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Peer Comparison: Berlin and Nordrhein-Westfalen

Land of Berlin has fiscal edge over wealthier peer Land of Nordrhein-Westfalen.

RATINGS

Berlin, Land of

Issuer Rating	Aa1
Senior Unsecured	Aa1

Nordrhein-Westfalen, Land of (NRW)

Issuer Rating	Aa1
Senior Unsecured	Aa1

KEY INDICATORS, 2013

	Berlin	NRW
GDP per Capita (% of national average)	91.9%	100.8%
Gross Operating Balance (% of op. rev.)	4.4%	0.1%
Financial Balance (% of total re.)	2.3%	-5.6%
Direct Debt (% of op. rev.)	277.5%	247.8%
Net Direct and Indirect Debt (% of op. rev.)	341.5%	358.2%
Total Tax Revenues (% of total rev.)	52.5%	79.0%
Total Intergovernmental Revenues (% of total rev.)	38.8%	16.6%
Interest Expenses (% of op. rev.)	8.8%	7.2%
Debt Service (% of op. rev.)	44.7%	43.4%

Source: German Federal Ministry of Finance, Moody's

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Summary

The two German regions (Laender) will remain among the biggest sub-sovereign issuers, reflecting their high existing debt levels and significant refinancing needs. Berlin and Nordrhein-Westfalen (NRW) are also constrained by similar credit weaknesses, notably their high debt servicing costs. However, Berlin is in a stronger fiscal position than its more affluent peer thanks to a combination of robust financial management and substantial government subsidies.

Berlin has first mover advantage and stronger financial management than NRW. Berlin started the process of fiscal consolidation earlier, and its superior financial discipline has put it ahead of NRW in the race to comply with new rules obliging German regions to balance their budgets by 2020, supporting its credit profile. NRW's steps towards bringing its budget into balance, in contrast, have been less effective, and extra measures would be required in the event of a slowdown in economic growth.

Berlin benefits under the current “equalization” system, although changes are envisaged from 2020. Berlin has had a helping hand from annual subsidies amounting to 39 percent of revenues that it receives under national “equalization” schemes aimed at helping economically weaker regions, especially those in former East Germany, catch up with their more affluent peers. “City-states”¹ like Berlin benefit from additional government support. In comparison, total subsidies account for just 17 percent of NRW's revenues.

This advantage of Berlin under the current system is offset only in part by NRW's stronger economy. NRW, Germany's biggest Land in terms of population, and home to the industrial and manufacturing powerhouse of the Ruhr region, has gross domestic product per capita of 101 percent of the national average, well ahead of Berlin's 92 percent.

Policymakers are currently discussing adjustments to the equalization system beyond 2019, but at this stage we expect no fundamental changes, nor any significant rating implications.

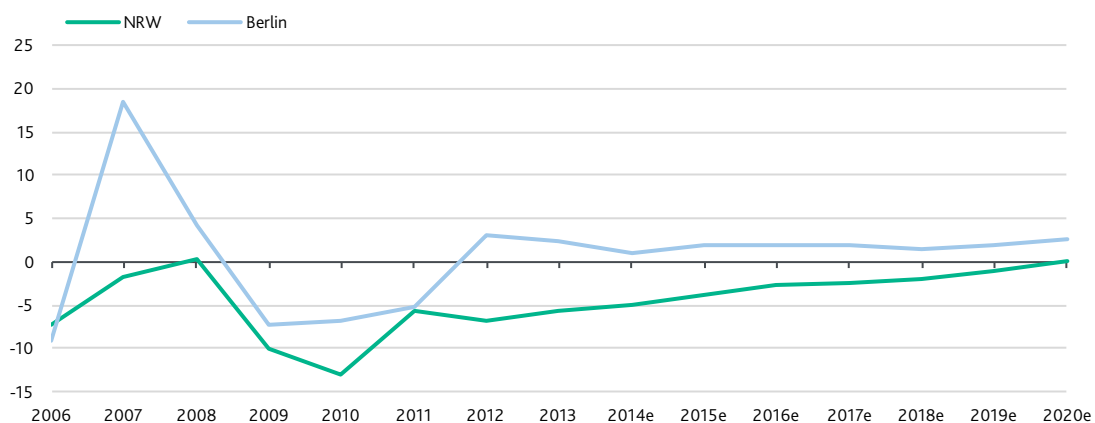
¹ The city-states of Berlin, Bremen and Hamburg are simultaneously both municipalities and Laender in their own right.

Berlin has first mover advantage and stronger financial management than NRW

We believe that Berlin's stronger financial management and greater fiscal prudence give it a key advantage that will soften the impact of new rules requiring German Laender to eliminate structural financial deficits over the next six years.² In an illustration of Berlin's commitment to fiscal discipline, the Land has surpassed its own initial targets for spending control, as well as those set out under the so-called debt brake mechanism. NRW, in contrast, is less ambitious, and aims simply to achieve the minimum requirement of balancing the budget by 2020 (see exhibit 1).

EXHIBIT 1

Berlin's financial result (% of total revenues) is ahead of NRW's



Source: German Ministry of Finance, Berlin and NRW's budget, Moody's estimate

Background: Berlin's rocky road to budget equilibrium

Berlin's recent embrace of fiscal restraint traces its origins back to a severe budgetary crisis (*Haushaltsnotlage*) that engulfed it during the early 2000s. The region, having absorbed a series of budget deficits in the 1990s as it incurred unexpected costs in the wake of German reunification, was forced in 2003 to apply for financial support from the federal government as it battled to balance its books. Its request was turned down, as was a subsequent complaint to the German Constitutional Court. In its 2006 verdict, the Constitutional Court ruled that the budgetary crisis facing Berlin was not severe enough to justify additional federal government help. This final refusal prompted the Berlin authorities, which had begun to impose tighter cost controls five years earlier, to push through a rigorously conservative fiscal program that delivered markedly improved financial performances up until 2009. This fiscal consolidation continues to yield results today, especially in the form of tight spending restraint.

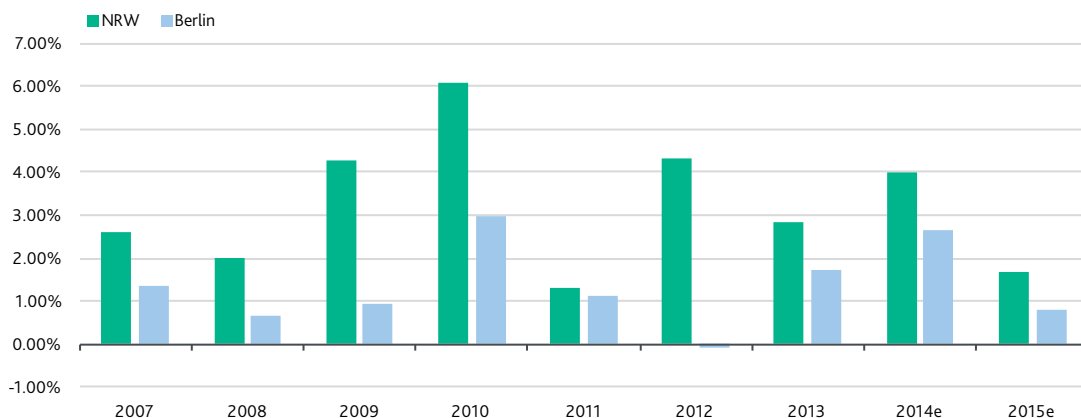
Berlin has demonstrated a particular aptitude for fiscal restraint, limiting total annual spending growth since 2008 to below 1 percent on average, and generating a financial surplus every year since 2012 (see exhibit 2). This has allowed the Land to reduce its direct debt ratios more rapidly than NRW, whose spending since 2008 has grown more than twice as fast as Berlin's, and whose budget position, although improving, remains in deficit.

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² In July 2009, Germany's 16 regional authorities committed to phasing out their budget deficits within ten years when they and the federal government signed up to a "debt brake" mechanism aimed at shoring up the public finances just as the euro zone sovereign debt crisis was gathering momentum.

EXHIBIT 2

Low expenditure growth rates (yoy) reflect management's savings commitment



Source: German Ministry of Finance, Berlin, NRW, Moody's estimate

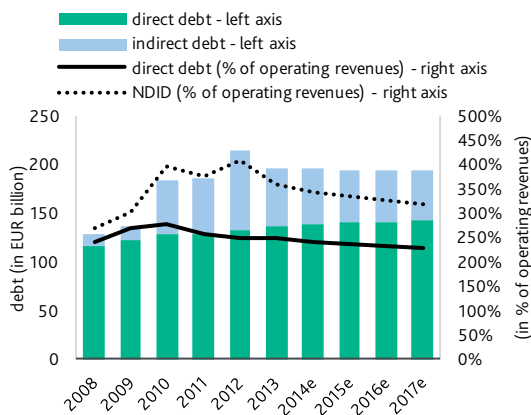
NRW has reported a string of budget deficits over the past six years, due in part to one-off costs related to the winding-up of its part-owned state bank, WestLB, which suffered investment losses during the 2008 crisis. A large part of WestLB's assets was finally transferred to a wind-down entity (Erste Abwicklungsanstalt, Aa1, stable) which needed capital and guarantees from the Land when it was set up.

The Land's budget shortfall has been narrowing since 2012, helped by steady growth in tax revenues on the back of solid economic expansion. However, we expect that NRW will continue to post budget deficits for now due to structural problems, including relatively high payroll costs and less rigorous spending restraint than some of its regional peers, including Berlin.

We believe the Land of Nordrhein-Westfalen will continue adding to its debt burden (see exhibit 3) until the debt brake mechanism puts a halt to new borrowing from 2020. The main threat to NRW's budget planning is a shortfall in tax revenue triggered by a potential economic slowdown.

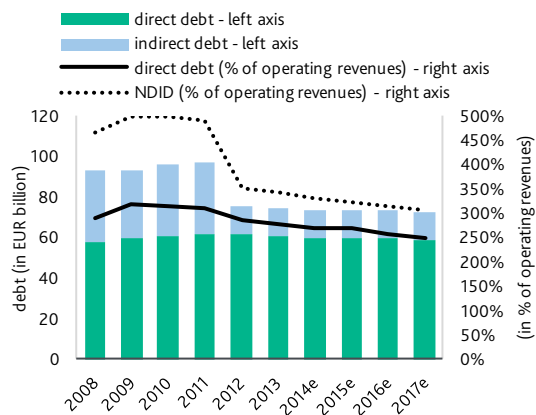
EXHIBIT 3

Outstanding Debt and Debt Ratios – Nordrhein-Westfalen - 2008 – 2017e



Source: German Ministry of Finance, Berlin, NRW, Moody's estimate

Outstanding Debt and Debt Ratios – Berlin - 2008 – 2017e



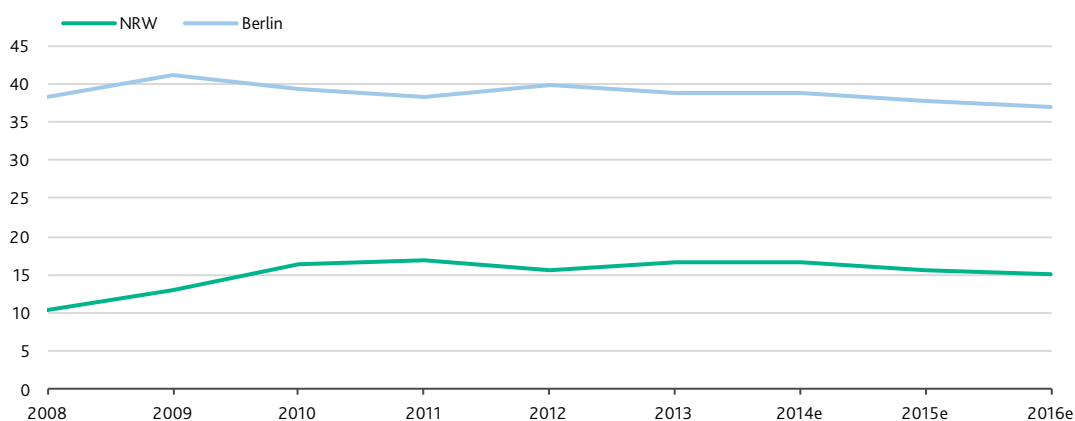
Source: German Ministry of Finance, Berlin, NRW, Moody's estimate

Berlin benefits under the current equalization system, although changes are envisaged from 2020

Judged by tax revenues, NRW is significantly stronger, with tax receipts accounting for nearly 80 percent of total revenues, against just 50 percent for Berlin. However, Berlin's comparatively weak tax revenues are counterbalanced by intergovernmental revenues (including subsidies under the equalization regime), designed to bring poorer regions into line with their more affluent peers. The city state derives 39 percent of its total revenues from this source (see exhibit 4).

EXHIBIT 4

Berlin's total budget is more dependent on intergovernmental revenues



Source: German Ministry of Finance, Berlin, NRW, Moody's estimate

Due to its special characteristics as (i) financially weak, (ii) a city state, and (iii) located in former East Germany, the Land of Berlin is one of the biggest winners of the German equalization system³. Berlin's financial weakness is mitigated through the equalization system, while NRW's available income is driven primarily off its own-source revenue base.

Although NRW is the German region with the largest tax base, even above-average economic and population growth would have only a limited effect on its finances, as any increases in revenue would be largely offset by lower transfer income from, and/or higher donor obligations to, the equalization pool.

The German equalization system will cease to exist in its current form by 2019. By then, specific purpose grants for infrastructure development in eastern states will gradually be phased out. However, we expect that any changes to the equalization scheme will be well predictable and take into account specific financial needs of the Laender. Moreover, Laender will not be able to bridge funding gaps with new debts, because the debt brake will come into effect at the same time.

³ By international standards, Germany has one of the strongest systems of financial support for regional governments, backed by a constitutional guarantee that regions receive appropriate revenues. The German equalization system combines (1) the allocation of certain tax revenues to the Laender and other layers of government (vertical distribution) and (2) horizontal distribution of tax revenue between the Laender; (3) financial equalization between poor and rich Laender and (4) investment support from the federal government. Additional federal grants are available for specific purposes, such as infrastructure development in eastern states.

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