Research Update:

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

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Overview

- Solid tax revenue based on the economic recovery will help curb further debt increases.
- We continue to project improving budgetary performance and a decreasing debt burden relative to operating revenue over 2021-2024.
- We expect North Rhine-Westphalia (NRW) will be able to absorb the financial effects of the recent devastating floods.
- We have affirmed our 'AA/A-1+' long- and short-term issuer credit ratings on NRW and maintained the stable outlook.

Rating Action

On Aug. 27, 2021, 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 stable outlook reflects our expectation that the pandemic-related weakening of the state's budgetary performance and debt accumulation will remain temporary, and the debt burden relative to operating revenue will start declining again after 2021 alongside significant budgetary improvements.

Downside scenario

We could lower the rating if, against our expectations, NRW's budgetary performance deteriorated again, cementing higher deficits over the coming two to three years. This could result from protracted economic difficulties, less fiscal prudence, or significant fiscal policy slippages.

Upside scenario

We could raise the rating if NRW further significantly reduces remaining legacy contingent liabilities from financial institutions under its control, while the economic recovery translates into even faster budgetary improvements for the state and municipal governments than we expect.

Rationale

Our rating on NRW reflects the state's recovering tax revenue and consequently improving budgetary performance following the pandemic-induced hit in 2020-2021. That said, we still project a significantly increasing debt burden in 2021 compared with pre-pandemic levels, but which will gradually reduce from 2022. At the same time, we expect NRW will be able to absorb the costs of reconstruction following the devastating floods in some parts of the state in July 2021. Despite tax revenue outperforming our previous projections, we still expect a substantial deficit after capital accounts in 2021, given the state's considerable financial support, for example for the municipal sector and the local economy during the pandemic. We expect NRW to largely return to its pre-crisis balanced results after capital accounts by the end of 2023 and to reduce net new borrowing to zero, thereby buffering its credit profile from lasting negative effects.

The rating is supported by NRW's strong local economy and by the highly predictable and supportive institutional framework, in which the federal government has provided substantial financial assistance to the states for COVID-19-related expenditure and to support the state's economy. Moreover, we assess NRW's access to capital market funding as exceptionally strong.

Economic recovery is on the way

We expect the German economy will recover and expand by 3.5% in 2021 and 4.9% in 2022. This is translating into rising tax revenue in NRW together with the accompanying fiscal equalization system.

We assume that the state will continue to support the local economy and its municipal sector throughout the pandemic. NRW, like other German states, introduced a support package to finance revenue shortfalls and unforeseen expense, which the authorities report off-budget but which we consolidate in our metrics. We project new borrowing of roughly €16 billion (about 20% of operating revenue) for 2020-2022, which is below the total support package envelope.

We incorporate an outperformance of budgeted revenue numbers. In the first half of 2021, tax revenue increased by almost 10% annually and we continue to anticipate that expenditure execution will yield considerable savings, underpinning our base-case scenario. At the same time, the state will continue to provide support where needed. Although many restrictions have been lifted, a resurgence of infection numbers continues to remain a risk, although we think that the impact of renewed restrictions on the economy would be less severe than in the recent past.

The financial impact of the catastrophic floods in July 2021 will be very moderate in relation to NRW's budget size, despite the human tragedy and economic impact in the affected region. We project that the state will provide several hundred million euros of immediate financial support for the affected areas in NRW. For longer-term reconstruction, the first damage estimates suggest several billion euros needed in NRW alone. But the federal level and the states have already agreed on a joint reconstruction fund, which would be prefinanced by the federal level and the states will repay their share over several decades.

NRW continues to benefit from a robust industry mix, despite some structural challenges looming. This is why the state's economic position remained relatively strong by international standards notwithstanding the downturn in 2020. The state is Germany's largest by population and GDP. Its economy contributes over 20% to the national GDP. But there are 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 is providing several forms of financial support through 2038. Nonetheless, the state's economy will face a need to adapt to structural and technological changes, as well as threats to its competitiveness. Given the still-high importance of the manufacturing sector in NRW, employment trends in various industrial sectors, for instance in energy generation, could also hit its labor market. This could ultimately impact NRW financially if higher transfers are needed to preserve social cohesion. Against this backdrop, the state's ambitious investment program 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.

NRW's labor market reflects in part the structural transition that the economy has undergone with the transition away from coal and heavy industries. In July 2021, NRW's unemployment rate stood at 7.4%, above the German average of 5.6%, measured according to the German national definition.

We view the institutional framework in which German states operate as one of the most predictable and supportive among those we evaluate. During the pandemic, NRW, in line with all other German states, has benefited from the federal government's willingness to support the municipal sector and public transport under the federal stimulus package. And the supportiveness of the framework was underpinned again in the joint reconstruction financing of both the federal level and all states agreed following the devastating floods in summer 2021. In 2020, a new equalization system came into force, based primarily on the distribution of value-added tax. In our analysis, the amendment is beneficial for all states, thanks to higher contributions from the federal government, and is another supportive element in our analysis.

The state has reaffirmed its commitment to return to zero net new borrowing by 2023. According to the state's codified debt brake rule, NRW is obliged to achieve structurally balanced accounts, but the law contains exceptions that the authorities have used for 2020-2022 in response to the pandemic. At the federal level, the debt brake has come under discussion, especially in light of investment needs to comply with carbon emission reduction targets.

We consider the state's financial management strong and exceptionally experienced regarding the standards for debt and liquidity management. An example is the recurring issuance of 100-year bonds since 2019. We believe there is a mindset of prudent fiscal policy, which underpins our view of the state's political and managerial strength. We do not anticipate this commitment will substantially change in the run-up or immediate aftermath of the May 2022 state elections. In our view, the authorities have been transparent about the off-budget reporting of pandemic-related revenue shortfalls and additional spending. We continue to see lingering risks related to the legacy from the 2008-2009 financial crisis, for example in wind-up agency Erste Abwicklungsanstalt (EAA), although these risks continue to decrease. At the same time, we view the supervision and management of the state's participations as robust. This is notwithstanding the potential need for further state support to WestLB's successor, Portigon. In March 2021, NRW provided additional equity to Portigon of around €160 million and agreed to a credit line of €192 million with a term until the end of 2025. The backdrop to this is Portigon's ad hoc announcement of higher expected losses in 2020, caused by legal issues dating to before 2008.

Budgetary and debt metrics are improving, despite lingering pandemic effects, flood reconstruction costs, and sizable investment spending

After facing considerable financial challenges in 2020, we project German states' budgetary performance will improve from 2021. For NRW, actual tax revenue growth this year significantly exceeds previous projections, mainly due to sound value-added tax and profit tax revenue. This solid revenue performance, in line with a continued economic recovery, will enable the state to reduce net new borrowing to zero by 2023 in our base-case scenario. We understand that this is an important political signal for the return to established budgetary procedures following the pandemic. From 2024 on, when we project a surplus after capital accounts, the state intends to repay the debt taken on for the pandemic response over a 50-year horizon.

We project that NRW will achieve a modest operating surplus of 3.4% of operating revenue in 2021 and that this surplus will increase significantly to around 8% by 2024, in line with the overall economic recovery in Germany. In our forecast, we maintain the assumption that actual spending will remain below budgeted levels, as in previous years, thanks to additional consolidation measures and conservative planning by the state in interest or personnel expenditure, among others. Furthermore, pandemic-related spending is well below the approved envelope thus far in 2021.

We expect the state to increase its debt burden by another €5 billion to finance the pandemic-related revenue shortfalls and additional spending over 2021-2022. The largest pandemic-related new borrowing occurred in 2020 when debt increased by €11 billion in nominal terms. NRW's tax-supported debt will increase to 215% of operating revenue this year and gradually decline to just below 200% by 2024. In our tax-supported debt calculations, we include the credit market debt of non-self-supporting entities and a school investment program prefinanced by NRW.Bank. In our debt assessment, we also factor in our estimate of still-sizable contingent liabilities stemming from the state's institutions and companies, including EAA and NRW.Bank. As a COVID-19-related support measure, the state enlarged its guarantee framework and the guarantees for the various NRW.Bank development lines last year, but the overall uptake remains rather limited.

The state pays pensions from its budget on a pay-as-you-go basis. We consider pension payments to be predictable but, given that pension payments will peak in the next decade, we assume pressure on the state's budgetary position will remain in the long term. So far, the state has accumulated €13.2 billion in the pension fund. NRW's flexibility to adjust expenditure is therefore somewhat limited, because it can only adjust its very high pension burden, which owes to decades of expansion in public sector employment, over the long term. These pressures add to investment needs, not least related to climate policy targets.

We continue to view the state's liquidity position as excellent, thanks to its proven access to capital markets at all times, in addition to its access to liquidity from other German states. Debt service coverage has increased, given the state's policy to increase cash holdings and avoid short-term debt. We expect the cash balance to remain at a high level over the next few years. We consider parts of the pension fund assets as liquid, specifically as a last-resort source. This means that NRW's average cash balance will be significantly higher than in the years before 2019, when the state pursued a zero-cash strategy. The state has excellent access to capital markets and regularly issues private placements and benchmark bonds in 18 currencies. NRW covered its financing needs in 2020-2021 at exceptionally low (or even negative) yields. Its liquidity also benefits from access to short-term funding from the German federal treasury and intraday access to Bundesbank (the German central bank) funds.

We consider the contingent liabilities stemming from state ownership of financial institutions to be significant. Nevertheless, we assume that the remaining parts of the EAA will be wound up with only limited recourse to NRW's funds. The state has set aside earmarked reserves for EAA's expected losses, which further cushion the contingent liabilities. Another legacy with risks for the state budget concerns the former state bank WestLB's successor, Portigon.

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.

Key Statistics

Table 1

State of North Rhine-Westphalia -- Selected Indicators

	--Fiscal year ending Dec. 31--						
(Mil. €)	**2018**	**2019**	**2020**	**2021bc**	**2022bc**	**2023bc**	**2024bc**
Operating revenues	72,905	75,839	82,298	78,184	80,543	82,693	85,605
Operating expenditures	66,980	68,111	82,235	75,496	75,904	76,387	78,548
Operating balance	5,925	7,727	63	2,688	4,639	6,306	7,057
Operating balance (% of operating revenues)	8.1	10.2	0.1	3.4	5.8	7.6	8.2
Capital revenues	1,960	1,875	1,446	1,534	1,495	1,554	1,582
Capital expenditures	6,647	7,344	9,811	8,435	8,709	7,723	7,552
Balance after capital accounts	1,238	2,259	(8,302)	(4,213)	(2,575)	137	1,087
Balance after capital accounts (% of total revenues)	1.7	2.9	(9.9)	(5.3)	(3.1)	0.2	1.2
Debt repaid	17,059	16,642	15,430	15,389	13,710	12,160	10,550
Gross borrowings	13,560	16,630	26,808	19,889	14,210	12,160	10,350
Balance after borrowings	(2,346)	1,814	3,315	143	(2,220)	465	821
Direct debt (outstanding at year-end)	139,416	145,095	156,126	160,626	161,126	161,126	160,926
Direct debt (% of operating revenues)	191.2	191.3	189.7	205.4	200.0	194.8	188.0
Tax-supported debt (outstanding at year-end)	152,963	152,490	163,918	168,276	168,626	168,526	168,226
Tax-supported debt (% of consolidated operating revenues)	209.8	201.1	199.2	215.2	209.4	203.8	196.5
Interest (% of operating revenues)	3.4	2.6	1.7	2.0	2.3	2.4	2.6
Local GDP per capita (€)	39,119	39,995	38,876	40,960	43,512	45,056	46,448

Table 1

State of North Rhine-Westphalia -- Selected Indicators (cont.)

	--Fiscal year ending Dec. 31--						
(Mil. €)	2018	2019	2020	2021bc	2022bc	2023bc	2024bc
National GDP per capita (€)	40,540	41,545	40,114	42,292	44,956	46,565	48,013

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	Score
Institutional framework	1
Economy	1
Financial management	2
Budgetary perfomance	3
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 12, 2021. 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

- Institutional Framework Assessments For International Local And Regional Governments, Aug. 2, 2021
- European Economic Snapshots: The Economy Is Responding Quickly To The Grand Reopening, July 9, 2021
- Research Update: Germany 'AAA/A-1+' Ratings Affirmed; Outlook Stable, March 26, 2021
- Local Government Debt 2021: COVID Aftershocks Push German And Austrian LRGs Into Heavy Borrowing, But Not Swiss Peers, March 25, 2021
- Default, Transition, and Recovery: 2019 Annual International Public Finance Default And Rating Transition Study, Dec. 8, 2020
- Public Finance System Overview: German States, Aug. 13, 2019
- Everyone Is A Winner--German States And The Revised Tax Equalization System, Oct. 22, 2018

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

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.