S&P Global Ratings

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Research Update:

German State of North Rhine-Westphalia 'AA/A-1+' Ratings Affirmed; Outlook Stable

September 4, 2020

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Overview

- We project that the economic and fiscal impact of the pandemic will significantly weaken North Rhine-Westphalia's budgetary performance.
- The state's debt burden will also rise substantially in 2020 to cover revenue shortfalls and additional expenditure, and we expect financial metrics to recover from 2021.
- We are affirming our 'AA/A-1+' long- and short-term issuer credit rating on NRW as well as our 'AA' issue rating on the state's senior unsecured debt.
- The stable outlook reflects our view that budgetary performance will gradually strengthen as the economic recovery gains traction.

Rating Action

On Sept. 4, 2020, S&P Global Ratings affirmed its 'AA/A-1+' long- and short-term issuer credit ratings on the German state of North Rhine-Westphalia (NRW). The outlook is stable.

Outlook

The outlook is stable because we believe that, over the next two years, the projected recovery beyond 2022 balances risks from NRW's weaker budgetary performance, which is still commensurate with our current rating.

Downside scenario

We could lower the ratings if we oberved a stronger and more protracted budgetary weakening than we currently project, which could result from a weaker-than-expected recovery over the coming years or significant fiscal policy slippages. We could also lower the ratings if, contrary to our expectations, NRW's exceptional capital market access were to weaken.

Upside scenario

We could raise the ratings if NRW further substantially reduces the remaining contingent liabilities from financial institutions under its control and strengthens its municipal finances, while the economic recovery and budgetary improvements occur significantly faster than we currently expect. We currently view these developments as unlikely, however.

Rationale

Subdued economic activity, due to measures to contain the spread of the coronavirus, and measures to support the economy will affect North Rhine-Westphalia's budgetary performance. We now project deficits after capital accounts until 2023, versus our pre-pandemic forecast of surpluses. NRW has established a special budgetary vehicle to account for all COVID-19-related tax revenue shortfalls and additional expenditure. NRW's parliament has approved additional borrowing of up to €25 billion to fund the higher expected deficit. Although we think NRW's actual borrowing might be lower than €25 billion in 2020-2022, we still project tax-supported debt will rise substantially to almost 240% of operating revenue in 2020, before decreasing steadily until 2023.

The state's strong economic profile continues to support the ratings, since we expect the recovery to gain traction toward the end of this year and into 2021, after this year's GDP contraction. At the same time, Germany's highly predictable and supportive institutional framework for federal states also supports the ratings, as does our expectation that Germany's and the state's debt-brake rule will ultimately limit the growth in debt. Moreover, NRW enjoys exceptional access to capital markets for its liquidity needs.

The COVID-19 pandemic has triggered an extraordinary policy response

The COVID-19 pandemic has led us to significantly revise our economic and financial projections since our last review on North Rhine-Westphalia. We now expect a 6.2% contraction of real GDP for Germany and likely also for NRW in 2020. In response to the coronavirus outbreak, NRW has passed two supplemental budgets in which it provided additional guarantees totaling €15 billion for state-owned promotional institution, NRW.Bank. This enables NRW.Bank to provide liquidity support programs to private enterprises, public-sector and social infrastructure companies and providers, as well as the state's municipalities.

What's more, the first supplemental budget established a special account amounting to up to €25 billion that will capture all COVID-19-related items on the state's budget. This means that NRW will use debt to finance up to €25 billion of revenue shortfalls and additional expenditure that can be attributed to the pandemic until 2022. The state and federal governments' sizable support and stimulus measures aim to mitigate, as much as possible, the economic repercussions of the pandemic, preserve employment, cushion the impact on local governments, and support the recovery.

Despite the economic shock in 2020, NRW continues to benefit from its strong and diversified economy. NRW is Germany's largest state by population and GDP. The state's economy contributes over 20% to the national GDP. Several indicators, such as production decreases in the manufacturing sector, point to a slightly less pronounced recession in NRW than the German average. NRW's economy is facing structural challenges, for example from Germany's phase-out of coal-based energy production. To mitigate the impact on affected regions, such as NRW, the federal government will provide several forms of financial support through 2038. Nonetheless, NRW's economy will face a need to adapt to structural and technological changes. Given the still-high importance of the manufacturing sector in NRW, the future trend of industrial value added, for instance in energy generation, could also hit NRW's labor market. Against this backdrop, the state's investment program also intends to strengthen long-term growth potential. NRW's budget is only indirectly linked to the local economy because most taxes are shared with the federal government and redistributed to the 16 states.

In the near term, we expect unemployment to rise in 2020-2021 to almost 9% but the increase will likely remain contained because of the use of short-time work arrangements and other support measures.

We view the institutional framework in which German states operate as one of the most predictable and supportive in the world. Higher federal government contributions and a structural change in the equalization system will grant NRW additional revenue of about €1.5 billion per year (about 2% of operating revenue). The equalization of revenue also protects NRW from shocks to its revenue base, which is above the average for German states. We also note that the federal government has changed the equalization law to ensure that the temporary value-added tax rate reduction in 2020 will not be borne by the states. This is another supportive element, in addition to sizable support for the municipal sector and for public transport under the federal stimulus package.

NRW will deviate from balanced budget goals due to the pandemic. According to the debt-brake rule, NRW is required to achieve structurally balanced accounts. Although emergency exception clauses were invoked due to the pandemic, the related new debt incurred is set to be repaid from 2024 over a span of 50 years. We understand that NRW intends to return to zero net new borrowing by 2023, even though our projections still indicate a deficit in that year.

In our view, NRW's budgetary procedures are clear and established, and have regular review cycles. We consider the state's financial management to be strong and exceptionally experienced regarding the standards for debt and liquidity management. An example is the pioneering issuance of a 100-year bond in 2019. While we think that the debt brake will continue to anchor consolidation efforts, we believe there is also a mindset of prudent fiscal policy, which underpins our view of the state's political and managerial strength. The state's financial management has in recent years demonstrated its ability to implement savings throughout the budget's execution, for example in personnel or interest expenditure. The legacy from the 2008-2009 financial crisis is still visible, for example in winding up agency Erste Abwicklungsanstalt (EAA). However, the supervision and management of the state's participations improved before the financial crisis, as shown in its decreasing contingent liabilities.

Debt and deficit are soaring in 2020 due to COVID-19, but NRW can rely on its exceptional market access to cover its funding needs

We now forecast NRW will post an operating deficit of 3% of operating revenue and a deficit after capital accounts of 13% of total revenue in 2020. From 2020, with the economic recovery taking hold, we expect budgetary performance to improve steadily until 2023. Our forecast takes into account the additional operating and capital expenditure related to the pandemic, the stimulus packages spread over 2020-2022, as well as projected tax revenue shortfalls that are still subject to significant uncertainty. We understand that the extraordinary tax deferrals and temporary concessions granted by the state will be recovered in 2020.

NRW's tax revenue remains below our previous expectations, but we expect tax revenue growth to resume in line with the economic recovery. This will help return operating balances to positive territory in 2021 although we expect deficits after capital accounts to persist until 2023. We maintain our previous assumption that the state will realize savings during budget execution, given buffers in some positions (such as interest or personnel expenditures). These and other positions could also offer room to maneuver if the need to avoid net new borrowing re-emerges after 2022 once the stimulus programs end.

We expect the state to use debt to finance pandemic-related revenue shortfalls and additional spending to the tune of about €20 billion over 2020-2022. NRW's parliament has authorized up to €25 billion in debt financing of the pandemic-related budgetary gap. NRW will take on debt depending on its expenditure needs, and the state parliament's budgetary committee has to approve concrete expenditure and borrowing plans for the special pandemic-related accounting unit. We expect these to be spread over 2020-2022, depending on the implementation schedule of the measures, for example in the hospital sector, to support municipalities in the state and partly cover their business tax shortfalls. The special accounting unit's accounts will also reflect the tax revenue shortfalls in 2020 and accordingly the corresponding borrowing needs.

In our base case, NRW's tax-supported debt will increase to just below 240% of operating revenue this year and gradually decline to just above 210% by 2023. While NRW's debt burden remains very high in an international comparison, even with the significant pandemic-related surge, it is still well below the peak in 2010 of more than 300%. In our tax-supported debt calculations, we include the credit market debt of non-self-supporting entities and an NRW.Bank-prefinanced school investment program. We also factor in our estimate of contingent liabilities stemming from the state's institutions and companies, including EAA and NRW.Bank. As a COVID-19-related support measure, the state has enlarged its guarantee framework by €4.1 billion to €5.0 billion, but the overall uptake cannot yet be quantified. It also increased the guarantees for NRW.Bank for the bank's various support lines. The visibility on a pandemic-related contingent liability increase remains uncertain, but we note that many affected companies will likely rely on federal support programs if needed.

NRW pays pensions on a pay-as-you-go basis, and includes them in its budgets and financial planning. We regard pension payments as highly predictable, but acknowledge that long-term pressure on NRW's budgetary performance persists because pension payments are forecast to peak in the next decade. The state's flexibility is therefore somewhat limited because it can only adjust the very high pension burden in the longer term. At the same time, we don't expect annual pension payments to rise significantly over the next 20 years. NRW has set aside €12.7 billion in its pension fund so far.

We continue to view NRW's liquidity position as excellent, thanks to its proven access to capital markets at all times in addition to its access to sources of liquidity from other German states. Debt-service coverage has also increased, given the state's policy to increase cash holdings to reduce the reliance on short-term debt. The state also aims to increase transparency by covering financing needs through matching debt in the period in which it arises. We think that cash balances will remain elevated both due to the state's policy of keeping large cash balances and as a response to uncertainties regarding the further evolution of the pandemic. We consider parts of the pension fund assets to be liquid, specifically last-resort funds. As a result, NRW's average cash holdings will remain substantially higher than in previous years, when the state employed a zero-cash strategy. But more importantly, we still think that NRW will rely on its exceptional access to capital markets. The state is a regular issuer of private placements and benchmark bonds in 18 different currencies. The state's liquidity situation also benefits from access to short-term funding from the German federal treasury and intraday access to Bundesbank (central bank) funds.

We still consider contingent liabilities from financial institutions to be substantial. That said, we expect that the remaining parts of EAA will wind down with only limited recourse to funds from NRW. The state has accumulated reserves to cover for expected losses at EAA, which further buffer its contingent liabilities. EAA's overall balance sheet stood at €38.7 billion (or about 50% of the state's operating revenue) on June 30, 2020, down from €40 billion at year-end 2018 due to progress with its wind-down activities.

We view NRW.Bank as self-supporting, but factor it into our overall assessment of NRW's contingent liabilities because the bank's liabilities benefit from state guarantees. The bank is profitable, and its balance sheet amounts to about twice the state's yearly revenue. NRW issued an explicit legal guarantee for NRW.Bank's capital market obligations, which could result in large payments if this guarantee were called. For the bank, we assess the potential recapitalization needs in an 'A' type stress scenario as insignificant.

Key Statistics

Table 1

State of North Rhine-Westphalia Selected Indicators

	--Fiscal year end Dec. 31--					
Mil. €	**2018**	**2019**	**2020bc**	**2021bc**	**2022bc**	**2023bc**
Operating revenues	72,905	75,839	70,442	75,813	78,293	81,715
Operating expenditures	66,980	68,111	72,309	74,368	75,870	77,397
Operating balance	5,925	7,727	(1,867)	1,445	2,423	4,318
Operating balance (% of operating revenues)	8.1	10.2	(2.7)	1.9	3.1	5.3
Capital revenues	1,960	1,875	1,349	1,286	1,079	1,143
Capital expenditures	6,647	7,344	8,714	9,015	7,981	6,323
Balance after capital accounts	1,238	2,259	(9,232)	(6,284)	(4,479)	(862)
Balance after capital accounts (% of total revenues)	1.7	2.9	(12.9)	(8.2)	(5.6)	(1.0)
Debt repaid	17,059	16,642	15,251	15,390	13,753	12,219
Gross borrowings	13,560	16,630	30,251	19,390	15,253	12,219
Balance after borrowings	(2,346)	1,814	5,915	(2,223)	(3,218)	(1,102)
Direct debt (outstanding at year-end)	139,416	145,095	160,095	164,095	165,595	165,595
Direct debt (% of operating revenues)	191.2	191.3	227.3	216.4	211.5	202.6
Tax-supported debt (outstanding at year-end)	152,963	151,934	167,334	171,234	172,695	172,595
Tax-supported debt (% of consolidated operating revenues)	209.8	200.3	237.5	225.9	220.6	211.2
Interest (% of operating revenues)	3.4	2.6	3.2	3.4	3.6	3.7
Local GDP per capita (€)	39,358	40,314	37,459	39,816	41,688	43,186
National GDP per capita (€)	40,395	41,378	39,086	41,516	43,416	44,946

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. .

Ratings Score Snapshot

Table 2

State of North Rhine-Westphalia Ratings Score Snapshot

Key rating factors	Scores
Institutional framework	1
Economy	1
Financial management	2
Budgetary performance	4
Liquidity	1
Debt burden	5
Stand-alone credit profile	aa
Issuer credit rating	AA

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Key Sovereign Statistics

- Sovereign Risk Indicators, July 14, 2020. An interactive version is available at http://www.spratings.com/sri

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- 2018 Annual International Public Finance Default And Rating Transition Study, Aug. 19, 2019
- Public Finance System Overview: German States, Aug. 13, 2019
- Institutional Framework Assessments For International Local And Regional Governments, July 4, 2019

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Ratings Affirmed	
North Rhine-Westphalia (State of)	
Issuer Credit Rating	AA/Stable/A-1+
Senior Unsecured	AA