FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms State of North Rhine-Westphalia at 'AAA'; Outlook Stable

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Fitch Ratings - Frankfurt am Main - 15 Sep 2023: Fitch Ratings has affirmed the State of North Rhine-Westphalia's (NRW) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'AAA' with Stable Outlook.

The affirmations reflect Fitch's unchanged rating approach for German Laender, under which

the ratings are equalised with those of the Federal Republic of Germany (Bund; AAA/Stable/F1+).

KEY RATING DRIVERS

Risk Profile: 'Stronger'

Fitch assesses all of NRW's key risk factors as 'Stronger' The 'Stronger' risk profile also reflects NRW's very good access to capital markets, a corresponding strong refinancing capacity and appropriate treasury facilities preventing any temporary delays in the provision of liquidity and support.

Revenue Robustness: 'Stronger'

This assessment is driven by the high share of stable revenue sources due to the strong and diversified tax base and stable transfers from the Bund. We view Laender as resilient to shocks, mitigating the risk of a shrinking revenue base.

Laender's main revenue sources consist of common tax revenues (corporate income tax (CIT), VAT and personal income tax (PIT) between the Bund, Laender, and to a lesser extent, municipalities. By law Laender receive 50.0% of CIT and 42.5% of PIT. Their VAT shares have a more complex allocation process and marginally vary. In 2022, the share was 50.5% for Laender, 46.6% for the Bund and 2.8% for municipalities. In 2022 tax revenue accounted for 71.3% of NRW's total revenue, with PIT and VAT the largest contributors, at 25.4% and 31.4%, respectively.

Revenue Adjustability: 'Stronger'

This assessment is supported by a strong record of revenue equalisation, an essential part of Fitch's rating approach, which links Laender's ratings to the Bund's. An extensive equalisation system and a broad-based solidarity pact compensate for financial disparity. The equalisation framework requires financially stronger Laender to transfer part of their above-average tax proceeds to financially weaker members. The framework partly offsets the differences among Laender's tax revenue base and their financial strength.

The most recent reform of the financial equalisation system confirms the stability of revenue equalisation. This is likely to increase transfers from the Bund to financially weaker Laender and lower the burden of net donor states, which Fitch views as credit positive. NRW is a net recipient from the financial equalisation system with EUR1.2 billion in 2022 (2021: EUR0.2 billion) based on preliminary figures.

Expenditure Sustainability: 'Stronger'

Laender have a prudent record of control of operating spending. The main spending items are education and science, security and infrastructure, which are counter-cyclical. In times of economic stress, the Bund carries out anti-cyclical measures.

Laender have been applying cost-consolidation measures since 2010 to comply with the debt-brake rule starting in 2020. They have shown strong spending restraint since 2010 to keep operating spending growth below operating revenue growth. Cost-consolidation measures are subject to the supervision of the German Stability Board.

Expenditure Adjustability: 'Stronger'

Laender have effective budget rules in place and have demonstrated a strong ability to limit expenditure growth ahead of the debt brake. They have a moderate share of inflexible spending items. Personnel costs and operating subsidies accounted for 32.3% and 52.6%, respectively, of NRW's operating spending in 2022, while capex was a low 11.5% of total spending.

Operating revenue growth usually outpaces the growth of operating expenditure. However, for 2018-2022 NRW's operating revenue grew 8.0% on average, while operating spending growth was 8.5% on average, but this was driven by the pandemic.

Liabilities & Liquidity Robustness: 'Stronger'

German Laender operate in a solid national framework for debt and liquidity management and show strict market discipline, which Fitch views as credit positive. As one of the largest subnational and frequent issuers, Laender enjoy strong access to international capital markets, including Bund benchmark issues.

However, following the ECB's most recent interest rate increases, the interest burden of Laender is likely to rise following a long period of reductions. This risk has been mitigated by Laender extending their maturity profiles in recent years, including up to 100-year bond issues, or by forward-rate agreements.

In general, German Laender also face large contingent liabilities in the form of debt guarantees on behalf of their development banks and former Landesbanken, as well as their largely unfunded pension liabilities. The risk stemming from their commitments provided to banks is mitigated by adequate assets and the conservative business profiles of their development banks. In addition, the amount of contingent liabilities stemming from the deficiency guarantees provided to former Landesbanken is largely declining.

NRW has a strong record of access to capital market, which it regularly taps the markets with benchmark issues. NRW's floating-rate issues are largely hedged. In total, NRW has issued four 100-year bonds and nine sustainable bonds.

Liabilities & Liquidity Flexibility: 'Stronger'

German Laender operate in a strong framework for emergency liquidity support provided by upper tier governments with a counterparty risk of 'AAA'. This established and active liquidity management system, together with Laender's strong access to capital markets, a corresponding strong refinancing capacity and appropriate treasury facilities, should prevent delays in the provision of liquidity and support.

The liquidity risk of a single Land is avoided through bilateral and mutual agreements linking all Laender as well as the Bund, ensuring their ability to assist one another. Liquidity would only fail to be forthcoming for any given Land in the event of a complete federal breakdown, in which neither Laender nor the Bund itself could provide liquidity.

All the liquidity provision facilities underline the strong financial support mechanism that is anchored in the German financial constitution, which requires the Bund and Laender to support any single state in financial distress. This sub-factor is core to Fitch's rating approach for German Laender.

Debt Sustainability: 'a category'

Fitch classifies German Laender as type A local and regional government as the state has the ability to incur structural deficits and German Laender share some key attributes of sovereignty.

Our 'a' debt sustainability (DS) assessment of NRW is driven by its economic liability burden, assessed at 54.5%, corresponding to the 'aa' category according to our rating case for 2027, a debt payback ratio at 24.0x (bb), synthetic debt service coverage at 0.5x (b) and a fiscal debt burden at 145.3% (a).

DERIVATION SUMMARY

NRW's IDRs are linked to the Bund's. No other factors affect the IDRs. We assess NRW's Standalone Credit Profile (SCP) at 'aa +', which results from a 'Stronger' risk profile and a 'a' DS score under our rating case.

Equalisation of the German Laender's ratings with the Bund's is driven by the stability of the solidarity system underpinning the creditworthiness of all Laender, irrespective of the key risk factors and DS assessment.

The solidarity system is enshrined in the German constitution and reflects the institutional framework of Laender. Under the constitution, all member states of the federal republic are jointly responsible for supporting a Land in financial distress. If a Land experiences 'extreme budgetary hardship', it is entitled to financial assistance from all other Laender and the Bund. This principle has been reaffirmed by the constitutional courts on more than one occasion, most recently in 2006.

Short-Term Ratings

NRW's Short-Term IDRs of 'F1+' are mapped to its Long-Term IDRs of 'AAA'.

Debt Ratings

NRW's senior unsecured debt ratings are in line with its respective Long- and Short-Term IDRs.

KEY ASSUMPTIONS

Risk Profile: 'Stronger'

Revenue Robustness: 'Stronger'

Revenue Adjustability: 'Stronger'

Expenditure Sustainability: 'Stronger'

Expenditure Adjustability: 'Stronger'

Liabilities and Liquidity Robustness: 'Stronger'

Liabilities and Liquidity Flexibility: 'Stronger'

Debt sustainability: 'a'

Support (Budget Loans): 'N/A'

Support (Ad Hoc): 'N/A'

Asymmetric Risk: 'N/A'

Rating Cap (LT IDR): 'AAA'

Rating Cap (LT LC IDR) 'AAA'

Rating Floor: 'AAA'

Quantitative assumptions - Issuer Specific

Fitch's rating case is a "through-the-cycle" scenario, which incorporates a combination of revenue, cost and financial risk stresses. It is based on 2018-2022 reported figures and 2023-2027 projected ratios.

The key assumptions for the scenario include:

- Operating revenue to increase 2.6% yoy, including tax revenue growth of 3.7%

- Operating expenditure to increase 2.9% yoy

- A negative capital balance on average of EUR6,647 million

Quantitative assumptions - Sovereign Related

Figures as per Fitch's sovereign actual for 2022 and forecast for 2023-2025, respectively (no weights and changes since the last review are included as none of these assumptions was material to the rating action)

Liquidity and Debt Structure

Net Fitch-adjusted debt at end-2022 of EUR147.0 billion reflects NRW's direct debt (EUR163.8 billion) less unrestricted cash (EUR16.8 billion). NRW's debt can increase further by up to EUR5 billion in 2023 due to the establishment of a special fund ("Sondervermögen Krisenbewältigung") to cope with the effects of the war in Ukraine, ie. higher costs for energy and the refugees.

Net overall debt of EUR158.8 billion for 2022 further included the state's issued guarantees of EUR6.3 billion, debt of its majority-owned government-related entities and other contingent liabilities (2021: EUR5.5 billion; the latest available information). Fitch sees low risk from NRW's contingent liabilities.

Issuer Profile

NRW is the most populated state in Germany (2022: 18.1 million inhabitants) and the largest contributor to Germany's economy, at about 20% of GDP.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

A downgrade of the sovereign ratings would lead to a downgrade of NRW.

An adverse change to the most important institutional feature, the solidarity principle, which Fitch views as unlikely, could also lead to a downgrade of NRW.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

The ratings are the highest level on Fitch's rating scale, and cannot be upgraded.

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

DISCUSSION NOTE

Committee date: 12 September 2023

There was an appropriate quorum at the committee and the members confirmed that they were free from recusal. It was agreed that the data was sufficiently robust relative to its materiality. During the committee no material issues were raised that were not in the original committee package. The main rating factors under the relevant criteria were discussed by the committee members. The rating decision as discussed in this rating action commentary reflects the committee discussion.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

NRW's ratings are credit-linked to Germany's.

References for Substantially Material Source Cited as Key Driver Rating

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
North Rhine-Westphalia, State of	LT IDR	AAA Rating Outlook Stable	Affirmed	AAA Rating Outlook Stable
	ST IDR	F1+	Affirmed	F1+
	LC LT IDR	AAA Rating Outlook Stable	Affirmed	AAA Rating Outlook Stable
	LC ST IDR	F1+	Affirmed	F1+
senior unsecured	LT	AAA	Affirmed	AAA
senior unsecured	ST	F1+	Affirmed	F1+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

International Local and Regional Governments Rating Criteria (pub. 03 Sep 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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North Rhine-Westphalia, State of	EU Issued, UK Endorsed

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. Sector-specific best- and worst-case scenario credit ratings are listed in more detail at https://www.fitchratings.com/site/re/10238496

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