

Laender 53

Presale

Expected Ratings

Issuer	Amount (EURbn)	Final maturity	Rating
Laender 53 (five federated states)	1.0	10 years	AAA(EXP)

Source: Fitch

Transaction Summary

Joint Issue: This issue of EUR1.0 billion fixed-rate bonds is the second German Laender jumbo issue of 2017, and the 53rd Laender joint jumbo issue overall. The bonds are issued under German law and are the several and not the joint liability of the Laender involved, according to a fixed distribution between them. The bonds are senior unsecured and rank pari passu with all previous and future obligations of the issuers.

Division of Proceeds: The proceeds will be divided between the participating states as follows: Bremen, EUR200 million; Hamburg, EUR200 million; Rheinland-Pfalz, EUR200 million; Saarland, EUR200 million; and Schleswig-Holstein, EUR200 million.

Laender Credit Quality Supports Rating: Fitch Ratings has assigned this issue an expected Long-Term Local-Currency Rating of 'AAA(EXP)'. The expected rating reflects the creditworthiness of the five German federated states (Laender) involved in the joint issue. The final rating is contingent on the receipt of final documentation conforming with information already received.

Key Rating Drivers

Creditworthiness of Laender: Fitch affirmed the ratings of the German Laender on 5 May 2017. The creditworthiness of the Laender is based on the strong support mechanisms that apply to all members of the federation and the extensive liquidity facilities from which they benefit; these ensure timely payment and equate the creditworthiness of the states to that of the Federal Republic of Germany (AAA/F1+).

Support Mechanisms: Fitch has identified support mechanisms that apply uniformly to all members of the German federation, comprising the federal government (Bund) and the 16 federated states, which include the five states involved in this joint issue: Bremen, Hamburg, Rheinland-Pfalz, Saarland and Schleswig-Holstein. Differences in their individual economic and financial performances are irrelevant, as all Laender are equally entitled to financial support in the event of financial distress.

Implicit Guarantee: The solidarity and implicit guarantee mechanisms linking the federal government and the Laender ensure an equal and minimum risk of default for all. Fitch does not believe the strength of the support mechanisms will change in the medium term.

Liquidity: Bremen will act as paying agent. The liquidity of the issue is underpinned by the safe cash management system operated by the Laender (overnight cash exchanges between Laender and Bund when necessary, and recourse to appropriate short-term credit lines). The issue is zero risk-weighted and is European Central Bank repo-eligible. The objective of the Laender jumbo joint issue is to offer investors a large and liquid bond, with a portfolio exposure to several issuers.

Purpose: The bonds will fund the general budget operations of the Laender, according to their respective constitutions and financial ordinances.

Related Research

Fitch Affirms 11 German Laender at 'AAA'; Outlook Stable (May 2017)

Institutional Framework for German Subnationals (September 2015)

Fitch's Rating Approach for the German Laender (August 2015)

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Rating Considerations

Solidarity Is Enshrined in the Constitution

According to the German Constitution (Article 20), the 16 Laender are equal partners with the federal government and have the same rights and duties, even though in practice they are subordinate in some areas. The distribution of responsibilities between the Bund and the Laender guarantees their integration into federal decision-making processes. On average, between half and two-thirds of federal laws require the Laender's approval through the Bundesrat, one of the two legislative bodies in Germany and the one in which the Laender are represented.

The constitution recognises the need to iron out disparities in standards of living throughout the country and gives the Laender the opportunity to exercise financial independence. German financial federalism implies the need to balance resources between the constituent parts of the federation (the 16 Laender and the Bund). This has led to the tax-sharing system and the double income-equalisation system (for further information, see *Institutional Framework for German Subnationals* under *Related Research* above).

Mandatory Support for Laender Facing Financial Difficulties

In 1992, a ruling of the German Federal Constitutional Court highlighted the "Bundestreuekonzept" as a "solidarity principle", according to which all members 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 federal members, as in the cases of Saarland and Bremen after 1994. It is unlikely that support would not be forthcoming for any member of the federation that experienced financial distress.

Fitch considers that the decision made by the German Federal Constitutional Court on 19 October 2006 on Berlin's appeal for extraordinary financial support reaffirmed the validity of the Bundestreuekonzept. This was despite the Federal Constitutional Court's rejection of Berlin's appeal for extraordinary support because the capital city had not reached a situation of extreme budgetary hardship.

At the same time, the Federal Constitutional Court reaffirmed the obligation for the federal government and the other Laender to provide financial support as a last resort ("ultima ratio"), should a Land become unable to fulfil its constitutional duties. In Fitch's view, this confirms the strong support of German financial federalism, which has been one of the key rating factors (alongside the equalisation system and the Laender's cash management) underpinning the 'AAA' rating assigned to the German Laender by Fitch since 1999.

Extensive Equalisation Scheme Compensates for Financial Disparity

This constitutional support system works together with the far-reaching tax-sharing and equalisation system to establish a preventative framework to help the Laender avoid financial difficulties. The main taxes, which are personal income, corporate and VAT, are shared between the Bund, the Laender and the local authorities. Tax rates are set by federal law, minimising competition between Laender, but giving them almost no tax discretion.

The three-stage equalisation process ("Laenderfinanzausgleich") significantly reduces financial disparities between the Laender. The first two steps consist of sharing VAT and other tax proceeds among the Laender themselves, while the third element takes the form of additional federal transfers to the weakest Laender. Differences in financial strength are almost entirely evened out.

The 2001 reform of the equalisation system implemented in 2005 contained no fundamental changes to the previous system and confirmed the capacity of German federalism to guarantee financial solidarity among its constituent parts. A new solidarity pact ("Solidarity Pact II") was also signed in favour of the five eastern Laender (Brandenburg, Mecklenburg-Vorpommern,

Related Criteria

International Local and Regional Governments
Rating Criteria – Outside the United States
(April 2016)

Saxony, Saxony-Anhalt and Thuringia) and Berlin, which will receive a total of EUR156 billion during 2005-2019 to support their economic development.

Safe Liquidity Management Prevents Delay in Support

With respect to timeliness, Fitch believes that the issuers, as German Laender, run safe and predictable liquidity management procedures. Laender cash management covers one year so that a liquidity crisis could not arise unexpectedly. The Laender are tax collectors and their expenditure tends not to be volatile; they have substantial, predictable cash flows.

Their liquidity benefits from two kinds of short-term arrangement: daily cash transfers between the Laender as an alternative to the capital markets; and credit and back-up lines individually negotiated by each Land, which are available at short notice. German Laender are on an equal footing with banks in the interbank market and therefore have good access to liquidity through a wide range of public and private banks.

Federalism Reform II

A commission made up of the federal council (Bundesrat) and the federal parliament (Bundestag) was established in December 2006 to prepare Federalism Reform II (Föderalismusreform II) – a fundamental reform of the constitutional rules for borrowing. The commission approved the reforms on 12 June 2009. A core item is the implementation of a debt limit for the Bund and the Laender. As a result, both will be required to balance their budgets without taking on new debt. Only the Bund will be allowed to increase net debt, up to 0.35% of GDP (structural debt).

Exemptions will be allowed during economic downturns to stimulate the economy and in extraordinary circumstances such as natural disasters when rapid support is required. Should the Bund or a Land make use of those exemptions, it will have to set up measures to reduce this debt within a specific period.

The rules apply from 2011 but following the financial crisis both the Bund and Laender will be permitted a transition period for the introduction of the new rules until 2015 (for the Bund) and 2019 (for the Laender). They have to prepare their financial plans so that the new rules will be met after the transition period.

The states of Berlin, Bremen, Saarland, Saxony-Anhalt and Schleswig-Holstein will receive extraordinary support totalling EUR800 million annually from the Bund and the Laender during 2011-2019 to enable them to balance their budgets and comply with the new rules after the transition period. During this period, these states must take steps to consolidate the budget. Should they fail to do so, this support will be capped.

Compliance with these rules will be supervised by the Stabilitätsrat (a board comprising the federal Minister of Finance, the ministers of finance of the 16 Laender and the German Minister of Economy and Technology), as determined by the constitution. This should ensure early warning of budgetary hardship in any state and enable the timely introduction of counter-measures. Fitch views the reforms positively; they should promote greater budgetary discipline and establish serious cost-cutting measures, reduce structural deficits, and bring debt down to more manageable levels in the long term.

Appendix A

Figure 1

Statistical Overview of the Relevant Laender

	Population, 31 December 2015 (000)	GDP, 2016 (EURbn at current prices)	GDP per capita, 2015 (EUR at current prices)	Public debt (incl. local authorities), 2016 (EURbn)	Public debt (incl. local authorities) per capita, 2016 (EUR)
Bremen	667	32.3	46,755	21.3	31,736
Hamburg	1,775	110.7	60,912	31.1	17,415
Rheinland-Pfalz	4,032	139.5	33,589	45.4	11,199
Saarland	992	35.1	34,893	17.9	17,939
Schleswig-Holstein	2,845	89.2	30,482	33.7	11,781

Source: Destatis, Volkswirtschaftliche Gesamtrechnungen der Laender

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