

ISSUER-IN-DEPTH

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Issuer-In-Depth

Ticino's constitution ensures financial equilibrium

The Swiss Canton of Ticino (or CT - Aa2 stable) has a constitutional commitment to balanced budgets, a high degree of financial autonomy, and a track record of proactive financial and treasury management. These factors support Ticino's credit quality, outweighing its higher than average debt.

Ticino's strong institutional framework ensures financial equilibrium. A recent change in Ticino's constitutional law requires it to maintain an overall financial equilibrium, a credit positive. The wider institutional framework governing Ticino's fiscal policies and financial management further supports its credit quality. Switzerland's 26 cantons benefit from a high degree of financial autonomy under the federal constitution, giving them effective power to set and execute their own budgetary policy.

Ticino's financial performance set to improve. Ticino has put in place a financial plan designed to eliminate its deficit, bringing the canton into compliance with the new constitutional requirement, by 2018 at the latest. The plan, focused on spending reductions, aims to achieve savings of CHF141 million in 2017, CHF168 million in 2018 and CHF185 million in 2019.

Debt burden is high but sustainable. In 2015, Ticino's net direct and indirect debt (NDID) amounted to CHF3.3 billion, or 100% of realised operating revenue, which is high compared to national and international peers. However, we regard this level of debt as manageable given current low interest rates, and the canton's significant financial flexibility.

Ticino's strong institutional framework ensures financial equilibrium

A recent change in Ticino's constitutional law requires it to maintain an operating financial equilibrium, a credit positive. Article 31 of the cantonal Law of financial management and control requires Ticino to 1) report annual budgets in financial equilibrium overall; 2) report a cumulated deficit limit of maximum 9% of operating revenues. In case Canton Ticino reaches this maximum limit of 9% it must eliminate the cumulated deficit within 4 years either by cutting expenditure or increasing revenues. These recovery measures have already been approved by the canton's citizens in a referendum.

The consolidation path set by the canton, which we believe is feasible, will benefit from the wider institutional framework governing Ticino's fiscal policies and financial management. Switzerland's 26 cantons enjoy a high degree of financial autonomy under the federal constitution, giving them effective power to set and execute their own budgetary policy. This includes the full right of taxation, except for those taxes that are collected by the central government (the Confederation). The reform of the income tax system conducted in recent years has led to the harmonisation of the formal aspects of the various cantonal tax laws, regarding the determination of taxable income, deductions, tax periods, assessment procedures etc. The cantons, however, still enjoy a large autonomy in the quantitative aspects of taxation, in particular as regards the determination of the applicable rates. The tax burden, therefore, still varies greatly from one canton to another. On the expenditure side, the cantons are fully responsible for key public services such as education, healthcare and police.

Swiss Federal system

Switzerland is a federal State ("Confederation") since 1848. The federalism principle is enshrined in Article 3 of the Federal Constitution, which stipulates that the cantons are sovereign insofar as their sovereignty is not limited by the Federal Constitution and they exercise all rights not transferred to the Confederation.

Switzerland's power is shared between the federal government (central government), the 26 cantons (federal states) and approximately 2,352 municipalities. Each of these levels has a legislative power and executive power. The Confederation and the cantons also have a judiciary (set of courts) in charge of enforcing them.

The federal government has jurisdiction only in the areas that have been expressly assigned by the Federal Constitution, such as foreign policy and security, and financial matters. All other responsibilities (i.e. education, hospitals or police) belong to cantons which enjoy considerable budgetary, and financial autonomy.

The Swiss tax system reflects the country's federal structure (26 cantons). Under the Constitution, all cantons have the full right of taxation except for those taxes that are reserved for the Confederation. In Switzerland, therefore, the tax consists of the following levels: federal, cantonal and municipal.

Ticino's financial performance set to improve

Ticino has put in place a financial plan designed to reach financial equilibrium and to eliminate its deficit cumulated since the new law has been enforced, bringing the canton into compliance with its new constitutional requirement, by 2018 at the latest. Ticino aims to achieve savings of CHF141 million in 2017, CHF168 million in 2018 and CHF185 million in 2019. The canton's annual deficit stood at CHF128 million, or 4% of operating revenues, in 2014, and CHF91 million in 2015 (latest reported figures).

The plan is in line with the cantonal rule which sets annual and cumulative deficit limits of 4% and 9% of operating revenues (CHF130 million and CHF300 million) respectively.

We consider this a credible 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. We foresee persistently high, although manageable, demand for healthcare and social services, reflecting Ticino's ageing population.

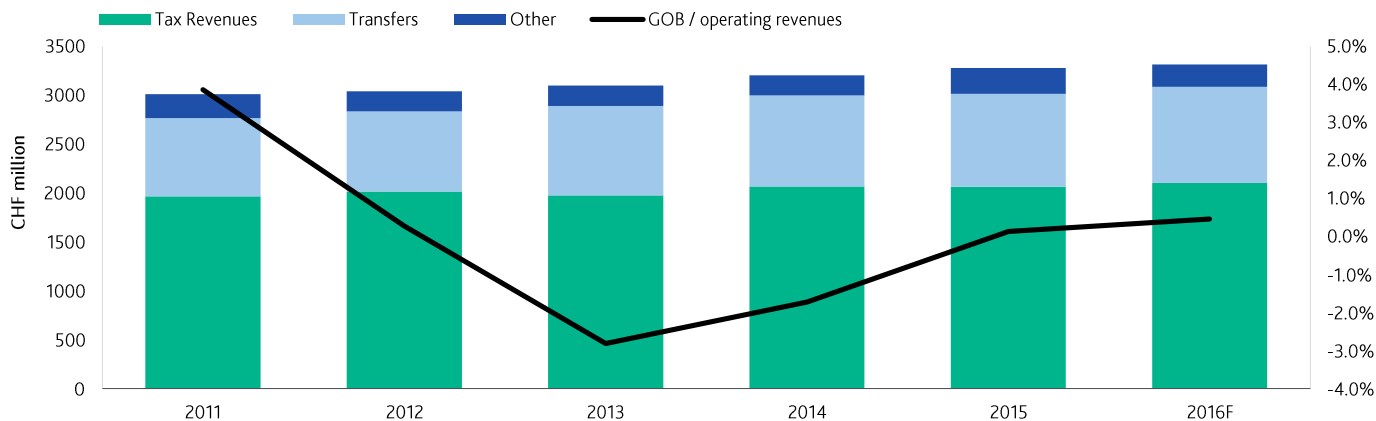
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Although the financial maneuver is more focused on expenditure side, CT's operating revenues dynamic will likely provide additional support, being correlated to local economy. CT recorded an increased by 9% in taxes collected in 2011-15 even though its tax rates remained unchanged, showing a positive correlation with local GDP growth.

The unemployment rate is moderate at 3.8% in 2015, slightly higher than the Swiss average at 3.3%. Located in the southern part of Switzerland, CT borders with Lombardy (Baa1 – stable) which is the wealthiest regions of Italy. Thanks to its diversified economy and the efficient fiscal system, CT attracts an increasing number of skilled frontier workers of about 62,000.

EXHIBIT 1

Growing operating revenues support fiscal consolidation.



Source: Issuer, Moody's

Debt burden is high but sustainable

In 2015, Ticino's net direct and indirect debt (NDID) amounted to CHF3.3 billion, or 100% of realised operating revenue, which is high compared to national and international peers. This was up from 62% in 2012, driven mainly by a one-off contribution to the cantonal pension fund.

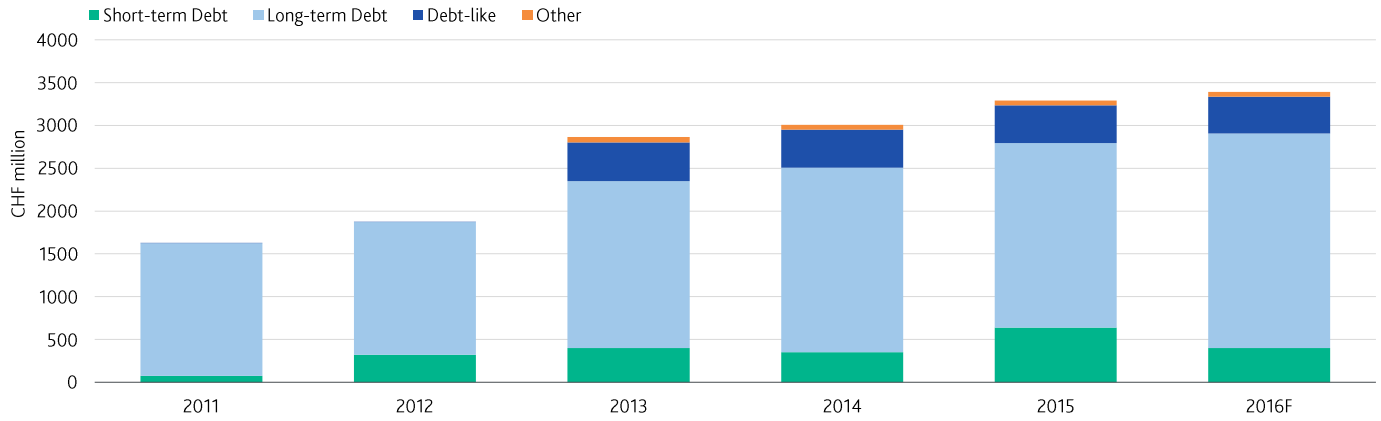
This level of debt is manageable considering current low interest rates, and the canton's significant financial flexibility. We expect NDID as a percentage of operating revenues to increase to 104% in 2016 to cover accumulated deficits. Indeed, last week CT issued CHF120 million bullet bond with 0.4% coupon due in 2044. This ratio should stabilise from 2017-18 as the canton reaches budgetary breakeven.

As of YE2015 long-term debt accounted for 66% of CT's NDID, followed by short-term (19%) and indirect debt (15%). We do not rule out that current market conditions will allow CT to issue new long-term debt to refinance its short-term debt (see exhibit 2). If it does not do so, we expect its short-term debt to increase to about CHF800 million from CHF640 million the previous year (24% of NDID in 2016 from 19% in 2015). In either scenario, Moody's is comfortable regarding the canton's debt sustainability. In 2015, Ticino's indirect debt consisted of a financial liability of about CHF440 million aimed at funding up to 85% of the canton's pension obligations by 2051. Its pension liabilities are currently 69% funded.

Ticino owns 100% of Banca Stato and provides a full deficiency guarantee on the bank's deposits (3.6x 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 capitalised with a Tier 1 ratio of 16.3% in 2015, 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.

EXHIBIT 2

Increasing debt burden, but still sustainable



Source: Issuer, Moody's

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