Research Update:

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

April 26, 2024

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Overview

- We anticipate that subdued German economic growth in 2024 will delay and dampen the rise in shared taxes, the dominant revenue source for the State of North Rhine-Westphalia (NRW).
- We project that NRW will have limited deficits after capital accounts, under our cash-focused approach to assessing budgetary performance, but this year's one-off transactions and the use of accounting reserves should allow the state to stay compliant with the re-applied German debt brake rule.
- Although balancing a sustained capital expenditure volume with the debt brake's zero-deficit target will remain a challenge, we expect NRW's financial management will make prudent spending decisions.
- We affirmed our 'AA/A-1+' long-term and short-term ratings on NRW. The outlook is stable.

Rating Action

On April 26, 2024, 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 NRW's operating revenue growth will rebound despite the current macroeconomic headwinds. This, alongside expenditure controls, will enable the state to again post operating budget surpluses above 6% from 2026, sustain current capital expenditure volumes, and reduce deficits after capital accounts. Even when allowing for the planned absorption of legacy municipal debt, the state's debt burden should remain broadly stable, albeit at a high level.

Downside scenario

We could lower the ratings if the current weakness in German economic growth continues, limiting NRW's tax revenue expansion and resulting in a persistently weaker budgetary performance. If, in this context, NRW meaningfully relaxes financial discipline, for example by setting up another large, debt-financed special spending envelope similar to the ones used during the pandemic and at the onset of the Russia-Ukraine war, we could reassess our view on the state's financial management.

Upside scenario

We could raise the ratings if NRW's budgetary performance improves markedly beyond our current expectations and contingent liability risk from legacy financial institutions and its municipal sector becomes less material. This could strengthen our assessment of the state's financial management.

Rationale

In our view, NRW's current key challenge is control of its budgetary performance amid constrained revenue growth and planned transformative capital expenditure that requires substantial financial resources. Until stronger economic growth bolsters the state's tax revenue, we expect the authorities to temporarily mobilize reserves in a prudent and measured way.

Our ratings on NRW remain supported by the state's large and diversified economy, its sophisticated debt management that shields the state against sudden swings in interest cost, and an exceptionally strong liquidity position that combines a high volume of reserves with unfettered access to external funding. The state's very high debt burden, including remaining contingent liability risk, is the weakest aspect of the rating.

Subdued German economic growth will likely constrain NRW's tax revenue dynamics

NRW continues to benefit from a very strong economic base in an international comparison. The state accounts for more than 20% of German national GDP and population, and it is home to many of the country's blue-chip companies. Energy and energy-intensive businesses such as utilities E.ON, RWE, and Uniper, or steel producer Thyssen Krupp and chemical giant Bayer, are, however, slightly overrepresented. This means that, after the sharp rise in energy prices in 2022, NRW was put at a mild disadvantage compared with German peers. Still, we project a local GDP per capita of about €47,400 (about $52,000) for 2024, only slightly below our forecast for the national average of €50,200 (about $55,000).

Germany's system of tax sharing between the federal, state, and municipal governments ties the fiscal dynamics of NRW very closely to the country's momentarily mutedeconomic growth. The state's participation in the major taxes--primarily payroll tax, personal and corporate income tax, and value-added tax (VAT)--accounts for about 80% of NRW's total adjusted revenue. However, most of these taxes are highly correlated with GDP growth in Germany. Our forecast of national real GDP expansion of only 0.3% in 2024, rising to 1.2% in 2025 and 2026, therefore constitutes a near-term fiscal headwind for NRW. In addition, the marginal reduction in tax revenues recorded in 2023 (-0.2%) has left an adverse base effect. This decline can be attributed to the various tax breaks introduced in the context of the 2022 German government's economic stimulus package and a 28%, or €1.1 billion, drop in real estate transfer tax receipts in NRW last year. Unlike in 2022-2023, the negative effect of sluggish real economic growth on tax receipts will, in our view, no longer be mitigated by elevated inflation over 2024-2026. Rather, we forecast German consumer price inflation to decline further, to 1.9% in 2026 from 2.7% in 2024.

We currently do not anticipate any major structural changes to the institutional framework under which NRW operates and, in particular, expect the country's debt brake legislation to remain in place for now. Germany's federal fiscal architecture, while having provided NRW with significant transfers during the recent crises, has the disadvantage of requiring states to co-fund many policy measures decided at the federal level, either directly or through lost (shared) tax revenue. Despite discussions in the media, we do not expect Germany's debt brake legislation--a cornerstone of the current fiscal framework--to be reformed any time soon. This primarily reflects our doubts that a supermajority, required to adopt constitutional changes, can be formed prior to the next German federal election in the second half of 2025, if at all.

Aligning capital expenditure volumes with the debt brake's zero-deficit target amid lower-than-planned tax revenue growth therefore creates a key challenge for NRW's financial management. To formally comply with the reinstated debt break regulation (suspended since 2019) but still implement its capital expenditure plans, this year NRW will withdraw €150 million from the government real estate manager Bau- und Liegenschaftsbetrieb NRW ("BLB") and receive a capital repayment of about €250 million from state promotional lender NRW.BANK, after the bank transfers its stake in the state lottery to another state holding vehicle. Furthermore, the budget will also claw back €860 million in reserves previously allocated to individual government departments. The latter has no cash impact, but positive accounting effects for the state. We understand that NRW has the capacity to mobilize a limited volume of further reserves in case that is required in the future. However, if--contrary to our projection--tax revenue growth doesn't normalize soon, the state's leadership will eventually face difficult political decisions to comply with the fiscal rules. These could include material expenditure cuts, reliance on the exemption in the debt brake legislation that allows limited net borrowing in an economic downturn, or even another suspension of the rules' applicability. Considering NRW's financial management's solid track record of technical competence, we think that any such decisions will be taken in a timely and prudent fashion, if needed.

Despite slight budget deficits, NRW's debt burden will remain broadly stable

Under our cash-based approach to assessing budgetary performance, we forecast NRW will post moderate budget deficits after capital accounts over 2024-2026, even as the state will probably comply with the existing zero-deficit target in accounting terms. Our projections incorporate a gradual recovery in the economy and tax revenue growth, but that levels will still fall short of prior state budgetary plans. Our forecast incorporates the recently agreed public sector wage deal, which amounts to an 11% average rise in salaries, albeit staggered over a two-year period. Furthermore, we reflect that NRW will aim to keep capital expenditure at about 10% of total expenditure, a historically high level for the state. Almost €6 billion of leftover funds in NRW's COVID-19- and energy crisis-related segregated spending envelopes can now only be used to redeem maturing crises-related debt; they can no longer fund budgetary expenditure.

Pension and related payments under the state's pay-as-you-go system for civil servants continue to reduce budgetary leeway for NRW. They currently consume about 10% of annual adjusted operating revenue and are expected to peak toward the end of this decade. Although NRW has set aside almost €15 billion in a dedicated pension reserve account, these funds only cover about 18 months of pension cost. Hence, they can only mitigate, but by no means fully finance, the outstanding burden. NRW has now changed its policy and will start to make annual withdrawals from the reserve account, planned to always correspond to the profits made two years prior. In 2024, this means a distribution of €342 million to the general budget.

We consider NRW's tax-supported debt burden of consolidated operating revenue, around 180% over the past few years, very high in an international comparison once contingent liability risk is also considered. However, the state benefits from sophisticated debt management. It is an established issuer in the capital market and active in various funding currencies, although always on a fully euro-hedged basis. NRW maintains a predominantly fixed-rate debt portfolio, with residual variable rate exposure largely matched by short-term assets. Its portfolio's average maturity of above 19 years and, since last year, a notional volume of so far €9 billion of derivative-based rate hedges help prevent a sudden increase in interest cost. To calculate our tax-supported debt metric, we add the financial liabilities of BLB and a school investment program prefinanced by promotional lender NRW.Bank to the core budget's direct debt.

Contingent liability risk arises primarily from legacy financial institutions and the municipal sector, according to our view. That said, Erste Abwicklungsanstalt (AA/stable/A-1+) and Portigon (not rated), which both manage the orderly wind-down of former state bank WestLB, have now reduced materially in size. To increase debt sustainability for several, highly indebted cities, NRW plans to assume almost €10 billion in legacy municipal short-term loans ("Kassenkredite"). We doubt that the German federal government will contribute an equal amount to this purpose, despite NRW's request. That said, NRW remains in negotiations with the federal authorities and no date for the transaction has been fixed yet.

NRW's about €15 billion cash balance and the almost €15 billion of securities held in its pension reserve account (as of January 2024) more than fully cover this year's debt service. Considering this, alongside the state's proven borrowing ability in the capital market and its access to liquidity from other levels of government, we assess NRW's liquidity position as exceptionally strong. NRW does not maintain any committed bank credit facilities.

Key Statistics

Table 1

State of North Rhine-Westphalia--Selected Indicators

Mil. €	2022	2023	2024bc	2025bc	2026bc	2027bc
Operating revenues	95,562	92,934	92,917	96,723	100,056	103,423
Operating expenditures	89,254	87,945	88,384	91,682	94,035	96,490
Operating balance	6,308	4,989	4,533	5,041	6,021	6,933
Operating balance (% of operating revenues)	6.6	5.4	4.9	5.2	6.0	6.7
Capital revenues	2,390	2,013	2,470	2,482	2,341	2,393
Capital expenditures	12,044	10,404	9,831	10,227	10,774	10,569
Balance after capital accounts	(3,346)	(3,402)	(2,828)	(2,704)	(2,412)	(1,243)
Balance after capital accounts (% of total revenues)	(3.4)	(3.6)	(3.0)	(2.7)	(2.4)	(1.2)
Debt repaid	15,610	15,142	14,340	14,912	11,414	9,063
Gross borrowings	19,844	15,782	11,300	15,482	10,984	8,633
Balance after borrowings	731	(2,536)	(6,083)	(2,350)	(3,058)	(1,889)

Table 1

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

Mil. €	2022	2023	2024bc	2025bc	2026bc	2027bc
Direct debt (outstanding at year-end)	165,500	166,140	163,100	163,670	173,240	172,810
Direct debt (% of operating revenues)	173.2	178.8	175.5	169.2	173.1	167.1
Tax-supported debt (outstanding at year-end)	172,126	172,631	169,491	169,961	179,431	178,901
Tax-supported debt (% of consolidated operating revenues)	180.1	185.8	182.4	175.7	179.3	173.0
Interest (% of operating revenues)	1.5	3.1	3.5	3.6	3.8	4.0
Local GDP per capita (single units)	44,032	46,194	47,441	48,926	50,428	51,916

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	
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, April 8, 2024. 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

- Economic Outlook Eurozone Q2 2024: Labor Costs Hinder Disinflation As Rate Cuts Loom, March 26, 2024
- Germany 'AAA/A-1+' Ratings Affirmed; Outlook Stable, March 22, 2024
- Full Analysis: NRW.Bank, March 5, 2024
- Subnational Debt 2024: Germany, Subdued fiscal performance suggests borrowing will rebound, Feb. 29, 2024
- Local And Regional Governments' Workarounds Are Running Out Of Time, Dec. 6, 2023
- Full Analysis: Erste Abwicklungsanstalt, Sept. 20, 2023
- Institutional Framework Assessment: New Challenges Could Test German States' Commitment To Balanced Budget Rules, May 25, 2023

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