Research Update:

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

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Overview

- The State of North Rhine-Westphalia's (NRW's) tax revenue currently benefits from inflation, which is more than compensating for slower economic growth.
- However, we forecast broadly stable budgetary performance since we anticipate that higher expenditure--particularly for staff compensation--in response to rising prices will eventually replace COVID-19-related disbursements as the primary impediment to stronger results.
- Overall, we expect only minor deficits after capital accounts and no material change in NRW's debt burden, unless the worst-case scenario of a complete and permanent stop of Russian gas deliveries materializes in the short term.
- We have affirmed our 'AA/A-1+' long-term and short-term ratings on NRW and maintained our stable outlook.

Rating Action

On Aug. 26, 2022, S&P Global Ratings affirmed its 'AA/A-1+' long- and short-term issuer credit ratings on the German State of North Rhine-Westphalia. The outlook is stable. At the same time, we affirmed our 'AA+' issue ratings on North Rhine-Westphalia's senior unsecured debt.

Outlook

The stable outlook reflects our expectation that rising prices will push up NRW's revenue and expenditure, thereby keeping budgets almost balanced and limiting the need for material net new borrowing, despite more subdued real economic growth. We also assume that, despite geopolitical issues, particularly the war in Ukraine, the state will not suffer from a sharp recession, large revenue losses, or be required to implement sizable support packages for its economy.

Downside scenario

We could take a negative rating action if NRW needs to respond to a significantly deteriorating economic environment, in particular due to a complete stop of Russian gas deliveries to Germany, and this leads to a collapse of budgetary performance and markedly higher debt. The materialization of meaningful contingent liabilities, particularly in the municipal sector and related to distortions in the energy market, could be a contributing factor.

Upside scenario

We might consider a positive rating action if the state manages to improve budgetary performance significantly beyond our current expectations and markedly reduce contingent liabilities from legacy financial institutions and its municipal sector. This could signal stronger financial management than we currently assess.

Rationale

The quick recovery of tax revenue following the pandemic, and the state's concurrent return to structurally more balanced budgets, support our ratings on NRW. Because NRW's major revenue sources, particularly value-added tax (VAT) and payroll tax, benefit from inflation, any negative effects from rising prices should remain contained.

NRW's very high debt burden, particularly once contingent liability risk from legacy financial institutions and its municipal sector is accounted for, constitutes the weakest aspect of our ratings. That said, the state profits from highly sophisticated debt management, which secured low funding costs through significantly extended maturities, a high volume of liquidity reserves, and a large and diversified economy that represents more than 20% of German GDP.

Potential geopolitical events with a subsequent massive economic fallout for Germany in general, and NRW in particular, represent the biggest threat to our ratings on the state. But, the impact is difficult to quantify.

Tax revenue currently defies weaker real economic growth prospects

The outlook for the German economy has deteriorated markedly over the past six months. Currently, we forecast real GDP growth in Germany at 1.9%-2.0% per year for 2022-2024. This reflects uncertainty about the implications from the war in Ukraine and the related spike in energy prices. NRW is Germany's biggest, most populous state, represents in excess of 20% of German GDP, and houses the headquarters of a significant number of the country's largest companies. It should therefore experience underlying economic developments similar to those at the national level. Our current projections include GDP per capita for NRW of just above €44,000 (currently about $45,400) in 2022. This is slightly below the anticipated national per capita GDP of almost €47,000 (currently almost $48,500) but is nevertheless very high in an international comparison.

The tax revenue of German states, including NRW, appears to be defying weaker underlying economic growth prospects for now. This can be attributed to inflation currently more than compensating for slower real growth. In particular, the state's share of VAT and payroll tax together represent almost 60% of its total tax revenue and close to 50% of adjusted operating revenue. Both are closely linked to rising prices, but we believe the latter also relates to recent collective wage agreements reflecting a shortage of skilled labor and hence incorporating material wage adjustments to offset price changes. The last official German tax revenue forecast from May 2022 was very positive and, compared with the forecast from November 2021, implies additional tax revenue of between €1.7 billion and €3.7 billion per year for NRW from 2022 to 2026. NRW

confirmed the positive trend in the first half of 2022 and collected €37 billion of taxes, up 17% from the first half of 2021 and clearly above the pro-rated €70 billion target in its 2022 budget. Plans currently being discussed by the German federal government for various tax breaks as a response to the higher cost of living could mean almost €1 billion in annual revenue losses for NRW but would not reverse the overall picture, in our view.

Notably, our current economic and tax revenue assumptions do not incorporate a complete stop of Russian gas supplies to Germany. If this were to materialize in the near term, various third-party academic studies predict a drop in GDP growth of around 5 percentage points compared with a scenario of reduced but continuing gas supplies, and only a slow recovery thereafter. This would cause major tax revenue losses and may even require government support programs similar to those observed during the pandemic.

We do not believe that the change in NRW's government, following the state elections in May this year, will have a material impact on the state's approach to financial management. The election brought a coalition of the Green Party and conservative CDU into power. However, the new finance minister is again a member of the conservative party. He will have to steer the budget into 2023, the first year when NRW's debt-brake law, suspended during the pandemic, will apply again. This means that NRW's special-purpose fund for spending to mitigate the impact of COVID-19 will be closed for new applications and the state must, in principle, again present balanced budgets, albeit only in government accounting rather than cash terms. We note positively that NRW's new government wants to tackle the problem of various fiscally weak municipalities constantly rolling over large amounts of legacy short-term "Kassenkredite" loans, and that it recognizes a need to consider guarantees for municipal utility companies that face liquidity pressure from distortions in the energy market resulting from the Russia-Ukraine war.

In our view, NRW will continue to benefit from the extremely supportive institutional framework under which German states operate. If the worst-case scenario of an energy shortage and subsequent recession materializes, we believe that German regional governments could again rely on federal support in a similar fashion as during the COVID-19 pandemic, when large transfers were made.

NRW looks set to post marginal deficits and broadly stable but high debt

We currently forecast a fairly stable budgetary performance for NRW over our 2022-2025 forecast horizon, with moderate operating margins and only minor deficits after capital accounts in cash terms. This year will be characterised by above-budget tax revenue and stable expenditure offsetting still existing outflows for pandemic-related measures. We anticipate inflation creeping into NRW's cost base from 2023, thereby producing softer results than we projected at the beginning of this year. Notably, although expenditure on goods and services and transfers could experience an inflation adjustment earlier, the current wage agreement for NRW's ordinary employees runs until almost the end of 2023. We hence assume a material hike in staff compensation, currently representing one-third of operating expenditure, to only kick in from 2024.

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

The state's high tax-supported debt burden of about €160 billion, or about 180%-190% of

consolidated operating revenue, constitutes the weakest factor in our rating assessment. In our respective calculation, we add to NRW's core budget debt the financial liabilities 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. The state uses a sophisticated approach to debt management. It regularly issues large benchmark bonds, social bonds, private placements, and foreign currency-denominated notes. Notably, NRW issued about €30 billion of bonds with tenors of between 30 years and 100 years recently. This has pushed its debt portfolio's weighted-average tenor toward 17 years and reduces its exposure to rising interest rates in the short term.

Our view of NRW's contingent liability risks is evolving in response to ongoing events. We now incorporate into our analysis currently discussed plans to issue guarantees supporting the liquidity access of municipal utilities ("Stadtwerke") in an environment of distorted energy prices. In addition, we note the new state administration's resolve to relieve fiscally weak municipalities of parts of their legacy short-term loans ("Kassenkredite") even without the federal government's participation, and we now consider this a more likely scenario. Unchanged from past reviews, our assessment continues to reflect the perceived risk from legacy financial institutions Erste Abwicklungsanstalt (AA/Stable/A-1+) and Portigon (not rated), which both manage the orderly winddown of former state bank WestLB. This is complemented by the debt of various non-financial companies owned by NRW and the state's granular guarantee portfolio.

Significant holdings of cash-type assets, the state's pension reserve account, as well as access to capital markets and funds from other government entities secure NRW's exceptional liquidity position. The state generally prefunds expenditure with long-term borrowings, which creates significant liquidity levels. NRW started 2022 with almost €15 billion of near-cash assets, which together with over €14 billion of securities held in its pension reserve account more than fully cover this year's debt maturities. The state's proven borrowing ability in the capital market and its access to liquidity from other levels of government further support our positive assessment. We understand that NRW has already executed most of its funding program for 2022. The state does not maintain any committed bank credit facilities.

Key Statistics

Table 1

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

	--Fiscal year end Dec. 31--					
Mil. €	**2020**	**2021**	**2022bc**	**2023bc**	**2024bc**	**2025bc**
Operating revenue	83,066	90,372	90,100	88,047	91,142	94,006
Operating expenditure	82,893	84,719	84,061	81,987	86,121	88,351
Operating balance	173	5,653	6,039	6,060	5,021	5,655
Operating balance (% of operating revenue)	0.2	6.3	6.7	6.9	5.5	6.0
Capital revenue	1,515	1,797	1,843	1,850	1,898	2,074
Capital expenditure	9,897	8,772	9,730	8,564	8,682	9,027
Balance after capital accounts	(8,210)	(1,322)	(1,848)	(654)	(1,763)	(1,298)
Balance after capital accounts (% of total revenue)	(9.7)	(1.4)	(2.0)	(0.7)	(1.9)	(1.4)
Debt repaid	16,854	16,969	15,505	13,896	12,763	11,321

Table 1

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

	--Fiscal year end Dec. 31--					
Mil. €	**2020**	**2021**	**2022bc**	**2023bc**	**2024bc**	**2025bc**
Gross borrowings	27,839	22,130	14,908	12,278	12,363	11,021
Balance after borrowings	3,013	3,717	(2,596)	(1,950)	(2,235)	(1,671)
Direct debt (outstanding at year-end)	156,954	162,215	161,618	160,000	159,600	159,300
Direct debt (% of operating revenues)	189.0	179.5	179.4	181.7	175.1	169.5
Tax-supported debt (outstanding at year-end)	164,728	169,878	169,281	167,663	167,263	166,963
Tax-supported debt (% of consolidated operating revenues)	198.3	188.0	187.9	190.4	183.5	177.6
Interest (% of operating revenues)	1.7	1.7	1.1	1.9	2.2	2.4
Local GDP per capita (€)	38,756	40,951	44,145	46,706	48,550	50,201
National GDP per capita (€)	40,492	42,939	46,943	50,176	52,175	53,962

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/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

North Rhine-Westphalia (State of)--Ratings Score Snapshot

Key rating factors	Scores
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 11, 2022. 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

- Institutional Framework Assessments For International Local And Regional Governments, July 26, 2022
- Local And Regional Governments Outlook 2022: Life Without Central Government Crutches, July 13, 2022
- Economic Outlook Eurozone Q3 2022: Inflation Dulls The Post-COVID Bounce, June 27, 2022
- Local Government Debt 2022: Credit Quality Recuperating For Largest Regions In Developed Markets, April 12, 2022
- Local Government Debt 2022: Can German, Austrian, And Swiss Borrowing Volumes Continue Their Post-COVID Normalization?, April 6, 2022
- Germany 'AAA/A-1+' Ratings Affirmed; Outlook Stable, March 25, 2022
- Full Analysis: North Rhine-Westphalia (State of), Feb. 28, 2022
- Full Analysis: NRW.BANK, Feb. 17, 2022
- Institutional Framework Assessment: German States, Dec. 7, 2021
- Full Analysis: Erste Abwicklungsanstalt, Sept. 20, 2021
- Default Transition and Recovery: 2020 Annual International Public Finance Default And Rating Transition Study, Sept. 14, 2021

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