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CREDIT OPINION
9 July 2018

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RATINGS

Ticino, Republic and Canton of

Domicile	Switzerland
Long Term Rating	Aa2
Type	LT Issuer Rating - Fgn Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Republic and Canton of Ticino (Switzerland)

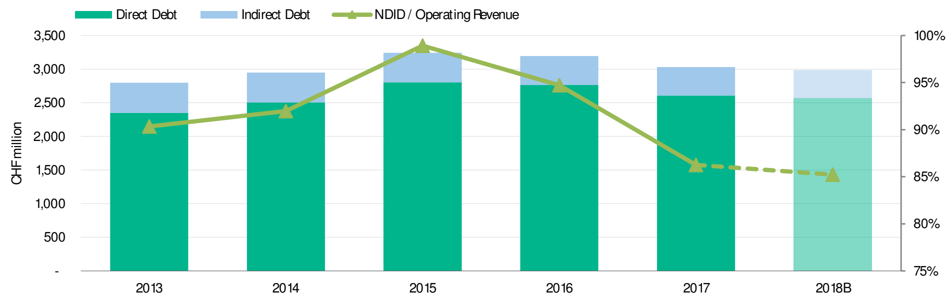
Update to credit analysis

Summary

The credit profile of Republic and Canton of Ticino (CT, Aa2 stable) is underpinned by (1) a constitutional requirement to maintain financial equilibrium, (2) a high degree of budgetary and financial flexibility, (3) efficient treasury management, and (4) a strong and diversified economy. CT faces the following credit challenges: (1) its gross operating balance (GOB) is tight, although it reached equilibrium in 2017; (2) a high debt exposure, which is expected to stabilise and potentially decline over 2019-20; and (3) the 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. The credit profile also reflects a moderate likelihood of the Government of Switzerland (Aaa, stable) providing support if the canton were to face acute liquidity stress.

Exhibit 1

Net direct and indirect debt (NDID) expected to remain stable



B = Budget
Sources: Issuer, Moody's Public Sector Europe

Credit strengths

» Financial equilibrium, ensured by a constitutional requirement

» A very high degree of budgetary and financial flexibility

» A strong and diversified economy

Credit challenges

» Tight GOB, although slowly increasing

» High debt levels expected to stabilise on the back of efficient treasury management

» Guarantees issued to Banca Stato

Rating outlook

The stable rating outlook reflects our expectation that Republic and Canton of Ticino will maintain financial equilibrium and absorb accumulated deficit. The canton's prudent and flexible budgetary management further supports the stable outlook.

Factors that could lead to an upgrade

» A positive GOB, amounting to and stabilising at a double-digit percentage of operating revenue

» A structural deleveraging

Factors that could lead to a downgrade

» A materially higher-than-expected increase in the CT's net direct and indirect debt (NDID) ratio

» Significant financial pressure arising from contingent liabilities triggered by the cantonal bank or cantonal pension fund

Key indicators

Exhibit 2

Republic and Canton of Ticino
Year ending 31 December

	2013	2014	2015	2016	2017	2018B
Net direct and indirect debt as % of operating revenue	92.4	93.7	100.6	96.4	87.9	86.8
Accrual financing surplus (requirement) as % of total revenue	-11.6	-7.9	-5.9	-3.5	-1.4	-3.2
Gross operating balance as % of operating revenue	-2.8	-1.7	0.1	1.4	5.2	3.2
Interest payments as % of operating revenue	1.3	1.1	1.1	1.0	0.7	0.7
Intergovernmental transfers as a % of operating revenue	29.5	29.1	29.0	29.0	29.2	29.6
Capital spending as a % of total expenditure	10.6	9.1	8.9	7.9	9.6	9.5
GDP per capita as a % of national average	102.4	104.9	104.9	104.9	104.9	104.9

B = Budget
Sources: Issuer, Moody's Public Sector Europe

Detailed credit considerations

The credit profile of the Republic and Canton of Ticino, as expressed in its Aa2 stable rating, combines (1) a Baseline Credit Assessment (BCA) of aa2, and (2) a moderate likelihood of extraordinary support coming from the Swiss Confederation in the event of the canton facing acute liquidity stress.

Baseline Credit Assessment

Financial equilibrium ensured by a constitutional requirement

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 allowed CT to reach financial equilibrium one year ahead of its target.

CT started executing a spending review designed to reach a structural operating surplus, which was achieved in 2017 after years of operating deficits. The spending review is designed to achieve savings of CHF168 million in 2018 and CHF185 million in 2019. We consider this a credible and effective plan that will help ensure a positive financial performance in the next three years. Healthcare and social affairs are the sectors in which the greatest savings will likely be achieved. We foresee persistently high although manageable future 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, which gives it a high degree of fiscal flexibility. CT also has good access to capital markets, including the short-term money market.

Tax receipts account for 63% of the canton's revenue, followed by intergovernmental transfers (29%) and other revenue (8%). 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 account for the highest proportion of total tax payments.

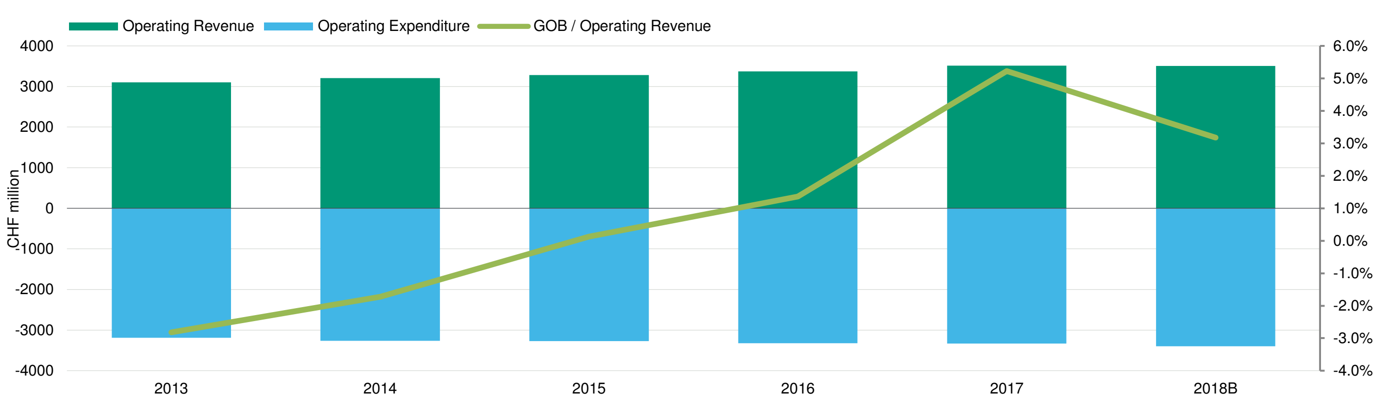
General purpose grants account for 56.7% of CT's intergovernmental transfers. CT also benefits from a robust inter-cantonal revenue equalisation system, which ensures a stable annual GOB. Budgetary flexibility is more limited on the expenditure side owing to costs associated with the canton's ageing population.

A strong and diversified economy
CT is a medium-sized canton with a population of about 350,000 and a relatively diversified service-based economy. Per capita GDP is slightly above the national average (104.9% as per the last reported figure in 2016), but significantly above the EU28 average (220%). The unemployment rate was 6% in 2017, lower than the Swiss average of 4.8%. Located in the southern part of Switzerland, CT shares a border with Region of Lombardy (Italy) (Baa1 RUR), the wealthiest region of Italy. CT's workforce includes about 64,000 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 CT'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 the City of Lugano (Aa3 stable) 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 help attract skilled workers. As a consequence of the economic dynamism, CT's operating revenue increased by 11.9% in 2013-17 even though its tax rates remained unchanged.

Tight GOB, although slowly increasing
In 2017, for the first time since 2011, CT reported a positive operating balance of 5.2% of operating revenue. This was owing to a 2.7% structural growth in its tax revenue and some one-off items like extraordinary dividends from the National Swiss Bank of CHF49 million compared with a regular annual dividend of CHF28 million.

In 2017, the canton reported an annual operating surplus of CHF80.4 million (gross of depreciation) compared with deficits of CHF47 million in 2016 and CHF90 million in 2015. We expect CT to record a smaller surplus of CHF7 million in 2018. The mandatory equilibrium requirement in the cantonal constitution should gradually reduce the cumulated deficit, which stood at CHF495 million in 2017.

Exhibit 3
GOB is improving owing to revenue growth



B = Budget
Sources: Issuer, Moody's Public Sector Europe

The canton's operating performance has been tight in the last five years, as indicated by a GOB ranging between +5.2% of operating revenue in 2017 and -2.8% in 2013. We expect the ratio to stabilise within 3%-6% owing to the canton's spending review and commitment towards maintaining a financial equilibrium.

High debt levels are expected to stabilise

In 2017, CT's NDID amounted to CHF3.1 billion, or 87.9% of realised operating revenue, which is higher than that of national and international peers. The NDID has declined from its peak of 100.6% in 2015, reflecting the manageable refinancing need.

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 revenue to stabilise to 87% in 2018 and potentially decline to 80% from 2019 if CT continues to reduce its cumulated deficit. In 2018, CT issued CHF100 million in bullet bonds with 0.25% coupon due 2028 with a record negative spread. As of year-end 2017, long-term debt accounted for 66% of CT's NDID, followed by short-term (19%) and indirect debt (15%). In 2017, the indirect debt consisted of a financial liability of about CHF425 million, with a fixed amortising schedule aimed at funding up to 85% of the canton's pension obligations by 2051. Its pension liabilities are currently 66% funded.

Efficient treasury management exploits a favourable interest rate environment

CT takes a proactive approach to treasury and debt management. Treasury budgets are carefully planned in advance through the fiscal year. As of 2017, CT had access to CHF3.4 billion of uncommitted credit lines with 29 banks and supranational organisations. The credit lines are renewable and have a maturity of between one week and 12 months. As of year-end 2017, the canton had used CHF580 million of short-term debt. We expect CT to convert a part of its short-term debt into long-term debt in 2018 to 15% of NDID from 19% in 2017. This is due to an active treasury management strategy aimed at keeping low interest rates.

Cash on hand stood at an adequate 12.8% of operating revenue in 2017, which was in line with that of peers. However, we do not consider the cash position as a challenge owing to easy borrowing fostered by Switzerland's current negative interest rates.

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

Guarantees issued to Banca Stato

CT owns 100% of Banca Stato and provides a full deficiency guarantee on the bank's deposits (2.6x cantonal revenue). However, the potential threat posed by Banca Stato is moderate owing 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 15.8% in 2017, in line with that of national peers.

Banca Stato is an autonomous institution under public law which aims to promote CT'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. About 70% of Banca Stato's revenue is generated through lending. 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 guarantees will grow proportionally, a credit negative.

Extraordinary support considerations

We consider Canton Ticino to have a moderate likelihood of extraordinary support from the Swiss Confederation, reflecting our assessment of the risk to the Swiss Confederation's reputation if Canton Ticino were to default. This reflects Swiss cantons' ample autonomy, and the strongly decentralised relationship between the cantons and the Swiss Confederation.

Rating methodology and scorecard factors

The assigned BCA of aa2 is close to the scorecard-indicated BCA of aa1. The one-notch differential reflects a number of factors that the scorecard does not capture. These include the potential pressure that might arise from the canton's contingent liabilities such as Banca Stato and its unfunded pension liability (260%-270% of operating revenue).

The matrix-generated BCA of aa1 reflects (1) an Idiosyncratic Risk score of 2 (presented below) on a 1-9 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).

For details about our rating approach, please refer to Rating Methodology: Regional and Local Governments, published on 16 January 2018.

Exhibit 4

Republic and Canton of Ticino

Regional and local governments

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub- factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	5	104.86	70%	3.80	20%	0.76
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	1.00	20%	0.20
Financial flexibility	1		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenue (%)	5	3.39	12.5%	3.00	30%	0.90
Interest payments / operating revenue (%)	1	0.82	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenue (%)	5	87.86	25%			
Short-term direct debt / total direct debt (%)	3	17.08	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1.00	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						2.16(2)
Systemic Risk Assessment						Aa2
Suggested BCA						aa1

Sources: Issuer, Moody's Public Sector Europe

Ratings

Exhibit 5

Category	Moody's Rating
TICINO, REPUBLIC AND CANTON OF	
Outlook	Stable
Issuer Rating	Aa2
Senior Unsecured -Dom Curr	Aa2

Source: Moody's Investors Service

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