S&P Global
Ratings

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North Rhine-Westphalia (State of)

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This report does not constitute a rating action.

Credit Highlights

Overview

Credit context and assumptions	Base-case expectations
The State of North Rhine-Westphalia (NRW)'s recovery from the fiscal effects of the COVID-19 pandemic has been slightly faster and with less additional debt than previously thought.	S&P Global Ratings continues to believe that NRW will achieve broadly balanced budgets from 2023, and we now anticipate a small first repayment of COVID-19-related debt from leftover liquidity already next year.
--Tax revenue recovered significantly more quickly during the past year than anticipated and has now surpassed pre-pandemic levels.	--Our expectation is conditional on the economy maintaining solid growth rates over the next three years and the state not having to cope with any German tax cuts that would cause substantial revenue losses.
--A large portion of pandemic-related transfer payments to local enterprises and infrastructure have been financed with federal, rather than state funds.	--The very positive revenue outlook presented by the most recent official German tax estimate from November 2021 fuels our forecast.
--Thanks to above-budget tax revenue, NRW's COVID-19-focused special financing account has borrowed significantly less than initially authorized and accumulated a substantial liquidity reserve	--The upcoming state election in May 2022 notwithstanding, we assume a fiscal policy that, while funding slightly increased capital expenditure (capex), will remain commensurate with balanced accounts once the pandemic abates.

Our ratings of NRW are based on the expectation that its management will achieve balanced accounts once the immediate budgetary performance hit from the pandemic subsides. The observed fast rebound in tax revenue should make this easier for the state.

The rating is supported by NRW's strong local economy, its robust and sophisticated access to capital market funding, and a beneficial institutional framework under which the German federal government and social security systems have provided substantial financial assistance to the states and their local economies for COVID-19-related expenditure. That said, a comparatively high debt burden accumulated in the past and contingent liability risk from legacy financial institutions affiliated with the state constitute the weaknesses of NRW's rating profile.

Outlook

The stable outlook reflects our view that the pandemic-related hit to the state's budgetary performance and debt accumulation will remain temporary. We also believe that the debt burden relative to operating revenue will start declining again, alongside significant budgetary improvements, if the distortive effect that the pass-through of elevated federal COVID-19 aid had on this ratio in 2021 is adjusted for.

Downside scenario

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

Upside scenario

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

Rationale

The state recorded a remarkable tax revenue recovery in 2021

Last year's realized tax revenue growth in Germany and NRW very significantly outpaced our expectations and the observed rebound in GDP. The state reported an almost 12% increase in tax collections over depressed 2020 levels, which means that it received about €5.7 billion more than budgeted. In fact, NRW's actual tax revenue has now surpassed 2019 pre-pandemic levels earlier than previously anticipated.

The most recent semi-annual German official tax forecast, from November 2021, expects the positive development to continue. Compared to the prior estimate from May 2021, it predicts NRW will have an additional €3.1 billion-€3.5 billion available annually over 2022-2025. This is based on the legislation currently in place and does not incorporate any potential tax cuts--an intention recently proposed by the new German federal finance minister, albeit without many details given--which would automatically affect NRW's revenue basis under Germany's system of shared taxes. However, given diverging interests in the three-party coalition governing at the national level, we currently do not anticipate any fiscally material reform is imminent.

German general economic growth is expected to accelerate in 2022, after it was still held back by pandemic-related restrictions last year. We anticipate 2022 real GDP growth of 4.3%, after an estimated 2.7% in 2021. This implies that the pandemic, although still very present, has ceased to be a major impediment to most economic activities. However, recent geopolitical tensions, namely the Russia-Ukraine conflict, could affect macroeconomic prospects. NRW, which is home to many large corporations with exposure to energy prices, would not be immune.

Our current economic predictions imply a local GDP per capita of €43,150 (equivalent to more than $49,700) for NRW in 2022. This is slightly below the anticipated national GDP per capita of €45,000 (almost $52,000), but nevertheless represents a very high value in an international comparison.

NRW continues to benefit from a strong and diversified local economy, despite some ongoing structural challenges. The state is Germany's largest by population, and its regional GDP--which contributes over 20% to national GDP--exceeds that of, for example, Switzerland. NRW hosts the headquarters of numerous German blue chip companies, with Deutsche Telekom, Deutsche Post, Aldi, Rewe Group, and E.ON the largest by revenue. That said, the phase-out of previously important coal-based energy production continues to challenge the state. A federal program that will channel more than €15 billion to NRW's coal-producing areas until 2038 will support the required economic transformation. NRW's unemployment rate of 6.7% at year-end 2021 is above the German national average of 5.1%. In our view, this still reflects the long-term socio-economic effects of the state's legacy coal and heavy industrial production.

We do not expect the outcome of the upcoming state election on May 15, 2022, to have a material effect on NRW's approach to financial management. Regardless of the outcome, we expect any new government to again abide by the--currently still suspended--zero deficit target in the debt brake legislation from 2023, close NRW's segregated special funding vehicle for COVID-19-related expenditure and borrowings, and generally focus on achieving balanced accounts while not neglecting moderately elevated capex.

Limited fiscal breathing space could be built by eventually suspending €200 million of annual contributions to a pension reserve account and instead starting to make withdrawals from it. However, to our knowledge, no such decision has been made.

In any case, NRW will continue to benefit from the extremely supportive institutional framework under which German states operate. More than €18 billion in operating transfers received by the state from the national government in 2021--about €8 billion more than originally budgeted--document federal solidarity in a challenging pandemic situation.

Broadly balanced budgets and a stable, albeit comparatively high, debt burden are forecast

We expect NRW to normalize budgetary performance and achieve balanced accounts after capex from 2023. Supported by the V-shaped recovery of tax revenue in 2021, the state already displayed an operating margin of 6.2%, according to our cash-focused calculation approach, and reduced its deficit after capital accounts to merely 1.4% during the past year, which is stronger than previously predicted. Although accounts are already balanced if the negative effects from COVID-19-related items are removed from the performance calculation, we anticipate that 2022 figures will remain burdened by pandemic-induced spending. Therefore, they might even be slightly weaker than 2021. For modeling purposes, we assume that--next to passing through federal money--NRW will spend about €3 billion of state funds on COVID-19-mitigation measures in 2022, slightly below 2021 levels. However, such expenditure is difficult to predict, and a different volume may eventually be realized. From 2023, we expect the state's budgetary performance to move on from the COVID-19 pandemic with a return to operating margins clearly above 8%, and--despite a declared focus on capex in support of education, economic innovation, environmental protection, and infrastructure--compliance with the zero-deficit target of the existing debt brake legislation again.

Ongoing pension payments for already retired civil servants under the state's pay-as-you-go system reduce its budgetary leeway, in our view. They currently consume more than 12% of annual adjusted operating revenue and are expected to increase further until presumably peaking toward the end of this decade. The state's accumulated pension reserve account of €14 billion can only dampen the rise, but not permanently offset it. It would only cover about 16 months of payments for pensions and pensioners' health care, according to our calculations.

The state's comparatively high tax-supported debt burden of 180%-190% of consolidated operating revenue constitutes the weakest factor in our rating assessment of NRW. In our respective calculation, we add the debt of Bau- und Liegenschaftsbetrieb NRW--which manages government-used real estate on behalf of the state--and a school investment program prefinanced by NRW.Bank to the core budget's debt. We expect no material change in debt, although we understand that the state plans to use any leftover liquidity in its segregated COVID-19 funding account at year-end 2022 to redeem up to €1.6 billion of pandemic-related debt that matures in 2023. NRW has developed a highly sophisticated approach to debt management, which includes, for example, the use of foreign currency financing on a fully hedged basis, ultra-long 100-year issues, and an issuance program for sustainability bonds that combine green and social features. With a duration of almost 17 years and more than 85% of the portfolio at fixed rates, we consider interest rate risk contained.

Next to existing debt, we perceive a material volume of contingent liability risk, primarily emanating from exposure to legacy state financial institutions. We note, however, that NRW has already earmarked reserves for potential losses in excess of residual equity at state-guaranteed winddown institution Erste Abwicklungsanstalt (EAA), and in 2021 it injected €160 million into Portigon AG, the legal successor of former WestLB that is also being closed. Debt of various nonfinancial companies, municipal debt, and a granular guarantee portfolio constitute further elements of our contingent liabilities assessment.

Stronger-than-expected tax collection, combined with precautionary borrowing at the beginning of last year, left NRW with €14.7 billion of liquidity at year-end 2021. Together with the €14 billion parked in the state's pension reserve account and invested in securities, this now more than covers 2022 estimated debt maturities of about €15 billion, even after applying haircuts. Also factoring in the state's proven borrowing ability in the capital market and its access to liquidity from other levels of government, we assess NRW's overall liquidity position as exceptionally strong. We note that the state has abandoned its previous zero-cash approach to liquidity management independently of the COVID-19-pandemic and instead now pre-funds expenditure with long-term borrowings. This should help to maintain a solid overall liquidity position, even though redeeming COVID-19-related debt that matures from 2023 might slightly reduce the state's cash balance. NRW does not maintain any committed bank credit facilities and rather relies on continuous access to market funding.

State of North Rhine-Westphalia Selected Indicators

Mil. €	2019	2020	2021e	2022bc	2023bc	2024bc

Operating revenue	75,838.7	83,066.0	90,339.0	87,090.8	86,187.0	89,568.0
Operating expenditure	68,111	82,893	84,720	82,998	79,065	81,848
Operating balance	7,727	173	5,619	4,093	7,122	7,720
Operating balance (% of operating revenue)	10.2	0.2	6.2	4.7	8.3	8.6
Capital revenue	1,875	1,515	1,796	1,811	1,850	1,898
Capital expenditure	7,344	9,897	8,736	9,303	8,664	8,782
Balance after capital accounts	2,259	(8,210)	(1,321)	(3,399)	308	836
Balance after capital accounts (% of total revenue)	2.9	(9.7)	(1.4)	(3.8)	0.3	0.9
Debt repaid	22,710	16,855	17,010	14,908	13,896	12,763
Gross borrowings	17,998	27,839	21,533	14,908	12,278	11,963
Balance after borrowings	(2,885)	3,013	3,081	(3,550)	(988)	(36)
Direct debt (outstanding at year-end)	145,096	156,126	160,649	160,649	159,031	158,231
Direct debt (% of operating revenue)	191.3	188.0	177.8	184.5	184.5	176.7
Tax-supported debt (outstanding at year-end)	152,490	163,900	168,312	168,312	166,694	165,894
Tax-supported debt (% of consolidated operating revenue)	201.1	197.3	186.3	193.3	193.4	185.2
Interest (% of operating revenue)	2.6	1.7	1.7	1.7	1.9	2.3
Local GDP per capita (single units)	39,995	38,876	40,703	43,154	44,862	46,172
National GDP per capita (single units)	41,838	40,492	42,415	45,004	46,804	48,179

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. e—Estimate, bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. €--euro. $--U.S. dollar.

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, Dec. 13, 2021. An interactive version is available at http://www.spratings.com/sri

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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

- NRW.BANK, Feb. 17, 2022
- Institutional Framework Assessments For International Local And Regional Governments, Feb. 10, 2022
- Institutional Framework Assessment: German States, Dec 7, 2021
- European Economic Snapshots: From Fast-Paced Recovery To Robust Expansion, Dec 6, 2021
- Erste Abwicklungsanstalt, Sept. 20, 2021
- Default, Transition, and Recovery: 2020 Annual International Public Finance Default And Rating Transition Study, Sept. 14, 2021
- German State of North Rhine-Westphalia 'AA/A-1+' Ratings Affirmed; Outlook Stable, Aug. 27, 2021
- 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, March 25, 2021

Ratings Detail (as of February 25, 2022)*

North Rhine-Westphalia (State of)	
Issuer Credit Rating	AA/Stable/A-1+
Senior Unsecured	AA
Short-Term Debt	A-1+
Issuer Credit Ratings History	
13-Sep-2019	AA/Stable/A-1+
16-Mar-2018	AA-/Positive/A-1+
21-Dec-2004	AA-/Stable/A-1+