MOODY'S
PUBLIC SECTOR EUROPE

Credit Opinion: Ticino, Republic and Canton of

Global Credit Research - 20 Apr 2016

Switzerland

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Aa2

Contacts

Analyst	Phone
Francesco Zambon/Moody's Investors Service EMEA LTD	44.20.7772.5454
Massimo Visconti/Milan	39.02.5821.5350
David Rubinoff/Moody's Investors Service EMEA LTD	44.20.7772.5454

Key Indicators

Ticino, Republic and Canton of

Key Indicators	2010	2011	2012	2013	2014
Net direct and indirect debt as % of operating revenues	60.3	54.1	61.6	92.4	93.7
Accrual financing surplus (requirement) as % of total revenue	-4.9	-4.1	-5.4	-11.6	-7.9
Gross operating balance as % of operating revenue	2.9	3.9	0.3	-2.8	-1.7
Interest payments as % of operating revenue	1.4	1.4	1.3	1.3	1.1
Intergovernmental transfers as a % of operating revenues	27.1	26.6	27.0	29.5	29.1
Capital spending as a % of total expenditures	10.8	11.0	8.4	10.6	9.1
GDP per capita as a % of national average	100.8	102.5	102.7	102.4	102.4

Note: Modified cash figures, net of depreciation and pass-through items

Opinion

SUMMARY RATING RATIONALE

The Canton of Ticino's (CT) Aa2 issuer rating is underpinned by (1) a constitutional requirement to maintain financial equilibrium; (2) a high degree of budgetary and financial flexibility; (3) efficient treasury management, (4) a strong and diversified economy. The canton faces the following credit challenges: (1) its gross operating balance has been negative for the past two years, although it is moving towards equilibrium; (2) a high debt exposure; (3) the moderate contingent liabilities in the form of guarantees issued to the canton's fully-owned bank, Banca dello Stato del Canton Ticino ("Banca Stato"), and partly unfunded pension liabilities.

Credit Strengths

The Canton of Ticino's credit strengths include:

- A constitutional requirement to maintain financial equilibrium

- A very high degree of budgetary and financial flexibility

- Efficient treasury management

- A strong and diversified economy

Credit Challenges

The Canton of Ticino's credit challenges include:

- Negative gross operating balance, although converging to balance

- High debt levels

- Guarantees issued to wholly-owned bank

Rating 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.

DETAILED RATING CONSIDERATIONS

Canton Ticino`s Aa2 rating combines (1) a baseline credit assessment (BCA) of aa2, and (2) a moderate likelihood of extraordinary support from the federal government in the event that the canton faced acute liquidity stress.

Baseline Credit Assessment

A CONSTITUTIONAL REQUIREMENT TO MAINTAIN FINANCIAL EQUILIBRIUM

A recent change in CT's constitutional law requires it to maintain an operating financial equilibrium, a credit positive. The cantonal government has put in place a financial plan, focused on spending reductions, which will allow it to comply by 2018 at the latest. This plan, which we see as realistic, is in line with the cantonal rule which sets annual and cumulative operating deficit limits of 4% and 9% of operating revenues (CHF130 million and CHF300 million for Ticino) respectively.

CT recently announced a spending review designed to eliminate its annual operating deficit, which stood at CHF128 million, or a modest 4% of operating revenues, in 2014 and CHF91 million in 2015 (latest reported figures). The spending review is designed to achieve savings of CHF120 million in 2017, CHF170 million in 2018 and CHF180 million in 2019. We consider this a credible and effective plan which will help ensure a positive financial performance in the next three years. The sector where the greatest savings will likely be achieved is healthcare and social affairs. In the future we foresee persistently high although manageable demand for healthcare and social services, reflecting CT's ageing population.

A VERY HIGH DEGREE OF BUDGETARY AND FINANCIAL FLEXIBILITY

CT's very low tax rates give it a significant financial 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. CT also has good access to capital markets, including the short-term money market.

CT's operating revenues increased by 10% in 2010-14 even though its tax rates remained unchanged. Tax receipts account for 62% of the canton's revenues, followed by intergovernmental transfers (28%) and other revenues (10%). 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.

General purpose grants account for 56% of CT's intergovernmental transfers. CT also benefits from a robust inter-cantonal revenue equalization system, which ensures a stable annual gross operating balance. Budgetary flexibility is more limited on the expenditure side due to costs associated with the canton's ageing population.

EFFICIENT TREASURY MANAGEMENT

CT takes a proactive approach to treasury and debt management. Treasury budgets are carefully planned in advance through the fiscal year. As of 2015, Ticino had access to CHF2.5 billion of uncommitted credit lines with 19 banks and supranational organizations. As of YE2015 the canton had used CHF650 million of short-term debt. The credit lines are renewable and have a maturity of between 1 week and 12 months.

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.

Treasury and debt are managed by CT's Department of Finance and Economy (DFE), which is responsible for: (1) Short and long-term funding and (2) Treasury management and short-term financial investments. The DFE can lend besides other public entities, such as its owns participated companies, only to counterparties that have a minimum rating of A3 and are regulated by FINMA, the Swiss financial supervisor.

A STRONG AND DIVERSIFIED ECONOMY

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-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 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. Cantonal GDP is mainly driven by the service industry (71%), followed by manufacturing (27%). Trade, banking and real estate account for the bulk of Ticino`s economic activity, even if banking industry growth has slowed since the financial crisis. More than 70% of CT's workforce is employed in the service industry, where trade, banking and tourism are the dominant sectors. The districts of Lugano and Mendrisio are key international hubs for import and export businesses, a strong source of potential growth. CT has particular strengths in raw material trading and fashion industry logistics, which helps attract skilled workers.

NEGATIVE GROSS OPERATING BALANCE, ALTHOUGH CONVERGING TO BALANCE

The canton's operating performance has been volatile in the last 5 years, as indicated by a gross operating balance (GOB) ranging from +3.9% of operating revenue in 2011 to -2.8% in 2013. The ratio stood at -1.7% in 2014 and is expected to have improved toward -0.5% in 2015. We expect GOB to become positive as of 2016, and to improve going forward.

In 2014, the canton reported an annual operating deficit of CHF128 million (gross of depreciation), down sharply from CHF178 million the previous year. The mandatory equilibrium requirement in the cantonal constitution should gradually reduce the deficit, allowing CT to reach breakeven in 2018.

HIGH DEBT LEVELS

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. This was up from 62% in 2012, reflecting mainly a one-off contribution to the cantonal pension fund.

This level of debt is manageable considering current low interest rates, and the canton's significant financial flexibility. We expect the NDID as a percentage of operating revenues to increase to 103% in 2015 and 106% in 2016 to cover accumulated deficits. NDID as a percentage of operating revenues should decline gradually from 2017-18 as the canton reaches budgetary breakeven. As of YE2014 long-term debt accounted for 71.7% of CT's NDID, followed by short-term (11.6%) and indirect debt (16.7%). 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.

GUARANTEES ISSUED TO WHOLLY-OWNED BANK

CT owns 100% of Banca Stato and provides a full deficiency guarantee on the bank`s deposits (3.4x cantonal revenues). 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 capitalized with a Tier 1 ratio of 14.4% in 2014, in line with national peers.

Banca Stato is an autonomous institution under public law which aims to promote Ticino's economic development through mortgage lending and asset management. The Bank is headquartered in Bellinzona and has 460 employees in four branches and 14 agencies. Its activities cover all the operations of a universal bank. Seventy percent of Banca Stato's revenues are generated through lending. In 2010 the lender increased its private banking business by acquiring a controlling stake in UniCredit (Suisse) Bank (USB), now called Axion SWISS Bank SA, and today fully owned by Banca Stato. The investment was designed to reduce the bank's lending exposure. Although the bank's risk appetite is low, we see some risk from M&A activity. Should the balance sheet of the bank expand, the value of cantonal guarantee will grow proportionally, a credit negative.

Extraordinary Support Considerations

Moody's assigns a moderate probability of extraordinary support from the Swiss Confederation. This reflects Swiss cantons' ample autonomy, and the strongly decentralized relationship between the cantons and Confederation.

Output of the Baseline Credit Assessment Scorecard

In the case of Ticino, the BCA matrix generates an estimated BCA of aa1, 1 notch higher compared to the BCA assigned by the rating committee.

The matrix-generated BCA of aa1 reflects (1) an idiosyncratic risk score of 2 (presented below) on a 1 to 9 scale, where 1 is the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Aaa, as reflected in the sovereign bond rating (Aaa stable).

The idiosyncratic risk scorecard and BCA matrix, which generate estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Implementation Guidance published in June 2014 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings."

The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.

MOODY'S
PUBLIC SECTOR EUROPE

registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJKK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJKK or MSFJ (as applicable) have, prior to assignment of any rating, agreed to pay to MJKK or MSFJ (as applicable) for appraisal and rating services rendered by it fees ranging from JPY200,000 to approximately JPY350,000,000. MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.

Moody's Public Sector Europe is the trading name of Moody's Investors Service EMEA Limited, a company incorporated in England with registered number 8922701 that operates as part of the Moody's Investors Service division of the Moody's group of companies.