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Research Update:

State of North Rhine-Westphalia Outlook Revised To Negative On Performance Recovery Risks, 'AA/A-1+' Ratings Affirmed

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PRIMARY CREDIT ANALYST

Michael Stroschein
Frankfurt
+ 49 693 399 9251
michael.stroschein
@spglobal.com

SECONDARY CONTACT

Sabine Daehn
Frankfurt
+ 49 693 399 9106
sabine.daehn
@spglobal.com

ADDITIONAL CONTACT

Sovereign and IPF EMEA
SOVIPF
@spglobal.com

Overview

- In 2024 and 2025, the State of North Rhine-Westphalia (NRW) will mobilize reserves, constrain certain expenditure, and use additional borrowing to address weak tax revenue growth and rising cost.
- From 2026, NRW will likely need to implement sharp budgetary consolidation to comply with existing debt brake legislation, unless tax revenue growth significantly outperforms current forecasts.
- While successful consolidation remains our base case, we consider budgetary gaps have widened and NRW's financial leadership challenges have exacerbated materially.
- We have therefore revised our outlook on NRW to negative and affirmed our 'AA/A-1+' long- and short-term ratings.

Rating Action

On Oct. 25, 2024, S&P Global Ratings revised its outlook on the German State of North Rhine-Westphalia (NRW) to negative from stable. We affirmed our 'AA/A-1+' long- and short-term issuer credit ratings, and the 'AA' issue ratings on NRW's senior unsecured debt.

Outlook

The negative outlook reflects the increasing risk that future tax revenue growth and consolidation measures by NRW's management may not be enough to restore operating margins to the extent required for our base-case assumptions to remain valid. These assumptions include a recovery in operating accounts, sustaining capital expenditure volumes, adhering to the debt brake rule's zero deficit target, and continuing to reduce the state's outstanding debt through the scheduled amortization of pandemic- and energy crisis-related borrowings from previous years.

Downside scenario

We could lower the ratings on NRW over the next 24 months if the state fails to reestablish operating margins structurally above 5%, and this results at least partially due to insufficent consolidation efforts by the administration. In particular, we would likely reassess our view on the state's financial management if NRW relies heavily on reserve mobilization, another debt brake suspension, or other unorthodox measures with one-off character, instead of achieving recurring improvements.

Upside scenario

We could revise the outlook back to stable over the next 24 months if budgetary performance improves in line with our current expectations and if NRW's debt burden and contingent liabilities continue to decline, disregarding the planned assumption of municipal legacy debt.

Rationale

The key challenge for NRW is to restore budgetary performance while dealing with subdued German economic growth weighing on tax revenue dynamics, rising costs, and the need for substantial financial resources for planned transformative capital expenditure. This challenge has become more pronounced, in our view. Updated state financial planning indicates that the gap that needs to be covered, either by stronger-than-anticipated tax collections or stringent budgetary consolidation, has widened substantially.

That said, 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. NRW's very high debt burden, including the remaining contingent liability risk, constitutes the weakest aspect of the rating.

Subdued German economic growth continues to put pressure on tax collections and challenges financial management

Through Germany's system of shared taxes, NRW's fiscal development remains closely tied to the country's momentarily subdued national economic growth. The state participates in the major national taxes--primarily payroll, personal and corporate income, and value-added (VAT) tax--which together account for about 80% of NRW's total adjusted revenue. However, these taxes are highly correlated with contemporaneous GDP growth in Germany. We currently forecast national real GDP expansion of only 0.2% in 2024, rising to 1.1% and 1.3% in 2025 and 2026, respectively. This constitutes a clear fiscal headwind for NRW. Unlike in 2022 and 2023, we do not expect elevated inflation to rescue tax collections by increasing nominal GDP growth.

We do not anticipate that the German federal government's pending "growth initiative"--a collection of planned economic stimulus measures--will have a decisive impact on NRW's budget. Although full adoption of the embedded tax relief measures would create annual cost for NRW, rising from €350 million in 2025 to €1.5 billion by 2028 due to shared tax revenue losses, we assume the German states will use their collective blocking power in the second chamber of the national parliament to largely prevent the required legislation, unless compensated by the federal level.

Germany's debt brake rule, a cornerstone of the otherwise extremely supportive insitutional framework for the federal states, limits NRW's freedom to manouver and prescribes fiscal objectives. It forces the state to strive for fully balanced budgets after capital expenditure, unless an exception that allows for deficit spending can be invoked. This could be an extraordinary event, such as the pandemic or the outbreak of the Russia-Ukraine war, to which NRW responded with debt-financed special spending envelopes. In a cyclical economic downturn with growth below potential, the debt brake allows for limited net new borrowing that needs to be amortized when growth improves. While the debt brake has been criticized for preventing required capital expenditure on public infrastructure, we do not expect it to be reformed any time soon. This reflects our doubts that the supermajority required in both chambers of the national parliament to adopt constitutional changes can be formed prior to the next German federal election in September 2025, if at all.

NRW's financial management faces the key current challenge of drafting and executing budgets that sustainably respect the limits set by the debt brake rule. Following a smaller, similar transaction and other reserve mobilizations already budgeted for in 2024, NRW's administration intends to claw back €2.6 billion of funds previously allocated to individual government departments in another accounting-only, non-cash transaction in 2025. Furthermore, the state plans to use the business cycle-based exemption from the debt brake's zero deficit target to justify €1.3 billion of additional borrowing for its core budget in 2025. The state parliament is also still debating a second supplementary budget for 2024, which proposes similarly justified new borrowings of €2.0 billion to achieve balance. Updated planning for 2026 to 2028 shows a significant widening of an accounting position in NRW that traditionally indicates the gap between currently anticipated revenues and expenditures. This gap has increased to more than €5 billion per year, or about 5% of operating revenue, from €1.6 billion or less in the previous medium-term financial plan. While we still assume NRW can close this gap, for example through savings on budgeted, sharply growing staff cost and through restrictions on the growth of operating transfers made, we now see an elevated risk that sufficent structural adjustments could fall short of the required amounts. In this case, additional debt may be necessary, and a justification for it under the rules of the debt brake would be required.

Currently weak fiscal dynamics notwitstanding, NRW continues to benefit from a strong and diversified economic base. 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, including utilities such as E.ON, RWE, and Uniper, steel producer Thyssen Krupp, chemical giant Bayer, logistics company Deutsche Post, and Deutsche Telekom. Consequently, we project a local GDP per capita for NRW of about €47,400 (aproximately $52,000) for 2024, only slightly below the forecast German national average of €50,900 (approximately $55,800).

Consolidation measures could improve operating margins and maintain a stable debt burden level

Our current base-case scenario continues to assume a gradual recovery of NRW's operating margins to above 5%. This reflects our own tax revenue forecast, which is fairly aligned with Germany's official tax estimate from May 2024. Our projection incorporates the public sector salary agreement from December 2023, which amounts to an 11% average rise in salaries over the next two years, and further staff cost increases resulting from rising payments for civil servants' healthcare expenses. However, we assume meaningful savings compared to the state's recently updated financial planning, and we expect NRW can cap the growth in operating transfers paid. If this does not materialize, results could be decisively weaker. To reflect consolidation needs, we assume slightly reduced capital expenditure, averaging just below 10% of total adjusted revenue.

Pension and related payments under the state's pay-as-you-go system for civil servants continue to reduce budgetary leeway. They currently consume about 10% of annual adjusted operating revenue and will likely peak toward the end of this decade. While we estimate NRW's dedicated pension reserve account at €15 billion, these funds only cover about 18 months of pension cost. Hence, they can only mitigate NRW's pension burden, but by no means fully finance it. NRW has changed its policy and replaced contributions with annual withdrawals from the reserve account, which are planned to always correspond to the profits made two years prior. Accordingly, asset growth will now be limited to pension contributions paid by third parties for seconded state civil servants.

We consider NRW's tax-supported debt burden, which is about 180% of consolidated operating revenue, to be very high in an international comparison, especially when contingent liability risk is considered. However, the state benefits from sophisticated debt management. It is an established capital market issuer and is 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. The portfolio has an average maturity of above 19 years, and since last year, 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 the state's real estate manager, Bau- und Liegenschaftsbetrieb NRW, and a school investment program that has been prefinanced by the promotional lender NRW.Bank, to the core budget's direct debt. The decline in outstanding debt volume in 2024 and 2026, despite projected deficts in NRW's core budget, can be attributed to legally mandated redemptions of remaining pandemic- und energy crisis-related borrowings.

We think that contingent liability risk arises primarily from active and legacy financial institutions, and the municipal sector. That said, Erste Abwicklungsantalt and Portigon, which both manage the orderly wind-down of former state bank WestLB, have now reduced materially in size. This leaves state promotional lender NRW.Bank as the largest, albeit well-captalized, financial sector participation. NRW intends to assume a sizeable volume of legacy short-term loans ("Kassenkredite") from fiscally weaker municipalities, even though the German federal government might not not absorb an equal amount, contrary to earlier signals. Our debt forecast already incorporates a placeholder for this plan.

NRW's cash balance of approximately €15 billion held at the beginning of 2024, although predicted to decline, along with about €15 billion of securities in its pension reserve account, more than fully cover this year's debt service. Together with 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. It does not maintain any committed bank credit facilities.

Key Statistics

Table 1

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

	--Year ended Dec. 31--					
(Mil. €)	2022	2023	2024bc	2025bc	2026bc	2027bc
Operating revenues	95,562	92,934	92,426	97,272	101,005	104,346
Operating expenditures	89,254	87,945	88,974	93,081	95,334	98,081
Operating balance	6,308	4,989	3,452	4,191	5,671	6,265
Operating balance (% of operating revenues)	6.6	5.4	3.7	4.3	5.6	6.0

Table 1

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

	--Year ended Dec. 31--					
(Mil. €)	**2022**	**2023**	**2024bc**	**2025bc**	**2026bc**	**2027bc**
Capital revenues	2,390	2,013	2,470	2,554	2,431	2,436
Capital expenditures	12,044	10,404	9,735	9,992	10,637	10,795
Balance after capital accounts	(3,346)	(3,402)	(3,813)	(3,247)	(2,535)	(2,094)
Balance after capital accounts (% of total revenues)	(3.4)	(3.6)	(4.0)	(3.3)	(2.5)	(2.0)
Debt repaid	15,610	15,142	14,323	14,990	11,492	11,254
Gross borrowings	19,844	15,782	12,734	15,904	11,562	10,824
Balance after borrowings	731	(2,536)	(5,617)	(2,535)	(2,667)	(2,726)
Direct debt (outstanding at year-end)	165,500	166,140	164,551	165,465	175,535	175,105
Direct debt (% of operating revenues)	173.2	178.8	178.0	170.1	173.8	167.8
Tax-supported debt (outstanding at year-end)	172,126	172,570	170,881	171,694	181,664	181,134
Tax-supported debt (% of consolidated operating revenues)	180.1	185.7	184.9	176.5	179.9	173.6
Interest (% of operating revenues)	1.5	3.1	3.8	3.8	3.9	3.9
Local GDP per capita (single units)	44,032	46,194	47,441	48,926	50,428	51,916
National GDP per capita (single units)	47,501	49,616	50,882	52,459	54,131	55,715

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

North Rhine-Westphalia (State of)--Ratings score snapshot

Key rating factors	Score
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, Oct. 7, 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 Q4 2024: Consumer Spending To The Rescue, Sept. 24, 2024
- Germany, Sept. 22, 2024
- Erste Abwicklungsanstalt, Sept. 10, 2024
- NRW.Bank, March 5, 2024
- Subnational Debt 2024: Germany, Subdued Fiscal Performance Suggests Borrowing Will Rebound, Feb. 29, 2024
- 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; Outlook Action

North Rhine-Westphalia (State of)		
	To	**From**
Issuer Credit Rating	AA/Negative/A-1+	AA/Stable/A-1+
Senior Unsecured	AA	