MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
23 July 2021

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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)

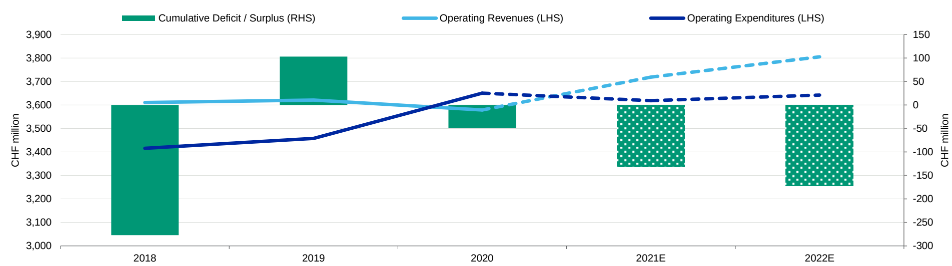
Update to credit analysis

Summary

The credit profile of the Republic and Canton of Ticino (Ticino, Aa2 stable) is underpinned by the canton's degree of budgetary and financial flexibility, combined with its strong and diversified economy, supporting robust operating balances. Ticino also has sound financial and debt management, which supports its liquidity in light of its high debt exposure and its sizeable exposure to the canton's fully owned bank, Banca dello Stato del Canton Ticino (Banca Stato), through deficiency guarantees. The sound, although temporarily declining, operating performance (Exhibit 1), with a gross operating balance (GOB) of minus 2% of operating revenue as of year-end 2020, reflects the canton's resilience to the unprecedented shock stemming from the coronavirus pandemic and the decline in global economic activity. The credit profile also reflects a moderate likelihood of support from the Government of Switzerland (Aaa stable) if the canton were to face acute liquidity stress.

Exhibit 1

Pandemic driving cumulated deficits, but operating balance to recover from 2021 onwards



Source: Issuer and Moody's Public Sector Europe

Credit strengths

» Sound performance supported by a constitutional requirement in terms of financial equilibrium

» A very high degree of budgetary and financial flexibility, combined with sound debt management

» A strong and diversified economy

Credit challenges

» High debt levels, although likely to stabilise

» Sizeable exposure to contingent liabilities

Rating outlook

The stable rating outlook reflects our expectation that the Republic and Canton of Ticino will return to financial equilibrium from 2023 onwards. The canton's prudent and flexible budgetary management further supports the stable outlook.

Factors that could lead to an upgrade

A combination of the following could have positive rating implications: a positive GOB, amounting to and stabilising at a double-digit percentage of operating revenue; and a sustained reduction in leverage.

Factors that could lead to a downgrade

Negative pressure could be exerted on the rating by one or a combination of the following: a substantially higher-than-expected net direct and indirect debt (NDID)-to-revenue ratio; and significant financial pressure arising from contingent liabilities.

Key indicators

Exhibit 2
Republic and Canton of Ticino
Year ending 31 December

	2018	2019	2020	2021E	2022E
Net Direct and Indirect Debt as a % of Operating Revenues	88.4	84.6	88.1	84.8	82.9
Financing Surplus (Deficit) as % of Total Revenues	-2.6	-2.9	-8.8	-3.9	-2.0
Gross Operating Balance as a % of Operating Revenues	5.4	4.5	-2.0	2.7	4.3
Interest Payments as a % of Operating Revenues	0.6	0.6	0.6	0.5	0.5
Intergovernmental Revenues as a % of Operating Revenues	29.1	29.1	30.7	31.8	31.0
Capital Expenses as a % of Total Expenses	11.0	10.1	9.2	9.4	9.0
GDP per capita as a % of national average	104.0	104.8	104.8	104.8	105.9

We adjusted our calculation of indirect debt to include our estimate of Ticino's pension fund (IPCT) liabilities to reach a coverage ratio of 80% on top of the debt-like amount sized in 2013.
Sources: Issuer, National Statistics Office and 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 a Baseline Credit Assessment (BCA) of aa2 and a moderate likelihood of extraordinary support from the Swiss Confederation in the event the canton faces acute liquidity stress.

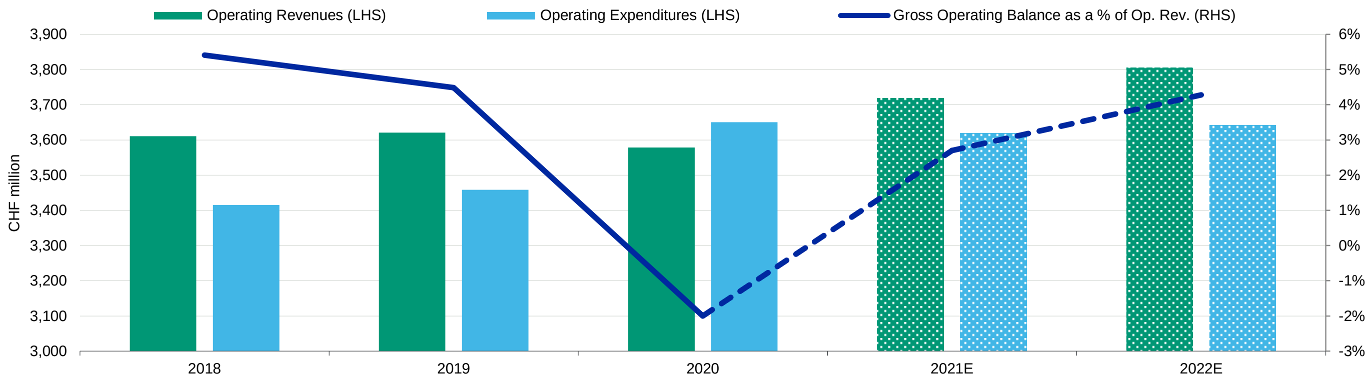
Baseline Credit Assessment

Sound financial performance supported by a constitutional requirement in terms of financial equilibrium

Ticino's constitutional law requires it to maintain a long-term operating financial equilibrium, a credit positive. The cantonal government has put in place a financial plan focused on spending reductions, which allowed Ticino to reach financial equilibrium during 2017-19 (Ticino actually reported a positive result of 4.5% of operating revenue in 2019). The pandemic strained the canton's financials in 2020 through additional costs (CHF100 million) and losses in revenue (CHF130 million), leading to a gross operating deficit of around CHF70 million, or minus 2% of its operating revenue (Exhibit 2)[1]. Taking into account capital revenue and expenditure, the canton recorded a financing deficit of 8.8% of total revenue in 2020.

In 2021, coronavirus-related expenses are forecast at CHF57 million, while losses in revenue should not exceed CHF5 million, leading to a GOB surplus of CHF100 million, or 2.7% of operating revenue, also supported by Ticino's diversified economy, which is likely to grow by 3.5% in the year. We expect revenue to grow further in line with the economic recovery, while the canton will be containing operating expenditure growth, bringing GOB close to pre-crisis levels, at 4.3% of operating revenue, in 2022. As for capital revenue and expenditure, we expect the canton to stabilise its gross capital spending around CHF250 million, with financing deficits estimated at around 4% and 2% of total revenue in 2021 and 2022, respectively, with a return to balanced financial performance likely in 2023.

Exhibit 3
Pandemic-induced fall in operating revenue and increase in expenditure resulted in a gross operating deficit in 2020, but operating performance to gradually improve again



Sources: Issuer and Moody's Public Sector Europe

Ticino started executing a spending review designed to reach an annual surplus, which was achieved in 2017 after years of deficits, one year ahead of its target. In 2019, Ticino's annual surplus was positive at CHF60.3 million, while the canton realised an extraordinary asset revaluation the same year. Hence, the canton absorbed its cumulated deficits, registering a surplus of CHF102.8 million (2.8% of operating revenue) that year. However, because of the extraordinary circumstance described above, Ticino is returning to a cumulated deficit after recording a larger deficit in 2020. We anticipate that the cumulated deficits will continue to grow until 2022 due to further, yet thanks to the canton's commitment to fiscal consolidation and ongoing spending reviews gradually decreasing, deficits over the next two years (Exhibit 1).

We foresee persistently high, although manageable, future demand for healthcare and social services, reflecting Ticino's ageing population. Although the ongoing pandemic requires higher spending, the canton does not expect this to translate into a structural increase. We also note that the canton's hospital (Ente Ospedaliero Cantonale [EOC]) is suffering from revenue losses during the pandemic as surgeries and other medical interventions had to be postponed. However, we expect EOC's revenue to return to pre-crisis levels with the hospital's operations returning to normal, thereby demonstrating the entity's structurally strong situation. Overall, we consider Ticino's plan credible and expect revenue growth to exceed expenditure growth, contributing to continuous positive GOBs over the next two years. The trend of generating positive GOB demonstrates Ticino's strong stance towards achieving and maintaining long-term financial equilibrium.

A very high degree of budgetary and financial flexibility, combined with sound debt management

Ticino's very low tax rates provide 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. Ticino also has good access to capital markets, including the short-term money market.

Tax receipts accounted for 60.3% of the canton's revenue, followed by intergovernmental transfers (30.7%) and other revenue (8.9%) in 2020 (respectively 63.4%, 30.7% and 7.4% in 2019). Under the Swiss fiscal system, the federal government, the cantons and the municipalities all levy separate personal income taxes and corporate taxes. Ticino 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 55% of Ticino's intergovernmental transfers. Ticino 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 because of costs associated with the canton's ageing population.

Ticino takes a proactive approach to treasury and debt management. Treasury budgets are carefully planned in advance through the fiscal year. As of year-end 2020, the canton had access to CHF3.5 billion of uncommitted credit lines with 30 banks and supranational organisations. The credit lines are renewable and have a maturity of between one week and 12 months. As of year-end 2020, the canton had used CHF580 million of short-term debt – thereby temporarily exceeding the cantonal guideline to keep the share of short-term debt below 20% of total debt – to cover tax deferrals the canton had granted during the pandemic.

Cash on hand stood at an adequate 2.1% of operating revenue in 2020. However, we do not consider the cash position as a challenge because of easy borrowing fostered by current negative interest rates environment.

A strong and diversified economy

Ticino is a medium-sized canton, with a population of about 351,500 and a relatively diversified service-based economy. Ticino's per capita GDP is slightly above the national average (around 105%), but significantly above the EU28 average (over 250%). The canton's unemployment rate was 3.6% in 2020, higher than the Swiss average of 3.2%. Located in the southern part of Switzerland, Ticino shares its border with the Region of Lombardy (Italy) (Baa2 stable), the wealthiest region of Italy. Ticino's workforce includes about 65,000 skilled cross-border workers, a number that has increased over the last few years. Cantonal GDP is mainly driven by the service industry (around three quarters), followed by manufacturing. Trade, banking and real estate account for the bulk of Ticino's economic activity, although banking industry growth has slowed since the financial crisis. Industries most affected by the pandemic (restaurants and hospitality) have somewhat benefited from economic support and domestic travel, preventing a rise in insolvency rates in 2020.

Around 80% of Ticino'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. Ticino has particular strengths in raw material trading and fashion industry logistics, which help attract skilled workers. As a result of the economic dynamism, Ticino's operating revenue increased by 10.4% in 2015-19 although its tax rates remained unchanged.

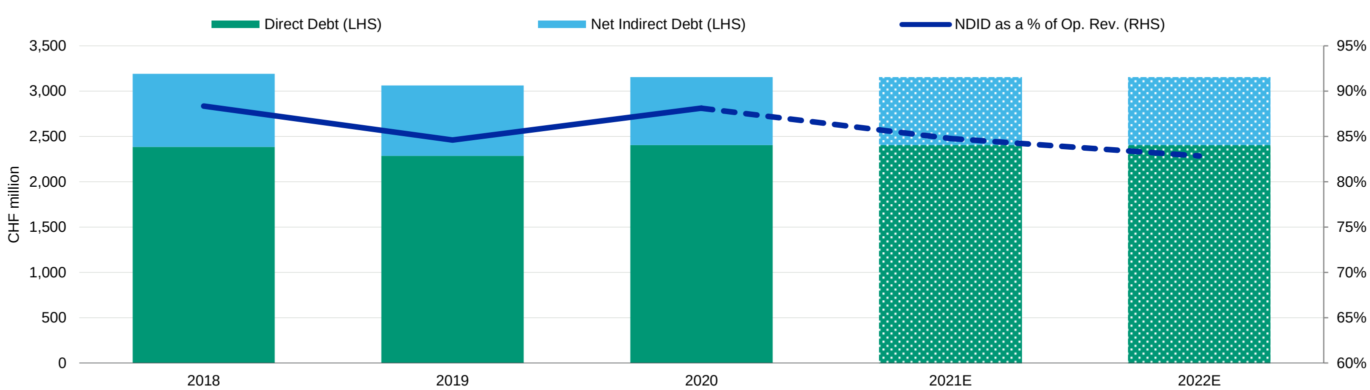
Switzerland recorded a signifiant economic contraction in 2020, with real GDP shrinking 3% as a result of the pandemic and its knock-on effects. We expect Switzerland's real GDP to recover in 2021 and 2022, with growth rates of 3% and 2.9%, respectively.

High debt levels, although likely to stabilise

In 2020, Ticino's NDID amounted to CHF3.1 billion, or 88.1% of realised operating revenue, which is higher than that of its national peers[2]. The increase in debt because of the pandemic was moderate, and we deem this level of debt to be manageable, considering the current low interest rates and the canton's significant financial flexibility. We expect NDID amounts to stabilise over the next two years and as a percentage of operating revenue to decrease slightly from 2021 onwards. Over the next two to three years, we expect the canton to continue its deleveraging path. We also note that Ticino is pursuing a debt management avoiding very long tenor and targeting a smooth amortisation profile.

Exhibit 4

Pandemic resulted in a moderate increase in debt in 2020, but debt level to stabilise



Source: Issuer and Moody's Public Sector Europe

As of year-end 2020, long-term direct debt accounted for 58% of Ticino's NDID, followed by indirect (24%) and short-term debt (18%). Indirect debt consists of a financial liability sized in 2013 to the cantonal pension fund with a fixed amortising schedule (amounting CHF403 million in 2020) aimed at funding up to 80% of the canton's pension obligations by 2051. Its pension liabilities are currently 70% funded including the canton's contributions under its current refinancing plan; we now include into the indirect debt our estimate of the additional coverage required to reach 80% of the cantonal pension fund liabilities, which is CHF323 million as of year-end 2020.

Sizeable exposure to contingent liabilities

Ticino owns 100% of Banca Stato and provides a full deficiency guarantee on the bank's liabilities (4.2x cantonal revenue). Banca Stato is an autonomous institution under public law, which aims to promote Ticino's economic development through mortgage lending and asset management. Its activities cover all the operations of a universal bank. Should the balance sheet of the bank expand, the value of cantonal guarantees will grow proportionally, a credit negative. However, the potential threat posed by Banca Stato is moderate because of its low-risk business profile, and the canton is further protected by its good access to the capital markets.

Ticino's exposure to contingent liabilities is also derived from its fully owned electricity wholesaler Azienda Elettrica Ticinese (AET). Ticino's exposure amounts to around CHF240 million. AET's institutional mandate is to guarantee the procurement of electricity for the canton at competitive prices. AET's leverage is currently low compared with that of Ticino, but should the debt of AET increase, Ticino's exposure to its subsidiary will increase, a credit negative. However, the risks posed by this contingent liability are low and manageable by Ticino.

Istituto di Previdenza del Cantone di Ticino (IPCT) is a public company aiming at serving the future pensions of Ticino's employees. Ticino guarantees the future payments of IPCT to its beneficiaries. In 2013, Ticino decided to register a CHF454.5 million liability (*debito di risanamento*) to meet the 80% legal minimal coverage by year-end 2051. This amount amortises every year based on a fixed amortisation schedule (interest and principal) and was at CHF403 million in 2020. As described above, this amount is already recorded in Ticino's indirect debt as well as the remaining funding gap to attain a coverage ratio of 80%. We view Ticino's exposure to the remaining unfunded part of its pension fund (20%), which corresponds to around 44% of its operating revenue, as a contingent liability. As Ticino can change the pension levels retroactively with a law, this could lead to a lower disbursement – thereby reducing liabilities – in case of need.

Extraordinary support considerations

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

ESG considerations

How environmental, social and governance (ESG) risks inform our credit analysis of Ticino

We take account of the impact of the ESG factors when assessing sub-sovereign issuers' economic and financial strength. In the case of Ticino, the significance of ESG factors to the credit profile is as follows:

Environmental risks are not material to Ticino's rating. It has a very limited exposure to flood risk; nevertheless, it is not material given that the higher-tier governments would provide support in such a scenario.

Social considerations are not material to the canton's rating. Budgetary pressures can emerge from increased social spending, but the provision of public services does not face material risks. We view the coronavirus pandemic as a social risk under our ESG framework, given the substantial implications for public health and safety. For Ticino, the shock transmits mainly through lower tax revenue and an increase in spending policies, particularly in the healthcare sector.

Governance considerations are material to Ticino's rating. The canton uses prudent financial planning, which is transparent and predictable.

Further details are provided in the Detailed credit considerations section above. Our approach to ESG is explained in our cross-sector methodology, General Principles for Assessing ESG Risks.

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.

The matrix-generated BCA of aa1 reflects 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 a Systemic Risk score of Aaa, as reflected in the Swiss 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 5

Republic and Canton of Ticino

Regional and Local Governments

Baseline Credit Assessment – Scorecard	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Factor 1: Economic Fundamentals				**3.80**	**20%**	**0.76**
Economic Strength [1]	5	104.77%	70%			
Economic Volatility	1		30%			
Factor 2: Institutional Framework				**1**	**20%**	**0.20**
Legislative Background	1		50%			
Financial Flexibility	1		50%			
Factor 3: Financial Position				**3.50**	**30%**	**1.05**
Operating Margin [2]	5	0.91%	12.5%			
Interest Burden [3]	1	0.60%	12.5%			
Liquidity	1		25%			
Debt Burden [4]	5	88.11%	25%			
Debt Structure [5]	5	24.11%	25%			
Factor 4: Governance and Management				**1**	**30%**	**0.30**
Risk Controls and Financial Management	1					
Investment and Debt Management	1					
Transparency and Disclosure	1					
Idiosyncratic Risk Assessment						**2.31 (2)**
Systemic Risk Assessment						**Aaa**
Suggested BCA						**aa1**

[1] Local GDP per capita as a percentage of national GDP per capita.
[2] Gross operating balance/operating revenue.
[3] Interest payments/operating revenue.
[4] Net direct and indirect debt/operating revenue.
[5] Short-term direct debt/total direct debt.
Source: Moody's Investors Service, Fiscal 2020

Ratings

Exhibit 6

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

Source: Moody's Investors Service

Endnotes

1 Ticino makes its accounting based on deferred taxes (*Steuerabgrenzung*) so that its 2020 accounts already reflect the impact of the pandemic on its revenue, while most Swiss cantons do their financial reporting based on either an accrual or a cash basis, which implies there is a lag in the recognition of the impact on the revenue.

2 Note that we now include our estimate of Ticino's pension fund (IPCT) liabilities on top of the debt-like amount sized in 2013 to reach a coverage ratio of 80% in the canton's indirect debt, resulting in a 10% increase in this ratio.

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