

CREDIT OPINION

29 May 2019

Update

 Rate this Research

RATINGS

Nordrhein-Westfalen, Land of

Domicile	Germany
Long Term Rating	Aa1
Type	LT Issuer Rating
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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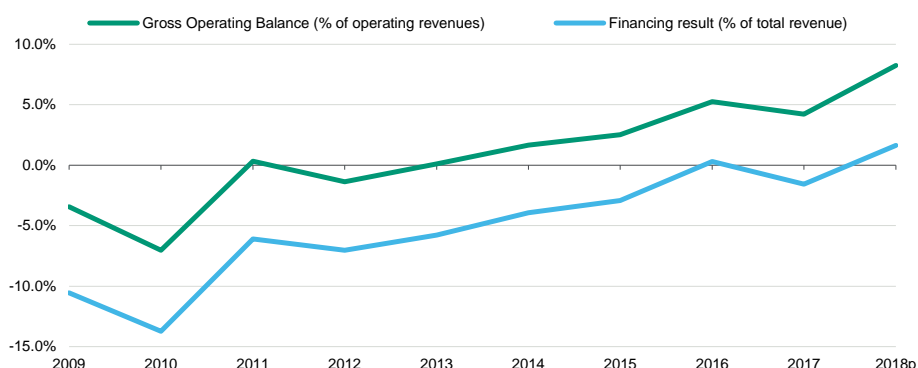
Land of Nordrhein-Westfalen (Germany)

Update to credit analysis

Summary

The credit profile of [Nordrhein-Westfalen \(NRW, Aa1 stable\)](#) reflects its well-diversified and strong regional economy, its improving financial ratios with a financial surplus in 2018 and our assessment of a very high likelihood that the [Government of Germany \(Aaa stable\)](#) would provide support in case of financial distress. However, it also accounts for somewhat below national average budgetary position, limited fiscal flexibility and very high, although steadily decreasing, debt levels. Additional credit risks are related to contingent liabilities mainly due to financial institutions.

Exhibit 1
 NRW reaching a financial surplus in 2018



2018p: preliminary

Source: Issuer, German Statistics Office, German Ministry of Finance, Moody's Investors Service

Credit strengths

- » Trend of improving financial performance, reaching surpluses
- » Strong institutional framework and largest regional economy
- » Excellent market access and sound debt management

Credit challenges

- » Very high, although declining, debt-to-revenue ratios
- » Some off-balance-sheet liabilities in the form of guarantees given to financial institutions

Rating outlook

The outlook is stable. This reflects the continued growth of NRW's tax revenue and the stable outlook on Germany's Aaa government bond ratings, given the extremely strong macroeconomic, fiscal and institutional links between the sovereign's and the regional governments' credit risk.

Factors that could lead to an upgrade

Upward pressure on NRW's rating could arise from a further substantial reduction in its debt burden, combined with a track record of a structurally balanced financial budget.

Factors that could lead to a downgrade

Although unlikely, a downgrade of Germany's sovereign rating could lead to a downgrade of NRW's rating. A significant deterioration in NRW's fiscal metrics, leading to an increase in debt levels, could also result in a downgrade.

Key indicators

Exhibit 2

Nordrhein-Westfalen, Land of						
	2013	2014	2015	2016	2017	2018p
GDP per capita	34,796	35,947	36,509	37,389	38,276	39,358
Intergovernmental revenues as a % of Operating Revenues	14.7	16.2	15.6	14.7	16.3	15.5
Interest payments as a % of Operating Revenues	7.2	6.2	5.4	4.3	3.8	3.4
Gross Operating Balance as a % of Operating Revenues	0.1	1.7	2.5	5.3	4.2	8.3
Financing surplus(deficit) as a % of Total Revenues	-5.6	-3.8	-2.8	0.3	-1.6	1.6
Net Direct and Indirect Debt as a % of Operating Revenues	358.1	329.8	306.9	283.2	255.0	232.6
Capital expenses as a % of Total expenses	8.7	8.4	8.3	8.8	9.4	10.0

2018p: preliminary

Sources: Issuer, German Statistics Office, German Ministry of Finance, Moody's Investors Service

Detailed credit considerations

The credit profile of NRW, as expressed in its Aa1 stable rating, combines (1) a Baseline Credit Assessment (BCA) of aa3 for the land, and (2) a very high likelihood of extraordinary support coming from the federal government in the event that the land faces acute liquidity stress.

Baseline Credit Assessment

Trend of improving financial performance, reaching surpluses

Tax revenue has grown considerably over the last five years, a trend that is set to continue — although somewhat slower — according to the latest official tax estimates, which project tax revenue for German regional governments to grow by 2.5% in 2019 and 3.5% in 2020, following 5.2% in 2018.

Reported figures show NRW's gross operating surplus standing at around 8.3% of operating revenue in 2018, up from 4.2% in 2017 (see Exhibit 1). This improvement is mainly because of continued positive tax revenue growth and declining interest costs for refinancing maturing debt, as well as savings measures implemented by the government. We expect a positive operating balance at the current level as indicated by the land's medium-term financial plan.

In 2018, the land's financing surplus was considerably high at 1.6% of total revenue, following a financial deficit the year before. For 2019 and the following years, we expect the government to be able to continue reporting financial surpluses as indicated by its medium-term planning and also because of the constitutional requirement (debt-brake) to maintain structurally balanced budgets from 2020.

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Compared with other German laender (or regions), NRW is still somewhat lagging behind, as most peers achieved considerable financing surpluses over the past three years. Given the relatively low financial flexibility of German regions to autonomously adapt revenue and expenditure, the government will need to continue to address the land's structural budgetary challenges proactively to remain prepared for more adverse economic environment in the future.

Strong institutional framework and largest regional economy

Compared internationally, Germany has one of the strongest equalisation systems, which combines revenue equalisation, both between the laender and the national government, and investment support from the federal government. This scheme protects all laender against dramatic revenue shortfalls, yet places limits on their revenue flexibility from the requirement to contribute to weaker parties. More than 90% of NRW's revenue stems from shared taxes and transfers, as German laender only have very limited tax rate-setting rights. A regional tax base that would grow above the national average would have only a limited effect on the land's budgetary performance as a share of the surpluses would be redistributed.

In October 2016, after years of negotiation, the German central government and the 16 laender agreed to changes in the German financial equalisation system. As a result, from 2020 onwards, the laender sector will benefit financially from a larger share of total tax revenue (at the expense of the central government). This confirms the laender's strong position within the federation. The new set of rules will govern the German financial equalisation mechanisms after 2019, when the current system phases out. As a result of these changes, NRW expects to keep an additional €1.5 billion under the new system.

Another factor is the so-called debt-brake mechanism, which was introduced in 2009 to limit future structural financial deficits of the federal government and the laender. From 2020, Germany's regional governments will no longer be allowed to run structural fiscal deficits. In addition to the limit, a stronger joint supervision of Bund and laender budgets has been implemented. We expect the mechanism to result in a decline of the laender sector's debt burden (see also [Fiscal Framework Prompts Sharp Decline in Debt Burden, reduces Political Interference](#), May 2017).

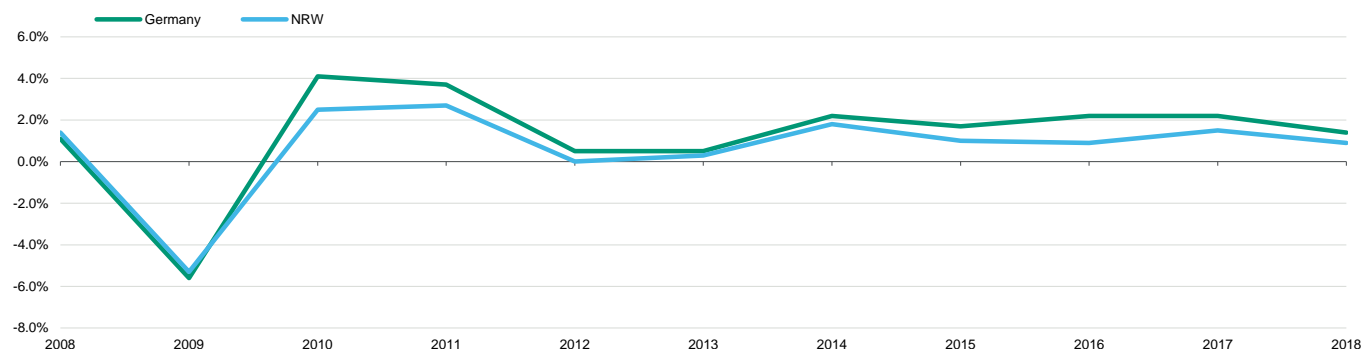
Because of its size and economic importance, NRW's administration has significant influence on the federal government. NRW is by far the most populous land in Germany, with around 18 million inhabitants or around 22% of the total population. Its GDP makes up around 21% of Germany's GDP and per capita GDP is broadly in line with the German average.

The land's economy tends to develop closely to the German average, despite the structural decline of the heavy industry (steel and coal), which primarily is located in NRW. Overall economic growth in NRW was driven by the service sector, which tends to be less dynamic than high-value-added industrial production in other German regions (such as automotive and machinery), and amounted to 0.9%, which is below Germany's growth of 1.4% in 2018 (see Exhibit 3). We expect German economy to grow around 1% in 2019 and 2020 each year.

Exhibit 3

NRW's and Germany's real GDP growth rates are closely connected because of the size of the regional economy

Annual GDP changes of NRW and Germany



Source: German Statistics Office

Excellent market access and sound debt management

NRW has excellent access to the capital markets because of a sophisticated state treasury, as well as excellent liquidity and debt management, which worked well even during the crisis a decade ago. NRW has financial relationships with several financial institutions that are willing to grant it continued access to liquidity based on their confidence in the German laender solidarity system. In the money markets, NRW has access to the inter-laender liquidity pool, whereby individual laender offer their surplus cash to other laender.

Despite the fact that its funding requirement of around €15 billion per year is the highest among the German laender, NRW benefits from low interest payments of only 3.4% of its operating revenue in 2018. This reflects investors' willingness to fund the German laender, because of their perceived status as a safe haven comparable with the German sovereign. NRW, as a long-established issuer, has the particular advantage of a broad investor base. Bonds of NRW are eligible to the European Central Banks public sector purchasing programme, which supports the very low interest levels. In March 2019, the land was able to issue with an extremely long maturity of 100 years, which reduces refinancing risk for the land, and at the same time locks in relatively low interest payments.

We estimate that NRW's interest payments as a percentage of operating revenue will continue to remain over the medium term at around 3.4% of operating revenue as the land has taken advantage of the low interest rate environment by extending its weighted average maturity of outstanding debt to nearly 10 years, compared with an average maturity of around five years a decade ago. Further, we expect the region to not take on any new debt issuances over the next two years to comply with the debt brake. The German debt-brake mechanism halts new borrowing from 2020, which the land has already reached two years ahead of the deadline.

The land's access to capital markets is supported by a broad set of instruments and currencies. As of March 2019, the land had issued its fifth sustainability bond with a volume of €2.25 billion and a coupon of 1.1% for 15 years. NRW committed to allocate the proceeds for a range of sustainability-related initiatives. Apart from the allocation of its proceeds, the bond does not differ from NRW's other bonds, and we view the issuance of sustainability bonds as credit positive as it widens NRW's investor base and helps to communicate and support its sustainable development policy.

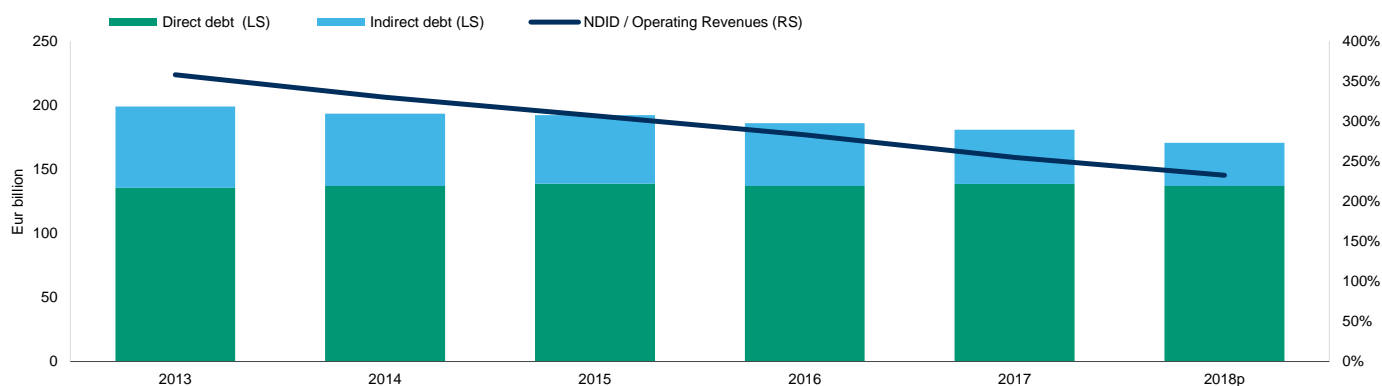
Very high, although declining, debt-to-revenue ratios

The direct debt ratio fell to around 188% of operating revenue in 2018, down from 202% in 2017, reflecting revenue growth linked to the strong economy. We expect a further decrease in NRW's direct debt ratio towards 180% of operating revenue in 2019, underpinned by sustained revenue growth and some ongoing consolidation efforts.

Including other indirect debt and guaranteed obligations, NRW's net direct and indirect debt (NDID) ratio stood at around 233% of operating revenue in 2018, down from nearly 400% six years ago (see Exhibit 4). The decrease was driven by strong tax collection and the winding down of [Erste Abwicklungsanstalt \(EAA, Aa1 stable\)](#), which is guaranteed by the land. As EAA is being wound down, a further reduction in the indirect debt component will continue. We expect NDID to fall to around 200% by year-end 2020. Over the medium term, indirect debt will further decline, though not at the same pace as in the last few years.

Exhibit 4

Debt indicators are steadily declining



Sources: Issuer, German Statistics Office, German Ministry of Finance, Erste Abwicklungsanstalt, Moody's Investors Service

As is the case for most German laender, NRW's pension obligations are only partially funded. The land established a pension fund, which we regard as a positive step in addressing the budget impact of its unfunded pension liabilities and rising pension cost. The pension fund has currently assets of around €12 billion, but may cover less than 10% of pension obligation. This may sound relatively low in an international context; however, it is medium high in a German context (see also [Small Pots, Big Impact - Pension Reserve Funds to Alleviate Budgetary Pressure, February 2017](#)).

Some off-balance-sheet liabilities in the form of guarantees given to financial institutions

NRW's most significant contingent liability is the public-law agency EAA. Under the legal framework, EAA's owners, who are also the former sole owners of WestLB AG (now Portigon AG), will likely remain liable for any losses that may occur in the future. However, NRW will play a key role, having assumed a financial commitment agreed with the German Financial Market Stabilisation Fund, which goes far beyond its 48.2% shares in EAA.

The decline in EAA's asset portfolio to an estimated €39.7 billion as of 31 December 2018 (versus €46.6 billion in the previous year) was mainly because of maturing loans, securities and derivatives, along with the sale of assets before maturity. Based on currently available information, we expect total cost for NRW in the mid-single-digit billions in euros, potentially spread over a medium- to long-term horizon. The land has built up reserves of around €1 billion to cope with payments stemming from the guarantees for its former bank.

In addition, NRW owns and guarantees [NRW.BANK \(Aa1/P-1 stable\)](#), which provides services to local small and medium-sized enterprises, public sector and real estate development. The bank is well capitalised, and its Tier 1 ratio stood at a very high 42.6% in 2018, which we consider an extraordinary strong loss-absorption buffer. We deem the entity to be self-supporting.

Extraordinary support considerations

We consider NRW to have a high likelihood of extraordinary support from the Federal Government of Germany in case of financial distress. This reflects our assessment of (1) the elevated reputational risk for Germany as a whole in the event of a default by a land; and (2) the Bundestreuekonzept, according to which all German laender must provide mutual support if one of them, or the Federal Republic, faces a severe budgetary crisis. Also, the debt volumes of German laender are high, and their debt structure is complex, and an event of non-payment would have a corresponding impact on Germany as a whole.

Rating methodology and scorecard factors

The assigned BCA of aa3 is in line with the scorecard-indicated BCA. The matrix-generated BCA of aa3 reflects an Idiosyncratic Risk score of 4 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a Systemic Risk score of Aaa, as reflected in the sovereign bond rating for Germany.

For details about our rating approach, please refer to [Rating Methodology: Regional and Local Governments, 16 Jan 2018](#).

Exhibit 5

Land of Nordrhein-Westfalen

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	97.17	70%	3.8	20%	0.76
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	3	20%	0.60
Financial flexibility	5		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	3	6.64	12.5%	4.25	30%	1.28
Interest payments / operating revenues (%)	5	3.59	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	9	232.61	25%			
Short-term direct debt / total direct debt (%)	3	14.10	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	5			5	30%	1.50
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						4.14(4)
Systemic Risk Assessment						Aaa
Suggested BCA						aa3

Note: 2018 preliminary

Source: Moody's Investors Service

Ratings

Exhibit 6

Category	Moody's Rating
NORDRHEIN-WESTFALEN, LAND OF	
Outlook	Stable
Issuer Rating	Aa1
Senior Unsecured	Aa1
Other Short Term -Dom Curr	(P)P-1

Source: Moody's Investors Service

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