Research Update:

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

February 26, 2021

Overview

- Lower tax revenue and pandemic-related spending resulted in a significant increase in debt issuance to finance the deficit after capital accounts in 2020.
- North Rhine Westphalia's (NRW's) debt capital market access has remained excellent, and borrowing cost very low.
- We expect improving budgetary performance and decreasing debt relative to operating revenue over 2021-2024.
- We are affirming our 'AA/A-1+' long- and short-term issuer credit rating on NRW. The outlook remains stable.

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Rating Action

On Feb. 26, 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 be temporary, and the debt burden relative to operating revenue will start declining again after 2021.

Downside scenario

We could lower the ratings if NRW's budgetary performance failed to recover over the coming two-to-three years. This could result from protracted economic difficulties or significant fiscal policy slippages. We could also lower the ratings if the state's exceptional capital market access were to weaken.

Upside scenario

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

Rationale

NRW's budgetary performance was affected by the pandemic in 2020, due to subdued economic activity and tax revenue, as well as the state's fiscal policy response. The impact was more moderate than we had projected, but the deficit after capital accounts still reached 10% of total revenue. Consequently, the state tapped capital markets and increased its nominal direct debt by €11 billion in 2020. We expect another €5 billion-€6 billion of net borrowing in 2021-2022 to cover COVID-19-related tax revenue shortfalls and additional expenditure. At the same time, we anticipate that accumulated liquid reserves and improving budgetary performance will enable the state to reach its goal of reducing net new borrowing to zero by 2023.

NRW's strong economic profile continues to support the ratings, because we expect the recovery to gain traction toward the second half of 2021. At the same time, Germany's highly predictable and supportive institutional framework for federal states 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 funding needs.

Recovery from COVID-19 fallout will accelerate in the second half of 2021

Germany and NRW are maintaining restrictions on economic activity at least until March 2021. We expect the economic recovery in Germany to gain traction in the second half of 2021, with an overall GDP growth rate of 3.7%. This will lead to increasing tax revenue in NRW and, together with the supportive equalization system, is set to improve the financial and debt indicators that weakened temporarily in 2020.

Tax revenue dropped less than 2% in 2020, more moderately than we had expected. The state and its municipalities received substantial support from the German federal government, and borrowing conditions for NRW remain exceptionally favorable. At the same time, we expect fiscal policy to continue being expansionary in 2021.

A key element of the state's fiscal policy response is a support package of a maximum amount of €25 billion (over 2020-2022) to finance budget shortcomings and unforeseen expenses. Authorities report pandemic-related revenue shortfalls and additional spending under this package off-budget, but we consolidate this into NRW's fiscal metrics. We anticipate that new debt taken on will be about €17 billion over 2020-2022, well below the €25 billion authorized by the state parliament.

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. Despite the economic shock in 2020, NRW continues to benefit from its strong and diversified economy. 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. 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. Against this backdrop, the state's ambitious investment program intends to strengthen long-term growth potential.

The reported unemployment rate in 2020, at 7.5% in December, was not as big as expected, and we expect that potential increases in 2021 will likely remain contained because of furlough schemes and other support measures.

We view the institutional framework in which German states operate as one of the most predictable and supportive globally, including the amended equalization system that took effect in 2020. The equalization of revenue also protects NRW from large shocks to its revenue base. The federal government changed the equalization law in 2020 again to ensure that the temporary value-added tax rate reduction in 2020 was not borne by the states. In our view, this further indicates the supportive nature of intergovernmental relations. The central government also provided sizable support to the municipal sector and for public transport under the federal stimulus package.

According to the debt-brake rule, NRW is required to achieve structurally balanced accounts, but the law contains exceptions that authorities invoked in response to the pandemic. We understand that the state intends to return to zero net new borrowing by 2023.

In our view, NRW's budgetary procedures are clear and established, and have regular review cycles. We consider the state's financial management strong and exceptionally experienced regarding the standards for debt and liquidity management. An example is the recurring issuances of 100-year bonds since 2019, the most recent coming in January 2021. While we think 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. In our view, authorities have been transparent about the off-budget reporting of pandemic-related revenue shortfalls and additional spending. The state's financial management has in recent years demonstrated its ability to underspend in budget execution, for example in personnel or interest expenditure. While the state still has a lingering issues from the 2008-2009 financial crisis, for example in wind-up agency Erste Abwicklungsanstalt (EAA), we view the supervision and management of the state's participations as robust. This is notwithstanding the potential need for state support to WestLB successor Portigon, because of the bank's recent ad hoc disclosure on higher expected losses. The issues causing Portigon's loss in 2020 date back to before 2008.

Budgetary and debt metrics are set to improve, and borrowing conditions are very favorable

We expect NRW to post an operating surplus of 1.5% of operating revenue in 2021, and we anticipate this surplus will rise significantly to 8.0% by 2024, in line with Germany's economic recovery. The overall deficit after capital accounts will turn to a surplus only in 2024. Our forecast takes into account the additional 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.

Tax revenue over the next two-to-three years will underperform pre-pandemic expectations, but the projections for 2020 successively improved in the year, and the tax revenue shortfall of €4.1 billion was lower than the €4.8 billion still expected in the November projections. The significant increase in transfers received from Germany's federal government supported the state's 2020 balanced operating result

We maintain our assumption that the state will underspend in budget execution, given conservative planning in some positions (such as interest or personnel expenditure), as was the case in 2020 and before. We expect the state to use debt to finance pandemic-related revenue shortfalls and additional spending of about €17 billion over 2020-2022.

We expect NRW's tax-supported debt will increase to above 220% of operating revenue this year and gradually decline to just below 200% by 2024. While the state's debt burden remains very high in an international comparison, 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 remains rather limited. It also increased the guarantees to NRW.Bank for the bank's various support lines. The effective amount of pandemic-related contingent liabilities is unclear, but we expect that many affected companies will likely rather rely on federal government support programs if needed.

NRW pays pensions out of its budget on a pay-as-you-go basis. We regard pension payments as highly predictable, but consider that long-term pressure on the state's budgetary performance persists as pension payments are forecast to peak in the next decade. NRW's flexibility is therefore somewhat limited because it can only adjust the very high pension burden in the long term as it reflects past decades' extension of public sector employment. The state has set aside €13.2 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 liquidity from other German states. Debt service coverage has increased, given the state's policy to increase cash holdings to reduce reliance on short-term debt. We think that cash balances will remain elevated, although they'll decline gradually, over the coming two years. We consider parts of the pension fund assets liquid, specifically as a very last-resort source. As a result, NRW's average cash holdings will remain substantially higher than in the years before 2019, when the state employed a zero-cash strategy. The state is a regular issuer of private placement and benchmark bonds in 18 currencies. It covered its financing needs in 2020 at exceptionally low or even negative yields. In January 2021, the state issued another €2.15 billion 100-year bond at a 0.95% coupon. Its liquidity also benefits from access to short-term funding from the German federal treasury and intraday access to Bundesbank (central bank) funds.

We consider contingent liabilities from financial institutions substantial. Nevertheless, we expect that the remaining parts of EAA will wind down with only limited recourse to funds from NRW. The state has accumulated earmarked reserves to cover for expected losses at EAA, which further buffer its contingent liabilities. EAA's overall balance sheet size stood at €38.2 billion (or about 50% of the state's operating revenue) on Sept. 30, 2020, down from €40 billion at year-end 2018 due to progress with its wind-down activities.

We understand that NRW could be required to provide funds to cover parts of losses of €600 million at former state bank WestLB successor Portigon, an announcement made at the end of 2020. These unexpected losses are because of dividend arbitrage transactions of the former state bank before 2008, which have been deemed unlawful. While we expect a decision on the state's financial contribution in the coming months, the amount depends on various factors such as Portigon's reserves buffers and loss absorption capacity.

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. 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 ended Dec. 31--						
(Mil. €)	**2018**	**2019**	**2020**	**2021bc**	**2022bc**	**2023bc**	**2024bc**
Operating revenue	72,905	75,839	82,298	76,194	78,649	82,049	85,387
Operating expenditure	66,980	68,111	82,235	75,036	75,904	76,387	78,548
Operating balance	5,925	7,727	63	1,158	2,745	5,662	6,839
Operating balance (% of operating revenue)	8.1	10.2	0.1	1.5	3.5	6.9	8.0
Capital revenue	1,960	1,875	1,446	1,534	1,495	1,554	1,582
Capital expenditure	6,647	7,344	9,811	8,435	8,709	7,723	7,552
Balance after capital accounts	1,238	2,259	(8,302)	(5,743)	(4,469)	(507)	869
Balance after capital accounts (% of total revenue)	1.7	2.9	(9.9)	(7.4)	(5.6)	(0.6)	1.0
Debt repaid	17,059	16,642	15,430	15,389	13,753	12,219	9,341
Gross borrowings	13,560	16,630	26,808	20,389	14,253	12,219	9,141
Balance after borrowings	(2,346)	1,814	3,315	(887)	(4,114)	(179)	603
Direct debt (outstanding at year-end)	139,416	145,095	156,126	161,126	161,626	161,626	161,426
Direct debt (% of operating revenue)	191.2	191.3	189.7	211.5	205.5	197.0	189.1
Tax-supported debt (outstanding at year-end)	152,963	152,490	163,918	168,776	169,126	169,026	168,726
Tax-supported debt (% of consolidated operating revenue)	209.8	201.1	199.2	221.5	215.0	206.0	197.6
Interest (% of operating revenue)	3.4	2.6	1.7	2.0	2.4	2.4	2.6
Local GDP per capita (€)	39,358	39,678	38,016	39,868	41,690	43,080	44,457
National GDP per capita (€)	40,540	41,545	39,810	41,700	43,582	45,005	N.M.

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. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

North Rhine-Westphalia--Ratings Score Snapshot

Key rating factors	Score
Institutional framework	1
Economy	1
Financial management	2
Budgetary perfomance	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, Dec. 14, 2020. 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: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Institutional Framework Assessments For International Local And Regional Governments, Jan. 11, 2021
- Local And Regional Governments Outlook 2021: Gradual Recovery Will Test Rating Resilience, Dec. 10, 2020
- Default, Transition, and Recovery: 2019 Annual International Public Finance Default And Rating Transition Study, Dec. 8, 2020
- Germany 'AAA/A-1+' Ratings Affirmed; Outlook Stable, Oct. 2, 2020
- Public Finance System Overview: German States, Aug. 13, 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