Research Update:

German State of North Rhine-Westphalia Upgraded To 'AA' From 'AA-' On Reduced Contingent Liabilities Burden

September 13, 2019

Overview

- We believe that a major call on guarantees that the German State of North Rhine-Westphalia (NRW) issued on the asset management company of a former state-owned bank is less likely than before.
- We deem the state well positioned to weather pressures on its budgetary performance from lower economic growth, given management's commitment and efforts on cost-savings to achieve balanced accounts.
- We are raising our long-term issuer credit and senior unsecured debt ratings on NRW to 'AA' from 'AA-'.
- The stable outlook reflects our expectation that the state will continue its robust financial performance despite potentially weakening tax revenue.

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Rating Action

On Sept. 13, 2019, S&P Global Ratings raised its long-term issuer credit and senior unsecured debt ratings on the German state of North Rhine-Westphalia (NRW) to 'AA' from 'AA-'. At the same time, S&P Global Ratings affirmed its 'A-1+' short-term rating on the state. The outlook is stable.

Outlook

The stable outlook reflects our expectation that NRW will continue its robust financial performance despite potentially weakening tax revenue, because the state is committed to control spending. This should allow NRW to further reduce its debt burden from current high levels. We also expect the state will continue to have very favorable access to external liquidity for long- and short-term financing.

Downside scenario

We could lower the rating if financial management deviates from consolidation efforts, leading to material deficits after capital accounts. In this case, NRW would also miss the requirement to refrain from net new borrowing as required by the German debt brake law.

Upside scenario

We could raise the ratings if the state's debt fell significantly to levels more comparable with those of international peers, while maintaining its excellent economic and liquidity situation.

We view both scenarios as unlikely over the next two years.

Rationale

The upgrade reflects our view of reduced risks from the legacy of a failed state bank. We believe that NRW should cover the remaining guarantees outstanding without significant recourse to debt financing, which helps the state to continue its budgetary consolidation. The ratings on NRW reflect the updated tax equalization system in Germany from 2020 onward, a balanced regional economy with decreasing unemployment rates, and a forecast of balanced accounts. The ratings also reflect the state's high debt burden and dependance on access to liquid debt markets.

NRW benefits from the updated tax-equalization system.

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 the change in the equalization system will grant NRW additional revenue of about €1.5 billion per year (about 2% of operating revenue). The state will be, for the first time in years, a donor state from 2020. The equalization of revenue also protects NRW from shocks to its revenue base, which is above average for German states. For example, the impact of Brexit might place a greater economic burden on it than other German states.

NRW's economy is very broad and well diversified, with regional GDP per capita at about $46,500 in 2018 (equivalent to about €42,500), just slightly below the German average ($48,300). We take the latter as the basis for our economic assessment. NRW's budget benefits only indirectly from its wealthy economy, because most taxes are shared between the federal government and the 16 states. NRW's economic growth usually follows national patterns, deviating only slightly. We expect Germany's real GDP will grow 0.5%-1.3% until 2022, down from 1.4% in 2018. Of the 50 largest German companies by revenue, 20 have their headquarters in NRW, which highlights its economic strength and importance. The state contributes about one-fifth to Germany's total GDP.

The region's economy is transitioning into more service-based sectors after two centuries of being dominated by hard coal mining and steel production. Germany's planned exit from brown coal-based energy production is placing additional pressure on NRW to transition from these industries. The federal government has agreed to assist the state with economic development funding through 2038, but we still believe this shift could present economic risks. Unemployment is moderate by international standards and declining, although it's still well above the national average (6.7% in August 2019, against a national average of 5.1%).

NRW is required to achieve structurally balanced accounts by 2020 at the latest. The draft budget for 2020 still shows a minor deficit of 1.7% of total revenue, which the government expects to close by implementing savings into the budget. We view this plan as achievable, given still-sound tax revenue and the state's commitment to contain expenditure growth. NRW's budgetary procedures are clear, are established, and have regular review cycles.

The likelihood of significant financial hits from legacies has fallen.

In our view, NRW's budgetary performance is sound. The state managed to close 2018 with a surplus after capital accounts, which it transferred to reserves. In our base-case scenario, we expect NRW to achieve moderate operating surpluses of about 8% of operating revenue, and a very small deficit after capital accounts on average from 2017-2021. Our forecast builds on solid tax revenue and contained expenditure growth, and depending on ongoing consolidation efforts and budgetary discipline to realize unspecified savings. We no longer include in our base-case scenario additional capital expenditure to cover losses at its bank wind-down unit, EAA, because we now deem it less likely that the guarantees will be drawn.

NRW pays pensions on a pay-as-you-go basis, and includes them in the state budgets and financial planning. We regard pension payments as highly predictable, but acknowledge that long-term pressure on NRW's budetary performance remains 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 long term. NRW has set aside €11.9 billion in a pension fund so far.

NRW's liquidity position is excellent due to proven access to capital markets at all times, in addition to its unconditional access to sources of liquidity from other governments. Debt service coverage is low, since net free cash and liquid assets cover about 50% of the next 12 months' debt service. We consider parts of the pension fund assets as liquid, specifically last-resort. We expect that the overall debt service coverage ratio will increase in the next few years because of the dual effect of an increasing pension fund and a decreasing debt burden. Nevertheless, the low coverage ratio leaves the state depending on its access to capital markets. NRW 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 funds.

NRW refinances a high level of debt every year, and €12 billion-€16 billion is scheduled to mature each year until 2022. Including interest payments, the share of debt service is consequently high, at about one-third of adjusted operating revenue. The state employs a zero-cash strategy, and has limited cash holdings throughout the year.

NRW's debt burden is very high in an international comparison, with tax-supported debt estimated to decrease below 180% of operating revenue in 2022 from its 2010 peak of 306%. We expect that the track record of debt reduction will become more pronounced with nominal debt reduction from 2019. 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 include in our debt assessment our estimate of contingent liabilities stemming from the state's institutions and companies, including EAA and NRW.Bank, the state's promotional bank.

EAA's overall wind-down portfolio has declined substantially each year, and stood at €43.3 billion as of second-quarter 2019. Its inherited derivatives portfolio has also reduced substantially by about 84% compared with 2011. We now 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 contingent liabilities.

NRW.Bank liabilities benefit from state guarantees. The bank is profitable, and has a balance sheet about twice the state's yearly revenue. NRW issued an explicit legal guarantee on NRW.Bank's capital market obligations, which could result in large-scale payments if this became a guarantee call. For the bank, we assess the potential recapitalization needs in an 'A' type stress scenario (for more information, see "Understanding S&P Global Ratings' Rating Definitions," published June 3, 2009, on RatingsDirect) as insignificant.

Key Statistics

Table 1

State of North Rhine-Westphalia -- Selected Indicators

	--Fiscal year ended Dec. 31--						
(Mil. €)	**2016**	**2017**	**2018**	**2019bc**	**2020bc**	**2021bc**	**2022bc**
Operating revenues	65,656	69,146	72,905	76,059	78,390	80,505	82,681
Operating expenditures	62,100	66,219	66,980	70,204	72,050	74,159	75,951
Operating balance	3,556	2,928	5,925	5,855	6,340	6,346	6,730
Operating balance (% of operating revenues)	5.4	4.2	8.1	7.7	8.1	7.9	8.1
Capital revenues	1,539	1,665	1,960	1,750	1,330	1,273	1,066
Capital expenditures	5,712	6,185	6,647	7,572	7,687	7,663	7,635
Balance after capital accounts	(617)	(1,593)	1,238	33	(17)	(44)	161
Balance after capital accounts (% of total revenues)	(0.9)	(2.2)	1.7	0	0	(0.1)	0.2
Debt repaid	18,579	19,137	17,059	16,700	15,000	13,829	13,352
Gross borrowings	18,388	20,224	13,560	16,667	15,017	13,873	13,191
Balance after borrowings	113	3	(2,346)	0	0	0	0
Direct debt (outstanding at year-end)	140,919	142,972	139,416	139,379	139,396	139,440	139,279
Direct debt (% of operating revenues)	214.6	206.8	191.2	183.3	177.8	173.2	168.5
Tax-supported debt (outstanding at year-end)	153,352	155,853	152,797	147,536	148,053	148,097	147,936
Tax-supported debt (% of consolidated operating revenues)	233.6	225.4	209.6	194.0	188.9	184.0	178.9
Interest (% of operating revenues)	4.2	3.8	3.4	3.4	3.2	3.2	3.1
Local GDP per capita (single units)	37,151	38,276	39,358	41,747	43,108	44,514	44,447
National GDP per capita (single units)	38,451	39,715	40,897	41,831	43,054	44,351	45,697

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	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 11, 2019. Interactive version 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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Default, Transition, and Recovery: 2018 Annual International Public Finance Default Study 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
- Germany 'AAA/A-1+' Ratings Affirmed; Outlook Stable, April 12, 2019
- Local Government Debt 2019: Slower Debt Reduction For German States And Little Change For Swiss And Austrian LRG Debt, March 1, 2019

- Local Government Debt 2019: Economic Slowdown Is Set To Spur European LRG Borrowings In 2019-2020, Feb. 25, 2019
- Local Government Debt 2019: Global Debt Stock, Outside The U.S., To Exceed US$11 Trillion By 2020, Feb. 25, 2019
- Banking Industry Country Risk Assessment: Germany, Nov. 2, 2018
- Everyone Is A Winner--German States And The Revised Tax Equalization System, Oct. 22, 2018
- Understanding S&P Global Ratings' Rating Definitions, June 3, 2009

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

Upgraded; CreditWatch/Outlook Action; Ratings Affirmed

	To	From
North Rhine-Westphalia (State of)		
Issuer Credit Rating	AA/Stable/A-1+	AA-/Positive/A-1+
Upgraded		
North Rhine-Westphalia (State of)		
Senior Unsecured	AA	AA-