

## CREDIT OPINION

31 March 2020



### 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)

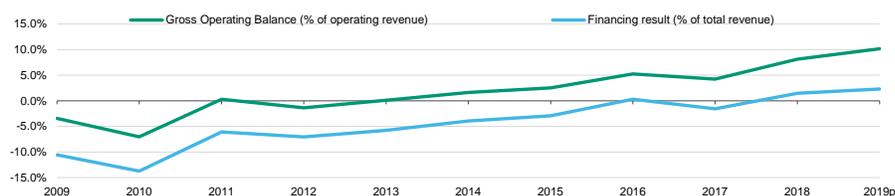
## Update to credit analysis

### Summary

The credit profile of the [Land of Nordrhein-Westfalen](#) (NRW, Aa1 stable) reflects the Land's revenue predictability, and improving financial performance, which has resulted in financing surpluses (see Exhibit 1); its conservative financial management and excellent market access; a strong, well-diversified regional economy; and our assessment of a very high likelihood that the [Government of Germany](#) (Aaa stable) would provide support in case of acute liquidity stress. However, the positives are counterbalanced by its limited financial flexibility and very high debt.

The rapid and widening spread of the coronavirus outbreak, the associated deterioration in the global economic outlook combined with material tax revenue decline expected are creating a considerable credit deterioration across many sectors and regions, including Nordrhein-Westfalen.

### Exhibit 1 NRW's financial performance is improving



2019p: preliminary.

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

### Credit strengths

- » Improving financial performance, resulting in surpluses
- » Strong institutional framework and largest regional economy
- » Excellent market access and debt management

### Credit challenges

- » Very high, although declining, debt-to-revenue ratio and some contingent liabilities
- » Low revenue and expenditure flexibility

## Rating outlook

The outlook is stable. This reflects our assumption that NRW will continue to report financial surpluses in the near future and maintain its commitment to steadily decreasing its debt burden.

## Factors that could lead to an upgrade

Upward rating pressure could be exerted by any significant improvement in NRW's financial performance, including a further reduction in its debt burden, combined with a sustained track record of balanced financial budgets, in line with the debt-break criteria.

## Factors that could lead to a downgrade

Although unlikely at present, any significant deterioration in the Land's fiscal metrics leading to a material increase in debt levels, or — although not expected — any alterations in the fundamental supportive structure of the Länder sector, or an — also unlikely — downgrade of Germany's sovereign rating would lead to a downgrade.

## Key indicators

Exhibit 2

Land of Nordrhein-Westfalen							
	2014	2015	2016	2017	2018	2019p	2020e
GDP per capita	35,809	36,559	37,151	38,276	39,358	40,492	41,559
Intergovernmental revenues as a % of Operating Revenues	16.2	15.6	14.7	16.3	15.5	15.3	13.1
Interest payments as a % of Operating Revenues	6.2	5.4	4.3	3.8	3.4	2.6	2.5
Gross Operating Balance as a % of Operating Revenues	1.7	2.5	5.3	4.2	8.3	10.2	9.0
Financing surplus(deficit) as a % of Total Revenues	-3.8	-2.8	0.3	-1.6	1.6	2.3	1.0
Net Direct and Indirect Debt as a % of Operating Revenues	329.8	306.9	283.2	255.0	232.6	222.0	210.0
Capital expenses as a % of Total expenses	8.4	8.3	8.8	9.4	10.0	11.0	10.0

2019p: preliminary data.

2020e: estimated data.

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

## Detailed credit considerations

On 7 February 2020, [we affirmed the ratings of Land of Nordrhein-Westfalen and maintained stable outlook](#).

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

### Baseline Credit Assessment

#### Improving financial performance, resulting in surpluses

Last year NRW continued to benefit from growing tax revenue, although at a slower pace. Preliminary 2019 actual financials show NRW's gross operating surplus standing at around 10.2% of operating revenue, up from 8.3% in 2018 (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.

NRW continued to improve its financial performance in 2019, reaching a financial surplus of 2.3% of total revenue, up from 1.6% the year earlier. The Land is fully in line with the constitutional requirement (debt-brake mechanism).

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### Strong institutional framework and largest regional economy

The institutional framework, which encompasses legislative background and financial flexibility, is reflected in the arrangements determining intergovernmental relations at all levels, and jurisdictional powers and responsibilities. The framework is mature and highly developed, with minor changes occurring at a measured pace and in a transparent manner.

Germany has one of the strongest equalisation systems in the world, which combines revenue sharing and financial transfers. This scheme protects all Länder (regions) against dramatic revenue shortfalls, yet places limits on their revenue flexibility. The German federal constitution guarantees that the Länder receive appropriate levels of funding and prescribes a very high fiscal homogeneity among the Länder.

With the recently amended financial equalisation scheme, the Länder sector will benefit financially from 2020 because of a higher share in value-added tax revenue, higher general federal transfers and higher supplementary transfers. This confirms the Länder's strong position within the federation. The new equalisation scheme will continue to support NRW's financial position. As a result of these changes, NRW expects to benefit from an additional €1.6 billion per year under the new system.

Another factor is the so-called "debt-brake mechanism", which was introduced in 2009 to limit structural financial deficits of the federal government and the Länder in the future. Starting from 2020, Germany's regional governments are no longer allowed to run structural fiscal deficits. In addition to the limit, a stronger joint supervision of the Bund and Länder budgets has been implemented. We expect the mechanism to result in a further decline in the Länder sector's debt burden.

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 national population. Its GDP makes up around 21% of Germany's GDP and its per capita GDP is broadly in line with the German average.

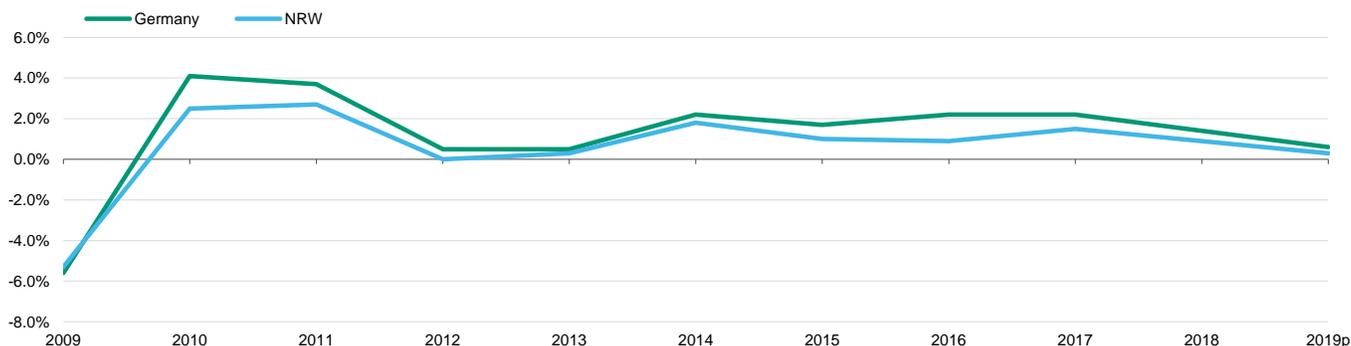
The Land's economy tends to grow in line with the German average, despite the structural decline of the heavy industry (steel and coal), which is located primarily in NRW. Overall economic growth in NRW is driven by the service sector, which tends to be less dynamic than high-value-added industrial production in other German regions, such as automotive and machinery (see Exhibit 3). The German economy has grown by 0.6% in 2019, while NRW's real GDP growth was 0.2%.

In 2020, the [deterioration in the global economic outlook](#) following the coronavirus (COVID-19) outbreak will impact Germany's economy significantly. We expect that Germany, like other global economies will experience an unprecedented shock in the first half of this year and will contract in 2020.

Exhibit 3

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

#### Annual GDP changes for NRW and Germany



2019p: preliminary data.

Sources: Issuer, German Statistics Office

### Excellent market access and debt management

NRW has excellent access to the capital markets because of a sophisticated state treasury, as well as excellent liquidity and debt management. The region has financial relationships with several financial institutions, which are willing to grant it continued access to liquidity based on their confidence in the German Länder solidarity system. In the money markets, NRW has access to the inter-Länder liquidity pool, whereby individual Länder offer their surplus cash to other Länder, as well as access to the German state financing agency (BRD Finanzagentur GmbH).

Although its funding requirement of around €15 billion per year is the highest among the German Länder, NRW benefitted from low interest payments of only 2.6% of its operating revenue in 2019. This reflects investors' willingness to fund the German Länder 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. Its bonds are eligible for the European Central Bank's public sector purchasing programme, which supports the very low interest levels. In 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 remain below 3% of operating revenue over the medium term as the Land has taken advantage of the low interest rates by extending its weighted average maturity of outstanding debt to 13 years, compared with an average maturity of around five years a decade ago. Further, according to initial budget plans the region intended to avoid new debt over the next two years to comply with the German debt-brake mechanism. The mechanism halts new borrowing from 2020, which the Land has already reached two years ahead of the deadline.

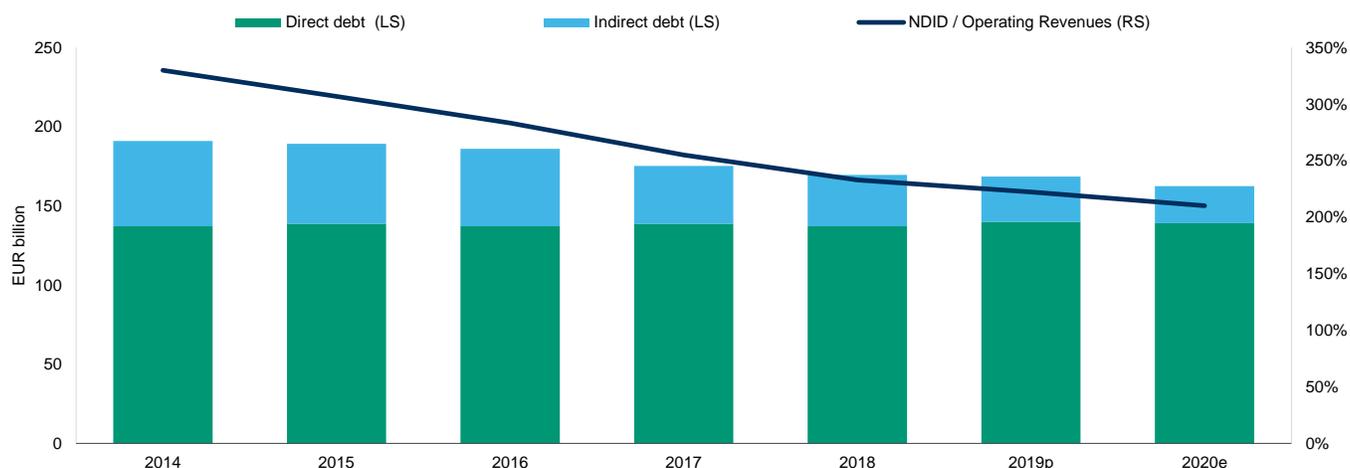
The Land's access to capital markets is supported by a broad set of instruments and currencies. As of November 2019, the Land issued its sixth sustainability bond with a volume of €2.5 billion (€1 billion, 10-year tranche with a coupon of 0% and a €1.5 billion, 20-year tranche with a coupon of 0.5%). 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, but we view the issuance of sustainability bonds as credit positive as it widens NRW's investor base and helps communicate and support its sustainable development policy (see also [Land of Nordrhein-Westfalen \(Germany\): The only German Land issuing sustainability bonds](#), October 2019).

### Very high, although declining, debt-to-revenue ratio and some contingent liabilities

The direct debt ratio fell to around 186% of operating revenue in 2019 from 188% the year earlier, driven by tax revenue growth. We expect a further decrease in NRW's direct debt ratio over the medium term. Including other indirect debt and guarantees, NRW's NDID ratio was 222% of operating revenue at year-end 2019, down from nearly 330% in 2014 (see Exhibit 4).

Exhibit 4

#### NRW's debt indicators are declining steadily



2019p: preliminary data.

2020e: estimated data.

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

The decrease was driven by budget consolidation, mainly through strong tax collection and low interest cost, but also by the winding down of [Erste Abwicklungsanstalt](#) (EAA, Aa1 stable), which is guaranteed by the Land and included in the Land's indirect debt. As EAA is being wound down, the indirect debt will decrease further. We expect the NDID ratio to fall towards 200% in the medium term. Over the medium term, indirect debt could decline, though not at the same pace as it did in the last few years.

NRW's most significant contingent liability is [NRW.BANK](#) (Aa1/P-1 stable), which provides services to local small and medium-sized enterprises, the 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 extraordinarily strong loss-absorption buffer. We deem the entity to be self-supporting. NRW owns and guarantees NRW.Bank.

Another contingent liability is the public-law agency EAA, which we account for mostly as indirect debt. 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 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 (from €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 the additional cost for NRW to be very limited. The Land has built reserves of around €1 billion to cope with the payments stemming from the guarantees for its former bank.

As is the case for most German Länder, 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. Currently, the pension fund has assets of around €13 billion, but may cover less than 10% of pension obligation. This may sound relatively low in the international context; however, it is medium high in the German context.

#### **Low revenue and expenditure flexibility**

As is the case for all German Länder, Nordrhein-Westfalen has a rigid expenditure structure and limited revenue-raising flexibility. If its regional tax base grew above the national average, it would have only a limited effect on the Land's budgetary performance. The above-average tax revenue growth would be partly offset by the equalisation system. In general, more than 90% of its revenue stems from shared taxes and transfers, and the German Länder have only limited tax-setting rights.

The tax rates, with very few exceptions, are set at the national level as well as some of the expenses are set and defined at other levels and are not adjustable by the Land. Personnel expenses (including pension payments), which make up 40% of the Land's operating expenses, are adjustable only over a very long period.

### Extraordinary support considerations

NRW has a high likelihood of receiving extraordinary support from the federal government in case of financial distress. This reflects our assessment of (1) the high 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 Länder must provide mutual support if one of them, or the federal republic, faces a severe budgetary crisis. Also, the debt volumes of German Länder are high, and their debt structure is complex, and an event of non-payment would have a corresponding impact on Germany as a whole.

### ESG considerations

#### How environmental, social and governance risks inform our credit analysis of NRW

We take account of the impact of environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of NRW, the significance of ESG factors to the credit profile is as follows:

Environmental considerations are not material to NRW's rating. The Land has very limited exposure to flood risk, for example. Nevertheless, this risk is not material, given our expectation that the central government would provide support in such a scenario.

Social considerations are also not material to the Land's credit profile. The German Länder face an ageing population, which results in declining labour supply and higher pension and social costs. We assess these effects as manageable. We view the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety in Nordrhein-Westfalen and the risk of a continued spread of the outbreak within the region.

With Germany's coal-exit strategy, environmental and social challenges for coal producing regions, including Nordrhein-Westfalen, are mitigated by subsidies from the central government. (see also: [Länder to receive significant funding to implement national coal exit strategy, a credit positive](#), published 31 January 2020).

Governance considerations are material to Nordrhein-Westfalen's rating. Budgetary discipline in Germany is a constitutional requirement (debt-brake mechanism), which requires each of the regions to maintain structurally balanced budgets. Budget planning in Nordrhein-Westfalen is prudent, 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 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 1-9 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 January 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
<b>Scorecard</b>						
<b>Factor 1: Economic Fundamentals</b>						
Economic strength	5	96.60	70%	3.8	20%	0.76
Economic volatility	1		30%			
<b>Factor 2: Institutional Framework</b>						
Legislative background	1		50%	3	20%	0.60
Financial flexibility	5		50%			
<b>Factor 3: Financial Performance and Debt Profile</b>						
Gross operating balance / operating revenues (%)	3	8.74	12.5%	4.25	30%	1.28
Interest payments / operating revenues (%)	5	3.01	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	9	222.00	25%			
Short-term direct debt / total direct debt (%)	3	10.73	25%			
<b>Factor 4: Governance and Management - MAX</b>						
Risk controls and financial management	5			5	30%	1.50
Investment and debt management	1					
Transparency and disclosure	1					
<b>Idiosyncratic Risk Assessment</b>						<b>4.14(4)</b>
<b>Systemic Risk Assessment</b>						<b>Aaa</b>
<b>Suggested BCA</b>						<b>aa3</b>

2019 preliminary data.

Source: Moody's Investors Service

## Ratings

Exhibit 6

Category	Moody's Rating
<b>NORDRHEIN-WESTFALEN, LAND OF</b>	
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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