Scope affirms and publishes the Land of Hesse's AAA rating with Stable Outlook

Robust budgetary performance, conservative budgetary, debt and liquidity management and low contingent liability risk support the rating. Low expenditure flexibility, coupled with cost pressures, is the main credit challenge.

Rating action

Scope Ratings GmbH (Scope) has today affirmed the Land of Hesse's (Hesse) local- and foreign-currency long-term issuer and senior unsecured debt ratings at AAA. Scope has also affirmed the local- and foreign currency short-term issuer ratings at S-1+. All Outlooks are Stable.

Download the rating report.

Key rating drivers

The German federal institutional framework under which all German Länder operate is highly integrated and results in a close alignment of German Länder's ratings with the AAA-rating of the federal government. Key elements of the framework include: i) a strong revenue equalisation mechanism; ii) wide-ranging participation of the Länder in national legislation and veto rights; iii) equal involvement of the Länder in negotiations on federal reforms; and iv) a solidarity principle that ensures extraordinary system support in budgetary emergencies.

A further key element of the institutional framework is the constitutional debt brake, which limits structural deficits. Budgetary practices under the debt brake rule were impacted by the federal constitutional court's ruling from 15 November 2023 on the Second Supplementary Budget Act 2021 of the federal government. The ruling effectively limits the budgetary practice of using emergency credit authorisations to create budgetary reserves for future spending, which was also commonly used by Länder governments since 2020, thus also impacting budgetary practices of the Länder.

In Hesse, the special fund set up in 2020 to tackle the Covid-19 pandemic, equipped with credit authorisations under the debt brake emergency clause, was closed on 1 January 2022. All measures and borrowings of around EUR 3.6bn under the special fund were transferred to the Land's core budget, following the State Court of Justice's ruling in 2021 that the special fund was unconstitutional. As a consequence, the Land's budgetary and financial planning for the current and future fiscal years was not impacted by the constitutional court ruling.

Hesse's strong individual credit profile with the following credit strengths: i) sound budgetary management with recurring operating surpluses and a strong commitment to the Land's debt brake; ii) conservative debt and liquidity management, with excellent market access and a favourable debt profile; iii) low contingent liabilities with a well-equipped pension fund for its civil servants; and iv) above-average revenue flexibility.

Hesse's conservative budgetary management, resulting in solid budgetary performance. Between 2016 and 2019, operating margins averaged 10% of operating revenue, while the balance after capital accounts averaged 2.3% of total revenue. This allowed Hesse to reduce legacy debt by EUR 200m per year before the state-level debt brake became binding in 2020.

In 2020, the Covid-19 pandemic led to a temporary budgetary deterioration due to revenue losses and additional expenditure, as well as higher borrowing under the debt brake emergency clause. At the same time, significant central government transfers cushioned the direct impact on Länder budgets. Budgetary performance recovered strongly in 2021/22, allowing Hesse to forego any additional net borrowing and enter 2023 with around EUR 2bn in budgetary reserves ('Konjunkturausgleichsrücklage').

In 2023, the budgetary performance deteriorated, with tax revenue underperforming compared to budgeted levels by around EUR 1bn, driving a decline in operating revenue of 5% YoY. In addition, operating expenditure increased by around 1%, driven mostly by higher personnel and transfer expenditure. This led to a reduction in the operating margin to 5.1% of operating revenue, from 10.3% in 2022. This decline, combined with moderately higher interest expenses and elevated capital expenditure led to a deterioration in the overall budgetary margin (after capital accounts) to -2.0% of total revenue, from 3.7% in 2022. However, overperformance vis-à-vis the budget for 2023, apart from tax revenue, allowed the state to broadly maintain its level of budgetary reserves entering the current fiscal year.

For 2024 to 2026, Scope expects continued deficits after capital accounts of an average 2.2% of total revenue due to budgetary headwinds. Tax revenue is projected to grow by an average 4.9% per year, despite relatively weak nation-wide economic growth, which Scope estimates at 0.2% in 2024 and 1.4% in 2025, and some federal measures which will weigh on tax revenue, such as the 'Wachstumschancengesetz'. However, high operating and investment spending will largely offset increased tax revenue. Despite the pressures, Scope expects remaining budgetary reserves, together with some consolidation measures, to allow Hesse to adhere to its commitment to the debt brake in coming years, and thus limit its net borrowing as laid out in its financial plan for 2023 to 2027. This should keep debt broadly stable in nominal terms, at around EUR 41bn, or 125% of operating revenue in 2023, and support a declining trajectory to around 114% of operating revenue in 2026.

Overall, the state's commitment to fiscal consolidation, conservative budget management and low debt service costs will help mitigate budgetary risks and enable the state to implement its long-term fiscal consolidation strategy.

Hesse's excellent debt management limits maturity, foreign-currency and interest-rate risks, while securing favourable funding conditions. The weighted average maturity of debt is 10.6 years. Derivatives are used to hedge foreign-exchange and interest-rate risk, and exposure to these risks is minimal. Since 2021, the Land can only enter new derivative contracts to hedge foreign-exchange risks and eliminate negative interest rate risks. Overall, derivative usage should decline in future years.

Further, the Land has broadened its capital market presence by issuing green benchmark bonds of EUR 600m in 2021 and EUR 1bn in 2023, the largest among Länder to date. Scope views the green bond issuance as credit positive, as it widened the Land's investor base. As a financially stronger Land (one of five net payers in the horizontal financial equalisation system in 2023) and a relatively larger issuer among the

Länder, with around EUR 5-6bn in annual issuance volume, the Land's capital market access is excellent.

The state's liquidity management is sound due to comprehensive inter-year cash planning and the availability of numerous sources of liquidity, as well as available cash buffers. Additional continued access to liquidity to bridge intraday needs, if required, is available through credit facilities from major financial institutions. An additional source of liquidity is also provided by commercial cash transactions between the German Länder, which lend excess liquidity to each other. As a consequence, the risk of liquidity shortages is negligible.

Finally, contingent liabilities and associated risks are low. This is driven by the low level and low-risk nature of contractual guarantees, limited contingency risk stemming from its shareholdings, and a relatively smaller unfunded pension provision compared to peers together with the Land's conservative and forward-looking management of its pension fund. Finally, pro-active management of municipal debt via its 'Hessenkasse' programme supports municipal finances.

While Hesse faces unfunded pension liabilities related to its civil servants, like all Länder, the risk related to these obligations is relatively lower than for most other states due to conservative management via Hesse's pension fund, with assets worth around EUR 5.1bn as of YE 2022, covering around 6% of pension provisions. The fund is managed in a forward-looking manner, with transfers to the core budget only permissible when the funding ratio exceeds 10% of the pension liability. The size of the transfers should not exceed the average return of the fund.

The main rating challenge is limited expenditure flexibility, coupled with spending pressures which weigh on budgetary margins over the forecast horizon.

Hesse's flexibility to adjust expenditure is moderate, as minimum legislative requirements and the socially sensitive nature of several expenditure items make most items difficult to trim. Inflexible spending items comprise personnel (38% of operating expenditure in 2023) and transfers (around 50%), including to municipalities. In addition, Scope expects expenditure to rise dynamically and in a broad-based fashion. This is predominantly driven by personnel expenditure, which is set to rise to EUR 13.8bn, from EUR 12.0bn in 2023, by an average 4.3% per year. This includes pay rises in 2023/24 in reaction to a ruling by the administrative court of justice (VGH), which found the remuneration of civil servants not to be in line with the constitutional requirements ('Alimentationsprinzip').

Spending pressures will make balancing budgets for the financial planning period until 2027 challenging, as evidenced by budgeted but yet unidentified, lower expenditure and higher revenue ('Globale Minderausgaben' und 'Globale Mehreinnahmen') of around EUR 1.3bn per year from 2025, or around 4% of operating revenue in 2023. At the same time, Scope expects the Land to maintain its target of zero net borrowing, although this will likely come at the cost of the remaining budgetary reserves being exhausted by YE 2025.

Finally, a contingency risk stems from an upcoming decision regarding the remuneration of civil servants between 2013 and 2020 by the constitutional court. A decision is expected this or next year. If the constitutional court were to confirm the assessment of Hesse's administrative court that civil servants' pay was too low, the Land would face significant costs. The overall budgetary effect would depend on the timeframe, especially regarding potential retroactive applicability.

Outlook and rating sensitivities

The **Stable Outlook** represents Scope's view that risks to the ratings over the next 12 to 18 months are balanced.

Downside scenarios for the rating and Outlooks are (individually or collectively):

1. The German sovereign rating/Outlook were downgraded;
2. Changes to the institutional framework were to result in a notably weaker individual credit profile;
3. The individual credit profile deteriorated significantly and structurally.

Institutional framework assessment

Scope's institutional framework assessment determines the intergovernmental integration between sub-sovereigns and their rating anchor, which is the sovereign or a higher-tier government. To perform this assessment, Scope applies the Institutional Framework scorecard (QS1), centred on six analytical components: i) *extraordinary support and bailout practices*; ii) *ordinary budgetary support and fiscal equalisation*; iii) *funding practices*; iv) *fiscal rules and oversight*; v) *revenue and spending powers*; and vi) *political coherence and multilevel governance*.

Scope considers the institutional framework under which the German Länder operate to display 'full' integration for: i) extraordinary support and bailout practices; ii) ordinary budgetary support and fiscal equalisation; iii) fiscal rules and oversight; iv) revenue and spending powers; and v) political coherence and multilevel governance. The institutional framework displays 'medium' integration for funding practices. Consequently, Scope's assessment results in an indicative downward rating distance of up to one notch between the German sovereign (AAA/Stable) and the rating of an individual state.

Individual credit profile

Scope assesses the individual credit profile based on quantitative and qualitative analysis of four risk categories: i) *debt and liquidity*; ii) *budget*; iii) *economy*; and iv) *governance*. These are further complemented by additional adjustments for *environmental and social factors & resilience*.

The outcome of these assessments, as reflected in the application of the Individual Credit Profile scorecard (QS2), is an individual credit profile score for Hesse of 75 out of 100.

The mapping of this score to the range defined by the Institutional Framework assessment results in an indicative rating for Hesse aligned with the sovereign rating, corresponding to an AAA indicative rating.

The review of potential exceptional circumstances that cannot be captured by the Institutional Framework and Individual Credit Profile scorecards did not lead to further adjustments. As such, the final rating corresponds to the indicative rating of AAA.

The results have been discussed and confirmed by a rating committee.

Environmental, social and governance (ESG) factors

ESG factors material to Hesse's credit quality are captured by Scope's rating approach through several analytical areas.

Scope's assessment of Germany's sovereign credit quality includes an appraisal of ESG risks, as detailed in Scope's Sovereign Rating Methodology.

Governance considerations are material to Hesse's rating and are included in Scope's institutional framework assessment and its assessment of the Land's individual credit profile. These highlight the high quality of governance alongside the administration's record of sound liquidity and debt management practices.

The institutional framework assessments capture governance factors under fiscal rules and oversight, assessed as 'full integration' for the German Länder. This reflects the comprehensive and credible fiscal framework in the form of the debt brake, as well as the strong oversight role of the Stability Council. Governance factors are also captured under political coherence and multilevel governance, assessed as 'full integration', reflecting Germany's predictable and supportive federal system, where any major reforms are discussed and agreed upon well in advance and in consultation with the Länder.

The individual credit profile captures governance factors under the 'quality of governance and financial management', where Hesse is assessed as 'stronger', reflecting its: i) track record of fiscal consolidation and credible commitment to fiscal sustainability; ii) strong debt and liquidity management; iii) management of contingent liability risks related to unfunded pension liabilities via its pension fund and regular annual transfers to the fund to ensure long-term sustainability; and iv) ability to formulate and implement long-term economic and fiscal strategies. Finally, due to its accrual-based accounting, the Land's financial reporting is more transparent than for Länder that only provide cash-based fiscal accounts, for example in relation to pension and contingent liabilities.

Social considerations are included in Scope's assessment of Hesse's 'economic sustainability'. Hesse maintains a robust economy characterised by diverse industries, including a financial hub in Frankfurt. The region's economic sustainability is underpinned by robust business dynamics and demographic trends, which will support the Land's status as a contributor to the financial equalisation system.

Additional environmental and social factors can be material for sub-sovereign creditworthiness beyond what is already captured in other sections of the methodology. In the case of Hesse, no additional adjustments to the individual credit profile apply for social and environmental factors & resilience.

Hesse has adopted its first climate law last year with the binding goal of reaching climate neutrality until 2045 at the latest, which is in line with the nationwide goal, with intermediate goals of a 65% reduction via-a-vis the 1990 level by 2030. In addition, the regional government is expected to become climate neutral by 2030.

The Land is exposed to transition risks over coming years on its path to carbon neutrality by 2045. Due to its relatively favourable energy mix and sectors driving the regional economy, Scope considers the state relatively less exposed to climate transition risks. Finally, Scope assesses physical climate risks to be in line with the national average and other Länder.

Rating Committee

The main points discussed by the rating committee were: i) institutional framework; ii) debt burden, liquidity profile and contingent liabilities; iii) debt management strategy; iv) budgetary performance and flexibility; v) regional socio-economic and demographic developments; vi) peer comparison; and vii) environmental and social factors.

Methodology

The methodology used for these Credit Ratings and/or Outlooks (Sub-sovereigns Rating Methodology, 11 October 2023) is available on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
Information on the meaning of each Credit Rating category, including definitions of default, recoveries, Outlooks and Under Review, can be viewed in 'Rating Definitions – Credit Ratings, Ancillary and Other Services', published on https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Historical default rates of the entities rated by Scope Ratings can be viewed in the Credit Rating performance report at https://scoperatings.com/governance-and-policies/regulatory/eu-regulation. Also refer to the central platform

(CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope Ratings' definitions of default and Credit Rating notations can be found at https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Guidance and information on how environmental, social or governance factors (ESG factors) are incorporated into the Credit Rating can be found in the respective sections of the methodologies or guidance documents provided on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
The Outlook indicates the most likely direction of the Credit Ratings if the Credit Ratings were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The Rated Entity and/or its Related Third Parties participated in the Credit Rating process.
The following substantially material sources of information were used to prepare the Credit Ratings: public domain, the Rated Entity.
Scope Ratings considers the quality of information available to Scope Ratings on the Rated Entity or instrument to be satisfactory. The information and data supporting these Credit Ratings originate from sources Scope Ratings considers to be reliable and accurate. Scope Ratings does not, however, independently verify the reliability and accuracy of the information and data.
Prior to the issuance of the Credit Rating action, the Rated Entity was given the opportunity to review the Credit Ratings and Outlooks and the principal grounds on which the Credit Ratings and Outlooks are based. Following that review, the Credit Ratings and Outlooks were not amended before being issued.

Regulatory disclosures

These Credit Ratings and Outlooks are issued by Scope Ratings GmbH, Lennéstraße 5, D-10785 Berlin, Tel +49 30 27891-0. The Credit Ratings and Outlooks are UK-endorsed.
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The Credit Ratings/Outlooks were first released by Scope Ratings on 9 November 2018.
As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on Hesse are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Publication Calendar 2024 Sovereign, Sub-Sovereign and Supranational Ratings" published on 19 February 2024 on www.scoperatings.com). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case the deviation from Scope's published calendar was due to the first-time publication of the ratings.

Potential conflicts

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With more than 300 employees operating from offices in Berlin, Frankfurt, London, Madrid, Milan, Oslo and Paris, Scope Group is the leading European provider of independent credit ratings, ESG analysis and fund research. Based on forward-looking and innovative methodologies, Scope offers a European perspective that contributes to greater diversity of opinion for institutional investors worldwide. Scope Ratings is registered in accordance with the EU rating regulation and operating in the European Union with ECAI status. Scope

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