Fitch Ratings-Frankfurt/London-26 April 2019: Fitch Ratings has affirmed the Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) of 11 German federated states (Laender) at 'AAA' with Stable Outlooks: Berlin, Bremen, Hamburg, Lower Saxony, Mecklenburg-Western Pomerania, North Rhine-Westphalia, Rhineland-Palatinate, Saarland, Saxony-Anhalt, Schleswig-Holstein and Thuringia.

The rated outstanding bonds of the Bund-Laender-Anleihe 1 and the German Laender's rated joint bond issues (Laender 32 and 40-56) have also been affirmed at 'AAA'. A full list of rating actions is below.

The affirmations and Stable Outlooks reflect the unchanged assumptions of Fitch's rating approach for the German Laender, under which the ratings are equalised with those of the Federal Republic of Germany (Bund; AAA/Stable/F1+).

KEY RATING DRIVERS
Revenue Robustness Assessed as Stronger
The Stronger assessment is driven by the high share of stable revenue sources due to both strong and diversified tax base and stable transfers from the Bund. We view the Laender to be resilient to any potential shocks mitigating risk of a shrinking revenue base.

The main revenue sources of the Laender consist of common tax revenues (corporate income tax (CIT), value added tax (VAT) and personal income tax (PIT) between the Bund, the Laender and - to a lesser extent - the municipalities. By law the Laender receive 50% from CIT and 42.5% of the PIT. The shares of VAT result from a more complex allocation process and the shares vary marginally yoy. In 2018, the share was 47.2% for the Laender, 49.6% for the Bund and 3.2% for the municipalities. The common tax revenues accounted for 73.4% of the total tax revenues collected in Germany in 2017.

In 2018, tax revenues accounted for 76% of the total revenues of the Laender, with VAT and PIT the largest contributors, with 30.8% and 26.6% respectively in 2017, while the more volatile CIT contributed a modest 4% in 2017. Over the last five years, the Laender tax revenue growth was above the level of the national economy.

Revenue Adjustability Assessed at Stronger
The Stronger assessment of Revenue Adjustability is supported by a strong track record of revenue equalisation with constitutional rank; an essential part of Fitch's rating approach, which links the rating of the Laender to that of the Bund. Extensive equalisation systems and a broad-based solidarity pact compensate for financial disparity. This equalisation framework requires financially stronger Laender to transfer part of their above-average tax proceeds to the financially weaker ones. The framework partly offsets the differences among Laender's tax revenue base and their financial strength.

The most recent reform of the "Bund-Laender-Finanzbeziehungen" (of the financial equalisation system) confirms the stability of the revenue equalisation and is likely to increase transfers to financial weaker Laender and lower the burden of the net donor states among the Laender, which we assess as credit positive.

Expenditure Sustainability Assessed as Stronger
The Laender have a prudent track record of control over operating expenditure (opex). This is evidenced by keeping opex growth consistently below that of operating revenues. The main spending items consist of administration costs towards their tax authorities (Finanzbehoerden), education and science and social security, which have a counter-cyclical nature. In times of economic stress, anti-cyclical measures are performed by the Bund.

Laender have been applying cost consolidation measures since 2010, resulting in opex growth below that of operating growth, complying with the debt brake rule from 2020 onward. Facing this debt brake, Laender have shown tight control of spending and started efforts back in 2010 to keep opex growth consistently below that of operating revenue. Accordingly, cost consolidation measures are subject to supervision and control of German Stability Board (Stabilitaetsrat).

Expenditure Adjustability Assessed as Stronger
The Laender have effective budget rules in place and have shown a strong ability to limit expenditure growth over the most recent years ahead of the debt brake. There is a moderate share of inflexible spending items, with personal costs and transfers accounting for 68% of the Laender's opex in 2018. Capex accounted for a moderate 11% of the Laender's total spending in 2018. Despite the limited flexibility in adjusting capex, the Laender have shown a good track record of cost consolidation to achieve balanced budgets and keep opex growth below the growth of operating revenues. They are legally obliged to run their budgets without taking on new net debt from 2020, which Fitch views positively for this factor.

Liabilities and Liquidity Robustness Assessed as Stronger
German Laender operate in a solid national framework for debt and liquidity management and are showing strict market discipline, which Fitch views as credit positive. As one of the largest subnational issuers, the Laender enjoy very good access to the international capital markets, with a strong track record. As frequent issuers they regularly tap the markets, including benchmark issues and are benchmarked to the Bund. There is no concentration risk with the maturity profiles and all foreign currency debt is hedged as well as most of the floating interest rate issues. The Laender are therefore not exposed to market volatilities and given their frequent refinancing needs, consistently reduce their interest burden.

Liabilities and Liquidity Flexibility Assessed as Stronger
German Laender operate in a strong framework for emergency liquidity support from upper tier government with counterparty risk on treasury facilities above the 'A+' level. The well-established and active liquidity management system that is in place, together with the Laender's very good access to capital markets and corresponding strong refinancing capacity and appropriate treasury facilities should prevent any temporary 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, and 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 the other Laender nor the Bund itself could provide liquidity.

All the liquidity provision facilities demonstrate the implication of the strong financial support mechanism, anchored in the German financial constitution: the Bund and the Laender would support a single state facing financial distress. This sub-factor is core for Fitch's rating approach to the German Laender.

Debt Sustainability Assessment: 'aa' to 'bbb'
Fitch classifies German Laender as Type A local and regional governments (LRG), whose main spending responsibilities are the administration of tax authorities, education & science, social security and public safety and their expenditure accounts for a material share of the public sector expenditure and debt. As quasi-sovereign entities, the Laender also show fiscal imbalances between funds received from the state and disbursements to municipalities. According
to preliminary results for 2018, Laender's total spending amounted to EUR355.2 billion, or 54% of the common expenditure performed by the Bund and the Laender (EUR653.6 billion) in 2018 and their total debt of EUR547.8 billion accounted for 34% of the common debt of the Bund and the Laender (EUR1.617 trillion) in 2018.

According to Fitch's rating case, the economic liability burden (net adjusted debt (+ a pro-rata share of central government debt) / local GDP) - the primary metric of the debt sustainability assessment for Type A LRGs, will gradually improve over next five years and will range from 76% to 39% for the German Laender in 2023. Both secondary metrics - fiscal debt burden measured as net adjusted debt to operating revenue and actual debt-servicing coverage ratio (ADSCR) will range between a 'aa' and 'b' assessment, given the high overall debt burden of the Laender and their relatively high, although prudently managed, annual debt servicing requirements. However, the debt sustainability is driven by the primary metrics, which are influenced by the secondary metrics, justifying an overall debt sustainability assessment of the German Laender between 'aa' and 'bbb'.

The Laender also face large contingent liabilities. This is the debt they guarantee on behalf of their development banks and former Landesbanks, 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 and the amount of contingent liabilities stemming from the deficiency guarantees provided to the former Landesbanks are largely declining.

RATING DERIVATION
The German Laender IDRs are linked to the rating of the Bund and are all 'AAA'. The standalone credit profiles (SCP) of the Laender are assessed at 'aaa' for the State of Hamburg, 'aa+' for the states of Lower Saxony, Mecklenburg-Western Pomerania, North Rhine-Westphalia, Rhineland-Palatinate, Schleswig-Holstein and Thuringia, 'aa' for the states of Berlin and Saxony-Anhalt, 'aa-' for the state OF Saarland and 'a+' for the State of Bremen. This reflects a combination of risk profile assessments of 'Stronger' for all Laender and debt sustainability ranging from a 'aa' to 'bbb' assessment.

The 'AAA' IDRs of the Laender are primarily driven by the stability of the solidarity system that underpins the creditworthiness of all Laender, irrespective of the key risk factors and debt sustainability assessment.

The solidarity system is enshrined in the German constitution and reflects the institutional framework of the Laender. According to the German 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 in the past, most recently in 2006.

KEY ASSUMPTIONS
Fitch's base and rating cases does not consider an increase of debt stock, as the Laender will be required to run their budgets without taking on net new debt starting 2020.

Fitch's key assumptions within our base case for 2020-2023 include:
- Growth of taxes in line with the expected national nominal GDP growth
- Growth of current transfers received in line with expected inflation
- Growth of opex by 3pp annually
- Interest expenditure growth stable
- Capital expenditure growth in line with expected inflation

Fitch's key assumptions within our rating case for 2020-2023 include:
- Growth of taxes in line with expected inflation
- Growth of personal costs by additional 1pp annually
- Growth of current transfers made by additional 1pp annually

RATING SENSITIVITIES
A downgrade of the sovereign ratings would lead to a downgrade of the Laender. An adverse change to the most important institutional feature - the solidarity principle - which is currently unlikely in Fitch's view, could also lead to a downgrade of the Laender's ratings.

The rating actions are as follows:

State of Berlin
Long-Term IDR affirmed at 'AAA' with Stable Outlook;
Long-Term Local-Currency IDR affirmed at 'AAA' with Stable Outlook
Short-Term IDR affirmed at 'F1+'
Short-Term Local-Currency IDR affirmed at 'F1+'
Senior unsecured long-term rating affirmed at 'AAA'
Senior unsecured short-term rating affirmed at 'F1+'

State of Bremen
Long-Term IDR affirmed at 'AAA' with Stable Outlook;
Long-Term Local-Currency IDR affirmed at 'AAA' with Stable Outlook
Short-Term IDR affirmed at 'F1+'
Short-Term Local-Currency IDR affirmed at 'F1+'
Senior unsecured long-term rating affirmed at 'AAA'
Senior unsecured short-term rating affirmed at 'F1+'

State of Hamburg
Long-Term IDR affirmed at 'AAA' with Stable Outlook
Long-Term Local-Currency IDR affirmed at 'AAA' with Stable Outlook
Short-Term IDR affirmed at 'F1+'
Short-Term Local-Currency IDR affirmed at 'F1+'
Senior unsecured long-term rating affirmed at 'AAA'
Senior unsecured short-term rating affirmed at 'F1+'

State of Lower Saxony
Long-Term IDR affirmed at 'AAA' with Stable Outlook
Long-Term Local-Currency IDR affirmed at 'AAA' with Stable Outlook
Short-Term IDR affirmed at 'F1+'
Short-Term Local-Currency IDR affirmed at 'F1+'
Senior unsecured long-term rating affirmed at 'AAA'

State of Mecklenburg-Western Pomerania
Long-Term IDR affirmed at 'AAA' with Stable Outlook
Long-Term Local-Currency IDR affirmed at 'AAA' with Stable Outlook
Short-Term IDR affirmed at 'F1+'
Short-Term Local-Currency IDR affirmed at 'F1+'
Senior unsecured long-term rating affirmed at 'AAA'
Senior unsecured short-term rating affirmed at 'F1+'

State of North Rhine-Westphalia
Long-Term IDR affirmed at 'AAA' with Stable Outlook
Long-Term Local-Currency IDR affirmed at 'AAA' with Stable Outlook
Short-Term IDR affirmed at 'F1+'
Short-Term Local-Currency IDR affirmed at 'F1+'
Senior unsecured long-term rating affirmed at 'AAA'
Senior unsecured short-term rating affirmed at 'F1+'

State of Rhineland-Palatinate
Long-Term IDR affirmed at 'AAA' with Stable Outlook;
Long-Term Local-Currency IDR affirmed at 'AAA' with Stable Outlook
Short-Term IDR affirmed at 'F1+'
Short-Term Local-Currency IDR affirmed at 'F1+'
Senior unsecured long-term rating affirmed at 'AAA'

State of Saarland
Long-Term IDR affirmed at 'AAA' with Stable Outlook;
Long-Term Local-Currency IDR affirmed at 'AAA' with Stable Outlook
Short-Term IDR affirmed at 'F1+'
Short-Term Local-Currency IDR affirmed at 'F1+'
Senior unsecured long-term rating affirmed at 'AAA'
Senior unsecured short-term rating affirmed at 'F1+'

State of Saxony-Anhalt
Long-Term IDR affirmed at 'AAA' with Stable Outlook
Long-Term Local-Currency IDR affirmed at 'AAA' with Stable Outlook
Short-Term IDR affirmed at 'F1+'
Short-Term Local-Currency IDR affirmed at 'F1+'
Senior unsecured long-term rating affirmed at 'AAA'
Senior unsecured short-term rating affirmed at 'F1+'

State of Schleswig-Holstein
Long-Term IDR affirmed at 'AAA' with Stable Outlook
Long-Term Local-Currency IDR affirmed at 'AAA' with Stable Outlook
Short-Term IDR affirmed at 'F1+'
Short-Term Local-Currency IDR affirmed at 'F1+'
Senior unsecured long-term rating affirmed at 'AAA'
Senior unsecured short-term rating affirmed at 'F1+'

State of Thuringia
Long-Term IDR affirmed at 'AAA' with Stable Outlook
Long-Term Local-Currency IDR affirmed at 'AAA' with Stable Outlook
Short-Term IDR affirmed at 'F1+'
Short-Term Local-Currency IDR affirmed at 'F1+'
Senior unsecured long-term rating affirmed at 'AAA'
Senior unsecured short-term rating affirmed at 'F1+'

Joint Bond Issues:
Laender 32 and Laender 40-56
Senior unsecured long-term ratings affirmed at 'AAA'

Bund-Laender-Anleihe 1:
Senior unsecured long-term rating affirmed at 'AAA'

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Applicable Criteria  
Rating Criteria for International Local and Regional Governments (pub. 09 Apr 2019)  
https://www.fitchratings.com/site/re/10067640

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