, limit unavoidable cost to an annual, easily digestible, CHF25 million.

We believe that the key challenge for Basel-City's financial management will be to balance the prevailing strong political desires for high investments in carbon neutrality and social cohesion against a possibly less dynamic revenue development than in the past. In 2022, the canton opportunistically acquired, in addition to other real estate, the so-called Clara portfolio, a 23,000 square meter area with more than 200 housing units, most classified as affordable housing. The canton plans significant spending on public transport electrification, urban development, and the canton's main sewage treatment facility in 2023-2025. Furthermore, Basel-City seeks to expand its directly owned portfolio of affordable housing units by 50% to 3,000 units. We currently trust that, in case of weaker revenue growth, Basel-City's pragmatic financial management will make the required adjustments to keep deficits and debt growth under control. However, this may then involve politically difficult discussions and decisions.

Capital expenditure-induced deficits will likely halt the recent decline of the debt burden

Our budgetary performance calculation adjusts Basel-City's reported 2022 results after capital expenditure by the CHF462 million spent on real estate acquisitions during the past year. It is our view that these assets, although officially held in the canton's financial account, largely are a core element of its policy focus on housing affordability or are needed for official use, and hence their purchase was not a pure asset-management decision. That said, we consider the spike in 2022 capital expenditure an outlier. It led to a higher-than-normal deficit after capital accounts, despite above-budget tax revenue, a record profit distribution from the Swiss National Bank (SNB), and lower-than-anticipated social expenditure having produced a 12% operating margin.

From 2023, we expect slightly softer operating margins but also smaller deficits after capital accounts than in 2022. This mainly reflects current economic headwinds, no SNB profit distribution (at least in 2023, but possibly also in 2024), and markedly higher staff costs driven by inflation-induced salary adjustments and additional personnel. Starting in 2024, the canton's new package of various small tax cuts that were approved by a referendum in March of this year will cost an additional 2.5 percentage points of performance or CHF112 million per year. We expect capital expenditure to remain high over 2023-2025 owing to the various ongoing investment projects, but we currently do not envisage a similarly large portfolio purchase like the Clara portfolio. Net gains from the OECD minimum tax, after related spending, could be supportive from 2025.

The predicted moderate deficits after capital accounts should slightly increase Basel-City's and debt burden again, after it reached a low point in 2022. The canton has used excess cash to retire maturing debt over the last several years but will likely now need to resume limited net new borrowing. All Basel-City's capital market debt is fixed rate and denominated in Swiss francs. The canton has issued green and social bonds. We note a slightly shorter average tenor than peers' and a peak in maturities in 2023 with CHF500 million becoming due, but, given the limited amounts, believe that the canton should have no issues refinancing this.

The canton's liquidity position is driven by a committed, CHF900 million credit facility with its majority-owned local lender Basler Kantonalbank and its access to the deep and liquid Swiss capital market for cantonal borrowers. Basel-City's cash held in bank accounts now clearly falls short of the next 12 months' debt service, following its use of liquid funds for debt repayment and elevated capital expenditure.

We continue to view Basler Kantonalbank as the canton's most economically relevant contingent liability, since Basel-City provides a statutory guarantee for almost all the bank's liabilities. The bank's balance sheet size exceeds the canton's annual operating revenue by more than a factor of 12x. That said, we also note a CHF90 million impairment of the value of Basel-City's geriatric hospital in 2022, similar to a neighboring canton. We therefore reckon that the risk for cantonal finances that emanate from the medical sector have increased, particularly since the canton is considering a multi-year construction project in excess of CHF1 billion for its university clinic.

Key Statistics

Table 1

Canton of Basel-City--Selected Indicators

	--Fiscal year ending Dec. 31--					
Mil. CHF	**2021**	**2022**	**2023bc**	**2024bc**	**2025bc**	**2026bc**
Operating revenues	4,510	4,666	4,669	4,657	4,870	4,996
Operating expenditures	4,048	4,067	4,279	4,389	4,501	4,560
Operating balance	463	599	390	268	369	436
Operating balance (% of operating revenues)	10.3	12.8	8.4	5.8	7.6	8.7
Capital revenues	28	11	12	12	11	11
Capital expenditures	380	853	447	515	556	545
Balance after capital accounts	111	(243)	(45)	(235)	(176)	(99)
Balance after capital accounts (% of total revenues)	2.4	(5.2)	(1.0)	(5.0)	(3.6)	(2.0)
Debt repaid	408	525	500	350	381	225
Gross borrowings	0	454	716	647	658	402
Balance after borrowings	(283)	(352)	96	(0)	(0)	(0)
Direct debt (outstanding at year-end)	2,781	2,710	2,926	3,223	3,500	3,677
Direct debt (% of operating revenues)	61.7	58.1	62.7	69.2	71.9	73.6
Tax-supported debt (outstanding at year-end)	2,870	2,799	3,015	3,312	3,589	3,766
Tax-supported debt (% of consolidated operating revenues)	63.6	60.0	64.6	71.1	73.7	75.4
Interest (% of operating revenues)	0.1	0.1	0.2	0.3	0.4	0.5
Local GDP per capita (CHF)	197,800	206,760	210,688	213,849	217,035	219,639
National GDP per capita (CHF)	83,726	87,552	89,215	90,554	91,911	93,014

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-City--Ratings Score Snapshot

Key rating factors	Score
Institutional framework	1
Economy	1
Financial management	1
Budgetary perfomance	1
Liquidity	1
Debt burden	4
Stand-alone credit profile	aaa
Issuer credit rating	AAA

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, April 10, 2023. An interactive version is available at http://www.spratings.com/sri

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings , Oct. 10, 2021
- 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

- Economic Outlook Eurozone Q2 2023: Rate Rises Weigh On Return To Growth, March 27, 2023
- Subnational Debt 2023: An Easing Burden In Germany, Austria, And Switzerland, March 02, 2023
- Switzerland, Feb. 13, 2023
- Record Loss At Swiss National Bank Wipes Out Profit Distribution To Cantons In 2023 And Jeopardizes 2024 Payment , Jan. 23, 2023

- Basler Kantonalbank, Dec. 13, 2022
- Banking Industry Country Risk Assessment: Switzerland, May 30, 2022
- Institutional Framework Assessment: Swiss Cantons, Jan. 14, 2021

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	
Canton of Basel-City	
Issuer Credit Rating	AAA/Stable/A-1+
Senior Unsecured	AAA