FitchRatings

Public Finance
Germany

Laender 58

Six Federated States

Transaction Summary

Joint Issue: This issue of EUR1.0 billion 0.0% fixed-rate bonds is the first German Laender jumbo issue of 2020, and the 58th 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: Four of the participating states – Bremen, Rheinland-Pfalz, Saarland and Schleswig-Holstein – each received EUR200 million, while Hamburg and Mecklenburg-Vorpommern each received EUR100 million.

Laender Credit Quality Supports Rating: Fitch Ratings has assigned this issue a final Long-Term Local-Currency Rating of 'AAA'. The rating reflects the creditworthiness of the six German federated states (Laender) involved in the joint issue. The final rating is due to the receipt of final documents conforming to information already received.

Key Rating Drivers

Creditworthiness of Laender: Fitch affirmed the ratings of the German Laender on 26 April 2019. 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 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 six states involved in this joint issue. 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: Rheinland-Pfalz acts 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 eligible for a repo at the ECB. 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.

Rating

Rating type	Rating	Amount (EURbn)	Final Maturity
IDR	AAA	1.0	19 Feb 2027

Applicable Criteria

Rating Criteria for International Local and Regional Governments (September 2019)

Related Research

Fitch Affirms 11 German Laender at 'AAA'; Outlook Stable (April 2019)

Institutional Framework for German Subnationals (September 2015)

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

Analysts

Guido Bach
+49 69 768076 111
guido.bach@fitchratings.com

Nazim Dadashov
+49 69 768076 149
nazim.dadashov@fitchratings.com

Issuer Contact

Dr. Frank Nagel
+49 6131 164 266
frank.nagel@fm.rlp.de

Dr. Frank Bornholdt
+49 385 588 4250
frank.bornholdt@fm.mv-regierung.de

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.

Federal Equalisation Mechanism Reform

In 2017, the new financial equalisation was made in law. A streamlined financial equalisation began operating in 2020, when the Solidarity Pact II with the eastern Laender and the existing financial equalisation expired. The former Solidarity Pact II, in favour of the five eastern Laender (Brandenburg, Mecklenburg-Vorpommern, Saxony, Saxony-Anhalt and Thuringia) and Berlin, ran from 2005-2019 and issued a total to EUR156 billion to support their economic development.

The new financial equalisation system includes an additional annual support from the Bund to the Laender amounting to about EUR9.7 billion. In return, the Bund takes on a larger role in certain areas, such as the construction and maintenance of highways, tax administration and investment in schools and public administration.

It also includes the commitment of the Bund to grant additional support of EUR400 million for two financially weaker Laender, Saarland and Bremen, which have the highest debt burden among the 16 Laender. The provision of the funds and related conditionality should ensure that they meet three core targets: to comply with the debt brake starting 2020; reduce total debt; and implement structural economic reforms. The package requires Bremen and Saarland to aim to reduce their debt burden by EUR50 million annually (although debt reduction can be extended), under the supervision the Bund.

The support for Bremen and Saarland confirms that the current solidarity principle is in operation. The principle makes Bund and Laender jointly responsible for supporting a Land that is at risk of becoming financially distressed. In this case, the Bund has pre-emptively moved to increase the financial flexibility of both states by reducing the debt burden and thus debt servicing requirements.

In Fitch's view, the new financial equalisation system confirmed the capacity of German federalism to guarantee financial solidarity among its constituent parts.

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.

Statistical Overview of the Relevant Laender

	Population, 31 December 2018 (000s)	GDP, 2018 (EURbn at current prices)	GDP per capita, 2018 (EUR at current prices)	Public debt (according to SFK4 reporting), 2019 (EURbn)	Public debt (according to SFK4 reporting) per capita, 2019 (EUR)
Bremen	683	34.3	50,389	30.0	44,014
Hamburg	1,841	120.3	65,603	25.3	12,644
Mecklenburg-Vorpommern	1,610	44.9	27,905	9.6	4,563
Rheinland-Pfalz	4,084	149.1	36,573	30.7	7,294
Saarland	991	36.0	36,243	13.9	13,830
Schleswig-Holstein	2,897	97.1	33,555	29.1	9,610

Source: Fitch Ratings, Destatis, Volkswirtschaftliche Gesamtrechnungen der Laender, German Federal Ministry of Finance

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.