MOODY'S
PUBLIC SECTOR EUROPE

Rating Action: MPSE's assigns Aa2 first-time long-term issuer rating to the Canton of Ticino (Switzerland)

Global Credit Research - 20 Apr 2016

London, 20 April 2016 -- Moody's Public Sector Europe (MPSE) has today assigned a first-time long-term issuer rating of Aa2 to the Republic and Canton of Ticino (CT). The outlook is stable.

RATINGS RATIONALE

Today's assignment of the Aa2 issuer rating reflects Ticino's (1) constitutional requirement to maintain financial equilibrium; (2) a high degree of budgetary and financial resilience; (3) efficient treasury management; (4) a strong and diversified economy. However, the rating also considers the Canton's: (1) gross operating balance, which has been negative for the past two years, although it is moving towards equilibrium; (2) high debt exposure; (3) moderate contingent liabilities through guarantees issued to its fully-owned bank, Banca dello Stato del Canton Ticino ("Banca Stato") and partly unfunded pension liabilities.

A recent change in Ticino's constitutional law requires it to maintain operating financial equilibrium, a credit positive. The Canton has put in place a financial plan, focused on spending reductions, which will allow it to comply by 2018 at the latest. It also recently announced a spending review to eliminate its annual deficit, which stood at CHF128 million in 2014 and CHF91 million in 2015. The spending review is designed to achieve savings of CHF120 million in 2017, CHF170 million in 2018 and CHF180 million in 2019. Moody's considers this spending review to be a feasible plan to ensure a positive financial performance in the next three years.

CT's very low tax rates give it a significant fiscal buffer. The canton, like its peers, has unlimited autonomy in setting tax rates and exerts full control over its costs, giving it a high degree of fiscal flexibility. Under the Swiss fiscal system, the federal government, the cantons and the municipalities all levy separate personal income taxes and corporate taxes. CT has complete freedom to set the rate for cantonal personal income tax and corporate tax, which accounts for the highest proportion of total tax payments. Budgetary flexibility is more limited on the expenditure side due to costs associated with the canton's ageing population.

Canton Ticino takes a proactive approach to treasury and debt management. Ticino also has good access to capital markets, including the short-term money market. As of 2015, Ticino had access to CHF2.5 billion of uncommitted credit lines with 19 banks and supranational organizations. Cash-on-hand stood at a modest 4% of operating revenues on average in 2011-15, which is low compared to peers. However, we do not consider the low cash position as a challenge due to easy borrowing fostered by Switzerland's current negative interest rates.

Ticino is a medium sized canton with a population of about 350,000 and a relatively diversified service-based economy. GDP per-capita is slightly above the national average (102% in 2013 -- the last reported figure), but significantly above the EU28 average (220%). The unemployment rate was 3.8% in 2015, slightly higher than the Swiss average of 3.3%. Located in the southern part of Switzerland, CT shares a border with Region of Lombardy (Baa1 -- stable), the wealthiest region of Italy. CT's workforce includes about 62,000 skilled cross-border workers, a number that has increased over the last years.

The Canton's operating performance has been volatile in the last five years and negative for the past two years. However, we expect operating performance to become positive as of 2016, and to improve going forward. The mandatory equilibrium requirement in the cantonal constitution should gradually reduce the deficit, allowing CT to reach breakeven in 2018.

In 2014, CT's net direct and indirect debt (NDID) amounted to CHF3 billion, or 94% of realized operating revenue, which is high compared to national and international peers. However, this level of debt is manageable considering the Canton's current low interest rates and its significant financial resilience. We expect the NDID as a percentage of operating revenues to increase to 103% in 2015 and 106% in 2016 to cover accumulated deficits. In 2014 the indirect debt consists of a financial liability of about CHF440 million with a fixed amortizing schedule aimed at funding up to 85% of the canton's pension obligations by 2051. Its pension liabilities are currently 69% funded.

The Canton of Ticino wholly owns a cantonal bank "Banca Stato" and provides a full deficiency guarantee on the bank's deposits (3.4x cantonal revenues). This creates a contingent liability as the Canton would have to provide the bank with funds if it were to require a bailout. However, the potential threat posed by Banca Stato is moderate thanks to its low-risk business profile, and the canton is further protected by its good access to the capital markets. Banca Stato is adequately capitalised with a Tier 1 ratio of 14.4% in 2014, in line with national peers. We see some risk from M&A activity. Should the bank's balance sheet expand, the value of the cantonal guarantee would grow proportionally, a credit negative.

RATIONALE FOR THE STABLE OUTLOOK

The rating outlook is stable.

WHAT COULD CHANGE THE RATING -- UP

A positive gross operating balance amounting to a double-digit percentage of operating revenues, coupled with a structural deleveraging, would likely lead to an upgrade of Canton Ticino's rating.

WHAT COULD CHANGE THE RATING -- DOWN

A downgrade could result from (1) a materially higher than expected increase in the Canton's net direct and indirect debt ratio; and (2) significant financial pressure arising from contingent liabilities triggered by the cantonal bank or cantonal pension fund.

The specific economic indicators, as required by EU regulation, are not available for Ticino, Republic and Canton of. The following national economic indicators are relevant to the sovereign rating, which was used as an input to this credit rating action.

Sovereign Issuer: Switzerland, Government of

GDP per capita (PPP basis, US$): 58,149 (2014 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 0.9% (2015 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): -1.6% (2015 Actual)

Gen. Gov. Financial Balance/GDP: -0.2% (2015 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 11% (2015 Actual) (also known as External Balance)

External debt/GDP: [not available]

Level of economic development: Very High level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

SUMMARY OF MINUTES FROM RATING COMMITTEE

On 24 February 2016, a rating committee was called to discuss the rating of the Ticino, Republic and Canton of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength. The issuer's institutional strength/ framework. The issuer's governance and/or management. The issuer's fiscal or financial strength, including its debt profile. The assessment of extraordinary support.

The principal methodology used in these ratings was Regional and Local Governments published in January 2013. Please see the Ratings Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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