Land of Berlin
Rating Report

SCOPE AAA STABLE OUTLOOK

Credit strengths

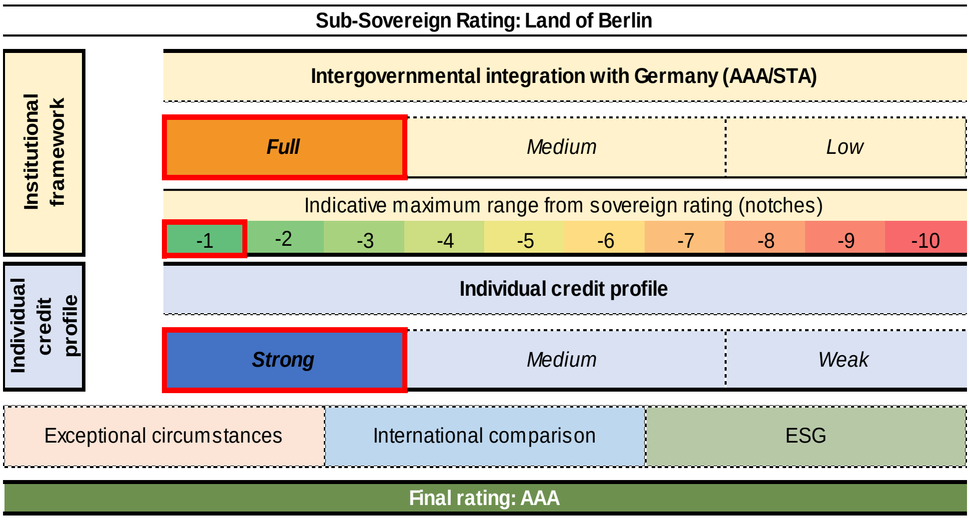
- Integrated institutional framework
- Good budgetary performance
- Commitment to fiscal consolidation
- Excellent capital market access
- Prudent liquidity management
- Favourable debt profile
- Solid economic base

Credit weaknesses

- High direct debt levels
- Sizeable, though largely low-risk, contingent liabilities
- Unfunded pension liabilities
- Limited revenue flexibility

Rating rationale and Outlook: The AAA rating reflects the Land of Berlin's strong individual credit profile, which is captured by its good budgetary performance, commitment to fiscal consolidation, favourable debt profile, excellent capital market access, prudent liquidity management, and solid economic base. In addition, the rating is underpinned by the highly integrated institutional framework under which Berlin operates, characterised by a very strong revenue equalisation system together with the federal solidarity principle. These aspects also enable the Land to counterbalance the Covid-19 economic shock. Credit challenges relate to high direct debt, low revenue flexibility given limited leeway to adjust revenues, unfunded pension liabilities weighing on long-term expenditure flexibility, as well as sizeable, yet manageable, contingent liabilities. The Stable Outlook reflects our assessment that the risks Berlin faces remain well balanced.

Figure 1: Scope's sub-sovereign approach to the rating for the Land of Berlin



Source: Scope Ratings GmbH

Positive rating-change drivers

- Not applicable

Negative rating-change drivers

- Downgrade of Germany's sovereign rating, necessitating a rating review
- Changes in the institutional framework, resulting in notably weaker support

Ratings & Outlook

Foreign currency

Long-term issuer rating	AAA/Stable
Senior unsecured debt	AAA/Stable
Short-term issuer rating	S-1+/Stable

Local currency

Long-term issuer rating	AAA/Stable
Senior unsecured debt	AAA/Stable
Short-term issuer rating	S-1+/Stable

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Institutional framework

Integrated framework results in strong alignment of creditworthiness

Like all of Germany's Länder, the Land of Berlin benefits from a mature, predictable and integrated institutional framework. The key elements are: i) a strongly interconnected revenue equalisation mechanism enshrined in the German constitution; ii) wide-ranging participation – and veto-rights – by the Länder in national legislation; iii) equal entitlement of the Länder regarding negotiations on federal reforms; and iv) a solidarity principle that ensures extraordinary system support in situations of budgetary emergency.

We consider the federal system under which the German Länder[1] operate to be the most integrated among European sub-sovereigns. We assess the system as high for: i) institutionalised support; ii) fiscal interlinkage; and iii) political coherence – both among the Länder as well as between the Länder and the federal government. Consequently, we determine a indicative downward rating distance of maximum one notch between the German sovereign (AAA) and the rating of the individual Land (see **Figure 2**).

In an international context, we anticipate the established German institutional framework, with a proven record of institutional support from the national government, to be able to tackle the economic challenges and withstand the pressure on sub-sovereign finances caused by the Covid-19 crisis. Co-operation on the policy response between the Länder and the sovereign has been strong during the crisis. In addition, the federal government has assumed the role as stabiliser by implementing substantial deficit spending policies to absorb the costs of higher unemployment and support economic output. The German parliament has approved EUR 218.5bn stimulus package to help the economy cope with the fallout of the pandemic.

Figure 2: Framework assessment

Institutional framework assessment: German Länder

Category	Weight	Sub-weight		Assessment: Integration	Score	Weighted score
Institutionalised support	50%	25%	Transfer & bailout regime	**High**	100	25
		15%	Borrowing limits	**High**	100	15
		10%	Funding support	**High**	100	10
Fiscal interlinkage	35%	20%	Tax authority	**High**	100	20
		15%	Fiscal equalisation	**High**	100	15
Political coherence	15%	10%	Distribution of powers	**High**	100	10
		5%	Common policymaking	**High**	100	5
			Integration with the sovereign		Σ	***100***

Integration score	0-10	10-20	20-30	30-40	40-50	50-60	60-70	70-80	80-90	90-100
Indicative notch range	0-10	0-9	0-8	0-7	0-6	0-5	0-4	0-3	0-2	0-1

Source: Scope Ratings GmbH

Institutionalised support

➢ Transfer and bailout regime

We assess the integration of sub-sovereigns as high when there is a constitutional and effective bailout rule and/or a legislative procedure that allows for rules-based financial support in situations of budgetary emergency. Conversely, we assess a credible no-bailout framework and/or past debt crises as low for integration, while ad-hoc financial support qualifies for medium.

[1] We use 'state' and the colloquial German terms interchangeably to refer to German federal states, individually as 'Land' and collectively as 'Länder'.

Länder have requested additional financial support from the federal government in five instances: Bremen (1992, 2006), Saarland (1992, 2005) and Berlin (2002). The court approves claims on the grounds of the 'Bundestreueprinzip', under which the Länder and the Bund are required to provide each other with mutual support in the event of a budgetary emergency. Berlin's claim was denied, with the court arguing that the city-state was not in an extreme budgetary situation. However, the judges noted that federal emergency support remains possible as ultima ratio if the budget and/or debt situation is assessed as extreme compared to that of other Länder.

We consider the interpretation of the Bundestreueprinzip to be an implicit bail-out rule, as it requires the provision of federal support in times of budgetary stress. We therefore define the degree of integration as high.

- Borrowing limits

Second, we assess intergovernmental integration as high if permanent, quantitatively specified, legally binding and credible borrowing limits for central and regional governments exist. Otherwise, we assign medium or low integration if deficit rules have limited credibility, i.e. are self-imposed, inappropriate, and/or non-existent.

Debt brake to be implemented in 2020

From 2020, Länder[2] must comply with a 'debt brake' under which no Länder are allowed to run structural financing deficits unless hit by a severe economic downturn or a natural disaster. The debt brake also caps the structural annual deficit of the central government at 0.35% of GDP. In March 2020, the German parliament suspended the debt brake and approved a stimulus package to help the economy deal with pandemic-related impacts. Separately, the Land of Berlin invoked the safeguard clause and temporarily suspended the regular debt brake provision to implement support measures and credit authorisations to mitigate the budgetary impact of Covid-19.

The finances of the Länder and their compliance with debt limits are monitored by the Stability Council, which was established in 2010 as a joint body of the German Federation and the Länder. The Stability Council monitors restructuring programmes and compliance with budgetary targets as defined in fiscal consolidation agreements between the Bund and the Länder. The Council comprises the finance ministers of each Land and the federal ministers of finance and economic affairs.

We view the Stability Council and the debt brake as important pillars for integrated financial relations between central and regional German governments, which leads us to assess integration as high.

- Funding support

The third criterion on institutional support relates to the degree of mutual funding support. A history of common funding and/or equal risk-weights with autonomous funding lead us to assess integration as high. A medium or low level of integration is characterised by either federal dominance on sub-sovereign funding or autonomous funding under separate risk weights.

Equal risk-weights combined with autonomous funding

We assign a high level of integration between the Länder and the federal government based on their history of stand-alone capital market issuance combined with aligned risk weights to the sovereign.[3]

[2] The debt brake is a legal framework that prohibits structural deficits from 2020 onwards; article 109 (3) of the Basic Law stipulates that the Länder may incur deficits in a case of a recession or a natural disaster provided they pass respective legislation at the Land level.
[3] Regulatory treatment of a sub-sovereign exposure in comparison with respective sovereign exposure for banks, which, in the European context, is defined under the European Banking Authority's Capital Requirements Regulation (CRR).

Fiscal interlinkage

➢ Tax authority

First, we assess the degree of intergovernmental integration based on the division of tax authority. The higher the degree of shared decision-making on taxes, the higher we assess the level of integration across jurisdictions. One-sided dependence leads to medium integration and a complete separation of tax authorities leads to a low assessment of interlinkage.

Shared tax authority with the Bund on high-revenue taxes

The Länder and the federal government share the tax authority, deciding together on rates and revenue distribution on high-revenue taxes (income and VAT). The latest reform on federal financial relations (in 2017) took effect in 2020 and has resulted in a higher distributed share of VAT revenues to the Länder. The VAT distribution will also fully compensate for the different taxing powers, thereby replacing the former two-step process of horizontal equalisation payments between the Länder. Alongside common taxes, the central government and the Länder have separate tax authority on other less-revenue-generating taxes.

We assess the tax authority as highly integrated, based on the high share of common taxes and the clear separation of tax authority on less-revenue-generating taxes.

➢ Fiscal equalisation

Second, we assess the extent of fiscal equalisation. Legal rules to lower differences in living standards lead to a high assessment of interlinkage. Predictable redistribution payments to cover mandatory spending justify a medium while unpredictable or ad-hoc transfers lead to a low assessment.

Strong revenue equalisation system

The German system is shaped by a mechanism that strongly aligns different fiscal capacities among the regions. The reformed equalisation system took effect in 2020, with distribution occurring via VAT. The net effect should be positive for all Länder as contributions from the federal government are greater under the new system. As a result, we maintain our assessment that the fiscal equalisation system contributes materially to high integration.

Political coherence

➢ Distribution of powers

First, we assess the degree of political coherence between government levels based on the distribution of powers. High (medium) integration is characterised by the distinct (imprecise) distribution of responsibilities. Low integration is assigned if relations are shaped by frequent conflicts and persistent separatist movements.

Federal reforms further strengthen the high level of political coherence

In 2017, the German government and the Länder agreed to reshape financial relations in the federal system, generally binding from 2020. In return for higher payments from the equalisation system, the regions have assigned limited executive and legislative rights to the central government in formerly autonomous policy areas, including physical and digital infrastructure and the higher-education system. In conformity with earlier federal reforms ('Föderalismusreformen II'), the higher the share of common national legislation ('konkurrierende Gesetzgebung'), the more integrated the German federal system is.

➢ Common policy-making

Second, we assess the degree of common policy-making as high if legislative processes require high co-ordination between government levels. Conversely, a medium (low) assessment reflects one-sided dominance (unilateral control by central government) in legislative processes.

The high share of common national legislation and the increasing political and financial involvement of the central government in regional policy areas lead us to assess the degree of common policy-making as high.

Individual credit profile

We assess Berlin's individual credit profile as strong in both a national and international context. This reflects the Land's: i) conservative debt management, favourable debt profile, prudent liquidity management and excellent capital market access; ii) good budgetary performance, which has enabled a gradual build-up of reserves and debt reduction in recent years, along with average revenue and expenditure flexibility compared to other German Länder; iii) large and diversified economic base with good growth prospects; and iv) high quality of governance.

Our qualitative assessments are also informed by our Core Variable Scorecard (CVS), which highlights Berlin's: i) low interest-payment burden along with high direct debt levels; ii) track record of financing surpluses with a rising share of investment relative to total expenditure; iii) growth trend above the national average underpinned by favourable demographics; and iv) governance indicators that compare favourably in both a national and international context.

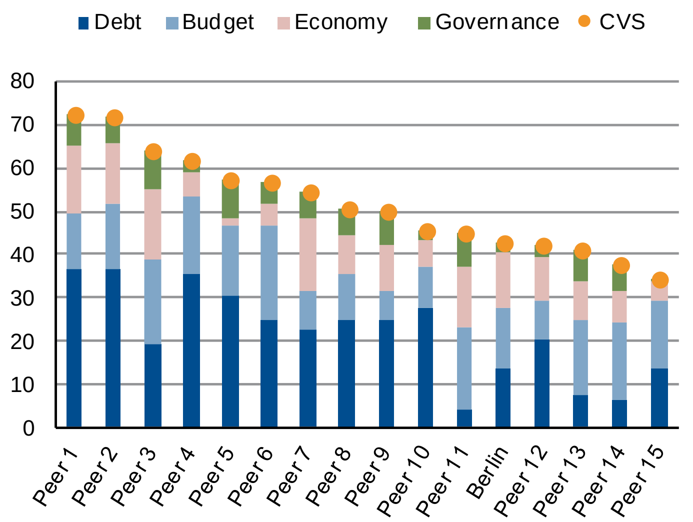
Our qualitative and quantitative assessments are summarised in **Figures 3 and 4.**

Figure 3: Qualitative Scorecard (QS) result

Individual credit profile - qualitative assessment (QS)					
Category	**Weight**	**Qualitative Scorecard**	**Risk** *Low*	*Medium*	*High*
Debt burden and liquidity profile	*40%*	Debt profile			
		Contingent liabilities			
		Funding and liquidity			
Budget performance and flexibility	*30%*	Budget management			
		Expenditure flexibility			
		Revenue flexibility			
Economy and social profile	*20%*	Growth & diversification			
		Labour & demographics			
Governance	*10%*	Recent events & policy risk			
		Transparency & accountability			

Source: Scope Ratings GmbH

Figure 4: Core Variable Scorecard (CVS) result



Source: Scope Ratings GmbH

Debt burden and liquidity profile

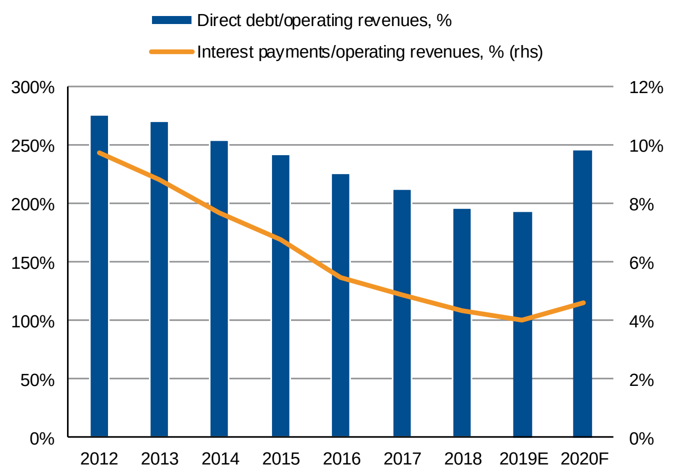
Relatively high but declining debt stock and debt service until end-2019

In 2019, Berlin reduced its direct debt for the eighth consecutive year to EUR 57.6bn or 199% of operating revenues, down from 289% in 2012 (see **Figure 5**). This is high in a national and international context, but risks related to the debt stock are mitigated by a favourable debt profile and excellent market access. Debt service was also on a declining trend as a result of interest savings, an increase in the average maturity of outstanding debt, gradual debt reduction and the long-term declining trend in interest rates. Although debt service remains high at EUR 5.7bn or 20% of operating revenues in 2019, it is significantly down from EUR 9.7bn or 45% of operating revenues in 2013.

The Covid-19 crisis reverses Berlin's debt reduction trend

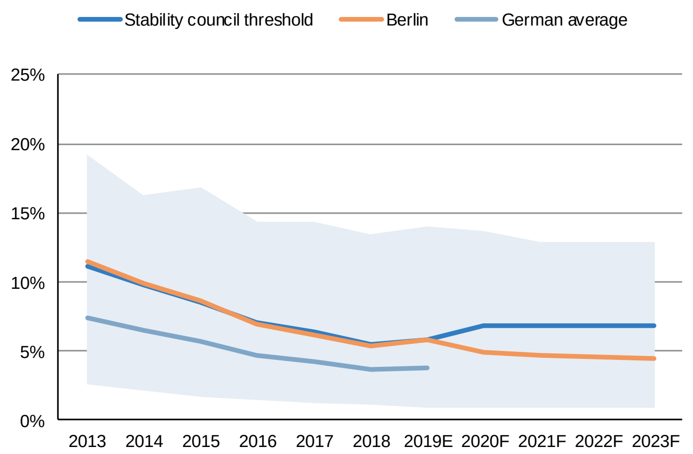
In response to the Covid-19 crisis and in line with the German sovereign and most other Länder, Berlin passed legislation to invoke the safeguard clause and temporarily suspend the debt brake and adopted budgetary measures that allow for EUR 6bn of new debt issuances this year[4]. Consequently, nominal direct debt will increase to around EUR 63.5bn in 2020, above its previous peak (EUR 62.9bn) in 2012. Relative to operating revenues, direct debt will increase to a projected 246% in 2020 (see **Figure 5**). While the Land intends to issue the full EUR 6bn this year, EUR 5.5bn thereof will be placed in a reserve earmarked for expected tax revenue shortfalls and additional support measures, mainly for fiscal years 2020 and 2021. Separate approvals must be obtained for uses of the reserve not defined under current budgetary laws. The new debt issuances will include an obligatory redemption plan with annual instalments of EUR 222m between 2023 and 2049, whose additional debt service costs will be manageable in view of the accommodative financing conditions.

Figure 5: Debt and interest burden



Source: Senatsverwaltung für Finanzen Berlin, Scope Ratings GmbH

Figure 6: Interest-to-adjusted-tax ratio, %



Source: German Stability Council, Scope Ratings GmbH

N.B. Shaded area represents the minimum-maximum range for national peers.

Low interest-payment burden

Berlin's interest expenses are in line with the safe-haven status of the Länder, with the average cost of outstanding debt at 1.68% in 2019, further down from 1.76% in 2018. This low cost of debt also continues to decrease, resulting in interest payments declining relative to operating revenues, to 4% in 2019 from 9.7% in 2012, thereby increasing Berlin's financial flexibility. While we expect Berlin's debt stock to increase above its previous peak, accommodative financing conditions will slow the increase in the interest-payment burden which we expect to remain below 4.5% of operating revenues. In the latest Stability Council report, which was passed before the effect of the pandemic on public finances materialized, the Land was expected to meet all four financial ratios by 2021 and comply with the debt brake. This is also supported by the increasing margin between the Land's interest-to-adjusted-tax ratio and the Stability Council threshold starting from 2021 (see **Figure 6**), which will serve as a buffer for the lower tax revenues and higher interest payments anticipated as a result of the pandemic.

Well-established capital market access and sound debt management

As for all German Länder, we assess Berlin's access to capital markets as excellent. This was evident during the last financial crisis when all Länder maintained their excellent access, demonstrating investor confidence in the German framework. In addition, Berlin employs a conservative debt-management strategy with no foreign currency risks and limited interest rate risks. At end-2019, the average maturity of outstanding debt was

[4] Gesetz über die Feststellung des Haushaltsplans von Berlin für die Haushaltsjahre 2020 und 2021 (Haushaltsgesetz 2020/2021 - HG 20/21) vom 17. Dezember 2019 (GVBl. S. 830), zuletzt geändert durch Gesetz vom 11.06.2020 (GVBl. S. 539).

broadly unchanged at 7.62 years from the previous year and refinancing needs for 2020 had decreased to EUR 5.3bn from EUR 11bn in 2009, close to the Land's strategic annual redemption target of EUR 5bn. Going forward, in view of the low interest rate environment, Berlin's debt management strategy foresees i) no new foreign currency exposure; ii) the majority of issuance at fixed interest rates; and iii) a limited and declining use of interest rate derivatives.

Prudent liquidity management

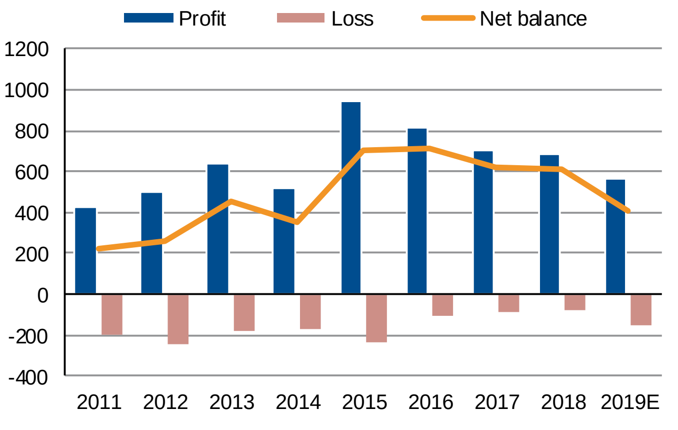
We view liquidity management as sound due to comprehensive inter-year cash planning and the availability of numerous sources of liquidity. The Land of Berlin also benefits from prudent financial planning and maintains a sizeable cash buffer throughout the year. The administration's liquidity strategy is to limit cash holdings by lending excess liquidity upon the receipt of large tax revenues. The Land's cash flows, especially inflows, are prone to seasonal variability driven by the tax calendar. 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. In combination with excellent market access, the risk of potential liquidity shortages is negligible.

Contractual guarantees exhibit low risks

As of 2019, outstanding guarantees issued by the Land of Berlin stood at EUR 3bn, down from EUR 4.3bn in 2018 and steadily declining from EUR 26.6bn in 2010. In our opinion, there is a limited risk that the obligations of entities and projects guaranteed by the Land of Berlin will crystallise on its balance sheet. In 2019, EUR 1.1bn of guarantees relating to real estate transactions conducted by Bankgesellschaft, a wind-down entity through which real estate assets were divested to repay outstanding liabilities, were fully redeemed.

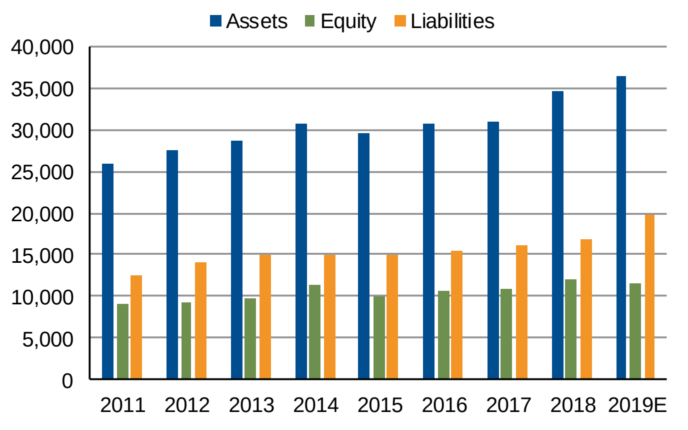
Guarantees are primarily related to three sectors: One-third of the outstanding guarantees (EUR 0.9bn in 2019 versus EUR 1.6bn in 2017) relate to subsidised housing transactions conducted by Investitionsbank Berlin and KfW. Guarantees for debt held by social housing associations are not relevant to the budget, in our opinion, because the associations generate stable rental income. We therefore expect guarantee risks to decline over time. Another third of the outstanding guarantees are mainly for Berlin public companies, especially Berlin Water Works, whose financial results have been consistently positive in recent years. The final third are guarantees for Berlin Brandenburg Airport amounting to EUR 963m in 2019 versus EUR 832m in 2018.

Figure 7: Profits and losses of Land of Berlin holdings, EUR m



Source: Senatsverwaltung für Finanzen Berlin, Scope Ratings GmbH

Figure 8: Assets, liabilities and equity 2011-19, EUR m



Source: Senatsverwaltung für Finanzen Berlin, Scope Ratings GmbH

Shareholdings play critical role in investment policy

Berlin's shareholdings play a critical role in the Land of Berlin's investment policy. The companies fulfil a significant public-sector mandate for the Land of Berlin by helping to boost the city's regional economy. A record of positive annual results overall support high and sustained investment volumes. With the exception of the Berlin Brandenburg Airport project and local transport provider BVG, all major units were profitable in 2019 (see **Figure 7**).

The Covid-19 crisis will adversely affect the profitability of several of the Land's holdings, especially in 2020. Among these are local transport provider BVG, Berlin Brandenburg Airport, exhibition centre Messe Berlin, and Berlin hospital operator Vivantes. EUR 25m in aid was granted to Messe Berlin, EUR 300m to transport companies, and EUR 111m to the airport project, based on conservative scenarios. The budgetary impact on the Land is therefore limited. In addition, while total liabilities at Berlin's holdings increased to EUR 19.9bn in 2019 from EUR 16.9bn in 2018, leverage remains low with a ratio of total liabilities to assets of 0.55, pointing to greater financial flexibility (see **Figure 8**). The high level of assets is in part due to the Land's holdings in real estate and housing sectors in which values have risen.

Budgetary performance and flexibility

Track record of good budgetary performance

Berlin's good budgetary performance has been underpinned by controlled expenditure growth since 2012, with high operating surpluses averaging 14.5% of operating revenues. The administration has shown a strict commitment to fiscal consolidation through effective mechanisms to control spending, with growth in operating expenditure slower than for operating revenues since 2012. Consistently high operating surpluses have enhanced Berlin's ability to not only fund operating expenses with operating revenue but also realise extra revenue to cover interest payments and some capital expenditure. As a result, after investment activities and interest payments, Berlin has posted surpluses since 2012 (averaging 2.6% of total revenues), supporting a gradual reduction of its direct debt.

High level of investment strengthens budgetary flexibility

Berlin benefits from a high share of investment relative to total expenditure (11% in 2019), enabling some capital expenditure to be postponed. Berlin's investment strategy is based on three pillars: i) the core budget including funds from the federal government's municipal investment promotion programme; ii) the SIWA fund; and iii) infrastructure investments by the Land's shareholdings, which improve budgetary flexibility. While the core budget and SIWA contribute EUR 3bn annually for investments, Berlin's major holdings have regularly undertaken EUR 2.5bn in infrastructure investments in recent years.

Budgetary reserves provide additional budgetary leeway

Conservative budgets and accommodative financing conditions have resulted in Berlin's interest-payment burden halving since 2012, strengthening budgetary flexibility. The Land has expanded its social infrastructure in recent years to respond to rapid population growth and a constrained local property market. Berlin also has around EUR 3bn of budgetary reserves (earmarked mostly for investments), accumulated via allocations of previous budgetary surpluses to the SIWA fund. The reserves can be used beyond an accrued fiscal year, providing additional budgetary leeway and partially mitigating shocks from economic downturns.

Financing surplus in 2019 for the eighth successive year

Along with the eight successive years of surpluses, Berlin also surpassed its own spending control targets in 2019 despite rising demand for social services due to population growth. As a result, Berlin reported an operating surplus of 14.2% of operating revenues in 2019 and a budgetary surplus (before debt movement) of 2.6% of total revenues (see **Figure 9**). Berlin has benefitted from higher-than-budgeted tax revenues, a lower interest payment burden and solid expenditure management. For example, interest payments are budgeted for on a conservative basis and social transfers to Berlin's districts regularly include an amount for contingencies. In addition, investments were lower than budgeted in 2019, reflecting capacity constraints in regional construction. Like in previous years, the budgetary surplus was used for net debt redemptions and various allocations to budgetary reserves.

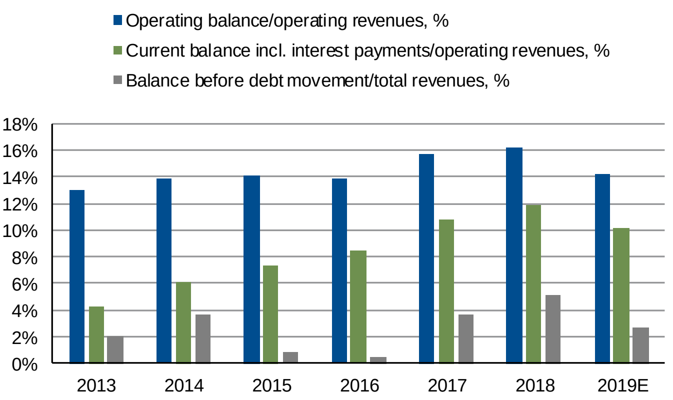
Rigid operating expenditure structure

In keeping with its responsibilities as a Land, Berlin's operating expenditure has a rigid structure, because minimum legislative requirements and the socially sensitive nature of several expenditure items make most items difficult to trim. Personnel costs represent the largest single expenditure item at 38% of operating expenditures in 2019, while transfers to districts represented 30% (see **Figure 10**). The remainder consists of material and various administrative costs.

Strong and diversified tax base, with stable transfers from the Bund

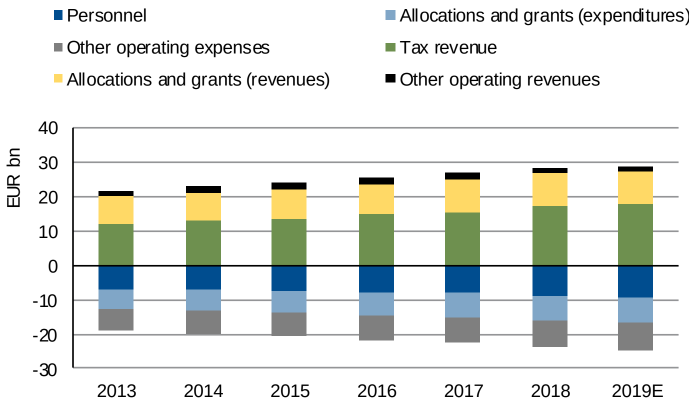
Like all German Länder, Berlin has limited flexibility to adjust its revenues. The German financial equalisation system weakens the link between a Land's tax revenues and its economic performance, which also dampens the effects of the Covid-19 shock. In line with constitutional arrangements between the Länder and the Bund, Berlin receives shared taxes, largely revenues from personal income taxes, VAT and corporate taxes (see **Figure 10**). These revenues are initially collected by Berlin's tax offices but are later redistributed at national level in accordance with revenue-sharing agreements and additional transfer mechanisms. Berlin has also made use of its city-state status to introduce municipal fees, which have supported budget consolidation. In addition, Berlin is a net recipient of the financial equalisation system (EUR 4.5bn received in 2019).

Figure 9: Budgetary performance



Source: Senatsverwaltung für Finanzen Berlin, Scope Ratings GmbH

Figure 10: Components of operating balance



Source Senatsverwaltung für Finanzen Berlin, Scope Ratings GmbH

Material shortfall in tax revenues anticipated for 2020 and 2021

For 2020/21, we expect a material shortfall in Berlin's tax revenues due to: i) substantial cyclical losses caused by the macroeconomic impact of pandemic lockdown measures in view of the Land's high share of businesses in the services sector; ii) temporary losses due to federal fiscal measures to support the national economic recovery such as VAT reductions; and iii) potential structural losses due to behavioural changes among individuals and businesses in response to the pandemic and global along with global travel restrictions, given Berlin's status as metropolitan city. Based on current tax revenue estimates, we expect revenue shortfalls of EUR 3.2bn (10% of budgeted revenue) in 2020 and EUR 1.8bn (6% of budgeted revenue) in 2021.

Additional spending related to the pandemic in 2020

For 2020, we estimate additional pandemic-related expenditure of around EUR 800m (2% of budgeted expenditure). Spending will relate to investment to increase healthcare capacity and procure medical equipment, fiscal support to compensate for revenue lost due to lockdowns including a EUR 25m capital injection for Messe Berlin, as well as transfers and loan guarantees to small and medium-sized businesses. We therefore expect Berlin's financial results to deteriorate from a surplus of around EUR 800m in 2019 to deficits of around EUR 4.1bn in 2020 and EUR 2.4bn in 2021.

Structural revenue shortfalls expected in 2022 and 2023

We also expect lasting structural consequences from the pandemic and the economic crisis in 2020. On the expenditure side, interest from the additional EUR 6bn in debt to be incurred in 2020 will be manageable given the Land's low costs of borrowing. On the revenue side, management expects structural annual revenue shortfalls of around 5% of planned revenue in 2022/23 and thus does not expect a reversion to pre-crisis levels. Consequently, Berlin's 2019-23 financial planning, which was already at conservative levels, will need to be re-balanced by prioritising investment and controlling costs.

Balanced accounts expected over the medium term

Over the medium term, we expect Berlin to report only small budgetary surpluses owing to rising operating expenses needed to address the growing population. Consequently, we expect Berlin to adhere to its long-term consolidation strategy, supported by the administration's commitment to fiscal consolidation, conservative budget management, low debt service costs, possibility to adjust budgets in view of the high investment level, and its economic and demographic outperformance vis-à-vis national peers.

Increasing pension burden

Going forward, pension expenditure will constitute an increasing budgetary burden. In 2019, pension payments amounted to 9% of total expenditure, which was below the national average of 10%, because after reunification, civil servants in the new Länder were not included in the pension scheme but in a pay-as-you-go system under the Pension Transition Act. To ease the pressure from pension obligations, Berlin provides mandatory payments to the pension contribution plan (required by German law), with a total size of around EUR 1.2bn in 2019, resulting in largely unfunded pension liabilities. However, the fund is not designed to cover future liabilities but instead serves as a buffer to ensure pensioners receive payments during an economic downturn when revenues are lower. According to an external actuary appointed by Berlin, pension obligations for the next 30 years amount to EUR 57bn in 2019 and will increase up to EUR 68bn within the next five years.

Economy and social profile

Strong growth trend driven by services sector

Berlin's economy continued to expand strongly in 2019, with real GDP growth exceeding the German average since 2014 (see **Figure 11**). In 2019, Berlin posted high real GDP growth for the fifth year in a row, at 3%, with the main driver being strong employment growth in the services sector, which accounts for 86% of gross value added (versus 70% nationally). As a result, GDP per capita rose above the national average for the first time since 2001, to 101.5% of the German average in 2019, or 121% of the euro area average, highlighting the Land's success in economic convergence with national peers.

Strong employment growth until end-2019

The unemployment rate declined further to 7.8% at end-2019 (2.8 percentage points above the national average), significantly down from 13.6% in 2010 (see **Figure 12**). In 2019, the number of employed increased by 48,500, or 2.4%, to 2.07m.

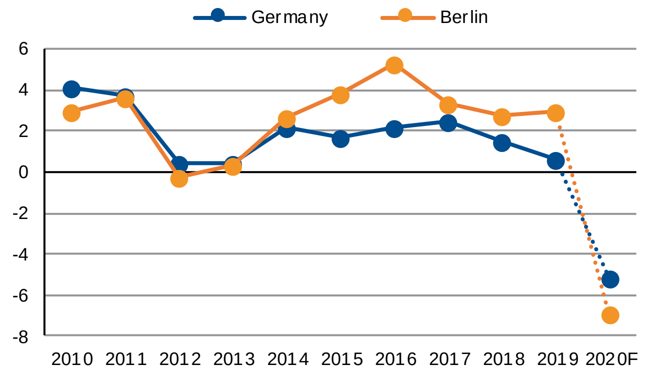
Covid-19 will lead to a stark economic recession in 2020, with a rebound in 2021

Due to structural factors, we expect the economic impact of Covid-19 to be greater for Berlin than for other Länder. Berlin's share of hard-hit sectors, like travel, trade and arts and recreation, make up about 22% of its gross value added, above the national average of 19%. Further, social distancing in a metropolitan city like Berlin, where the share of small businesses is high, could have lasting effects given the loss of urban consumers. Consequently, we project a decline in Berlin's real GDP by around 6-7% in 2020, versus the projected 5.2% decline for Germany (see **Figure 11**). However, we expect a strong rebound in 2021, absent a second wave of the pandemic, driven by Berlin's recent economic and demographic outperformance vis-à-vis other German Länder, which has strengthened economic resilience and by substantial support measures at the federal level – such as short-term work schemes ('Kurzarbeit'), loan guarantees and direct liquidity for the hardest-hit businesses.

The crisis led to a spike in unemployment, which should be partially reversed in 2020

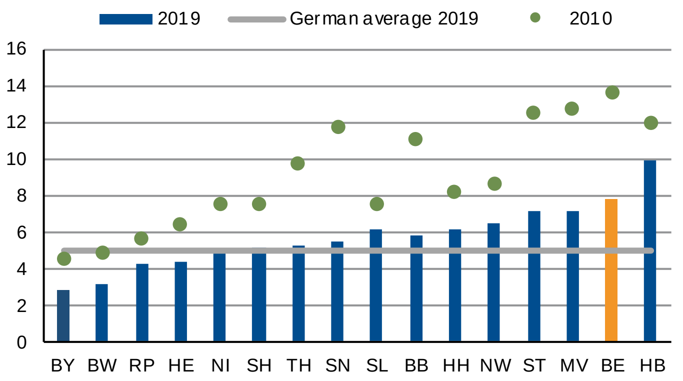
The Covid-19 crisis has also hit Berlin's labour market. The number of unemployed rose to around 200,000 in May versus around 150,000 from a year earlier (+31% vs 26% national average year-on-year increase). This has resulted in an unemployment rate of 10% in May 2020 versus 7.8% at end-2019. Job losses were mainly in sectors hit hard by the pandemic like restaurants and trade. We expect this trend to partially reverse as lockdown measures are lifted.

Figure 11: Real GDP growth, 2010-20F, %



Source: Federal Statistical Office, Scope Ratings GmbH

Figure 12: Unemployment rate, % total labour force



Source: Federal Statistical Office, Scope Ratings GmbH

Favourable demographics vis-à-vis other Länder

Berlin benefits from favourable social and demographic profiles. With around 3.65m inhabitants (based on the 2011 census), the German capital is also the country's largest city by far. Population growth has been strong, with 40,000-50,000 inhabitants added each year during 2011-19, mainly due to net immigration from other European countries, reflecting Berlin's attractiveness compared to other European capitals.

Quality of governance

Stable political environment

We view the government and administration of the Land of Berlin as stable. The last regional elections, held in September 2016, resulted in a three-party coalition (the centre-left Social Democratic Party, 38 seats; the Left Party, 27 seats; and the Greens, 27 seats) gaining 92 of the 160 seats in the regional parliament and replacing the two-party coalition of the Social Democratic Party and Christian Democratic Union. Opposition parties are the Christian Democratic Union, the Alternative for Germany and the Free Democratic Party. The next elections are scheduled for 2021.

Strong commitment of the administration to fiscal consolidation

Since 2016, Berlin's fiscal policy has been effective at balancing investment and consolidation needs. Berlin's stable political environment also underpins our expectation that its administration will focus on long-term-oriented policies in response to the Covid-19 crisis. These will need to strike a balance between fiscal stimulus during the crisis and fiscal prudence thereafter.

The administration acted promptly to the Covid-19 shock, making the necessary adjustments to the budget for 2020/21 and ensuring access to liquidity for the regional real economy via direct fiscal support or liquidity funds for the hardest-hit businesses. To support small and medium-sized businesses, the Land set up emergency measures ('Corona Soforthilfe') including extraordinary grants. Other measures include the pre-emptive establishment of a coronavirus treatment centre to increase healthcare capacity as well as the procurement of mobile devices to improve online teaching. At the same time, spending controls were reinforced.

Unique administrative organisation

The Land of Berlin is divided into 12 local districts ('Bezirke'), whose populations range from around 240,000 (Spandau) to 400,000 (Pankow). All districts have their own identification with elected local mayors and councils and their revenues rely mostly on financial allocations ('Globalsumme') from the Land of Berlin. The administrative organisation between the senate and the districts is unique in Germany: the districts fulfill certain functions, administrative tasks are not clearly separated between government levels, and financial transfers differ across years and districts.

Additional considerations

International comparison

Berlin's individual credit profile compares favourably in an international context. This is supported by i) its excellent capital market access; ii) strong budgetary performance, including a high investment level; iii) wealthy and large economic base; and iv) strong governance indicators.

Long-term environmental and social risks

Alongside our assessment of rating-relevant credit risks, we consider long-term environmental and social developments. We assess developments regarding the German Länder by using selected sustainability indicators as defined by the German Sustainability Strategy[5], which itself is based on the Sustainable Development Goals set by the United Nations for 2030.

Good performance on environmental benchmarks

With regards to environmental indicators, Berlin presents a positive profile relative to national peers. The Land was below average in 2015 regarding its share of renewable energy sources: 2.5% against the national average of 32%. However, Berlin was above average regarding reductions in both energy use and greenhouse gas emissions.

Outperformance on social indicators

With regards to social indicators, Berlin is above average in educational attainment, gender pay equality and childcare options. It is only below average for early school-leavers, which the Land is actively tackling via its 'Schulbauoffensive', one major investment programme of the current legislative period with up to EUR 5.5bn allocated to renovate existing schools and build new capacity to improve the quality of schooling. Moreover, the Land provided tablet computers to assist with digital learning during the Covid-19 pandemic.

Methodology

The methodology applicable for this rating and/or rating outlook, Sub-Sovereign Credit Rating, published on 18 May 2020, is available on www.scoperatings.com.

Historical default rates of the entities rated by Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerepweb/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope's public credit rating methodologies on www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

[5] https://www.destatis.de/DE/Themen/Gesellschaft-Umwelt/Nachhaltigkeitsindikatoren/Publikationen/Downloads-Nachhaltigkeit/machbarkeitsstudie-indikatoren-nachhaltigkeit-5911101159005.html

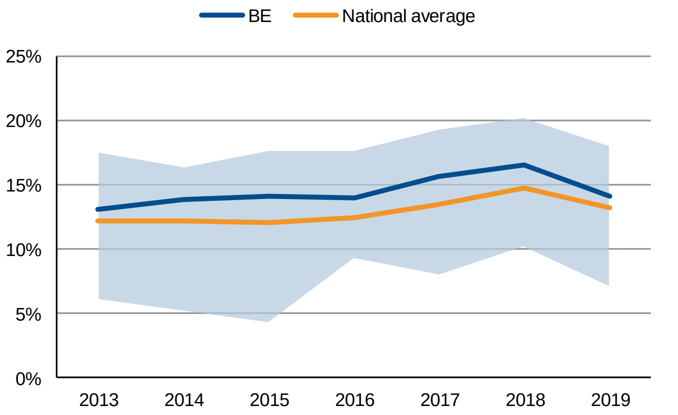
I. Appendix: CVS/QS results and mapping table

Category	Weight	QS	Risk	Score	CVS	Score	Weight	Total (QS-CVS avg)
Debt burden and liquidity profile	*40%*	Debt profile	Low	100	Interest, % op.rev.	94	*50%*	82
		Contingent liabilities	Medium	50	Debt, % op.rev	34	*25%*	
		Funding and liquidity mgmnt	Low	100	Balance before debt, % op.rev.	100	*25%*	
		Debt QS score	Σ	**83**	***Debt CVS score***	Σ	**80**	
Budget performance and flexibility	*30%*				Operating balance, % op.rev.	69	*40%*	57
		Budget management	Low	100	SD operating balance	51	*15%*	
		Expenditure flexibility	Medium	50	Personnel exp., % op.exp.	47	*15%*	
		Revenue flexibility	Medium	50	Capex, % tot exp.	26	*15%*	
					Transfers, % op.rev.	6	*15%*	
		Budget QS score	Σ	**67**	***Budget CVS score***	Σ	**47**	
Economy and social profile	*20%*				GDP per capita	65	*40%*	69
		Growth & diversification	Low	100	Unemployment rate	1	*20%*	
		Labour market & demographics	Medium	50	GDP volatility	100	*20%*	
					Old-age dependency ratio	89	*20%*	
		Economy QS score	Σ	**75**	***Economy CVS score***	Σ	**64**	
Quality of governance	*10%*	Recent events & policy risk	Low	100	Quality	1	*33%*	60
		Transparency & accountability	Low	100	Impartiality	16	*33%*	
					Corruption	42	*33%*	
		Governance QS score	Σ	**100**	***Governance CVS score***	Σ	**20**	
Individual credit profile							Σ	***70***

Indicative sub-sovereign rating					**Individual credit profile**						
					Strong		Medium			Weak	
					≥ 75	**≥ 65**	≥ 55	≥ 45	≥ 35	≥ 25	< 25
					Indicative maximum notch adjustment from sovereign rating:						
Institutional framework: Integration with sovereign	Full	0	-	1	0	0	0	-1	-1	-1	-1
		0	-	2	-1	-1	-1	-1	-1	-2	-2
		0	-	3	-1	-1	-1	-2	-2	-2	-3
	Medium	0	-	4	-1	-1	-2	-2	-3	-3	-4
		0	-	5	-1	-2	-2	-3	-3	-4	-5
		0	-	6	-2	-2	-3	-3	-4	-5	-6
		0	-	7	-2	-2	-3	-4	-5	-5	-7
	Low	0	-	8	-2	-3	-4	-4	-5	-6	-8
		0	-	9	-2	-3	-4	-5	-6	-7	-9
		0	-	10	-3	-4	-5	-6	-7	-8	-10

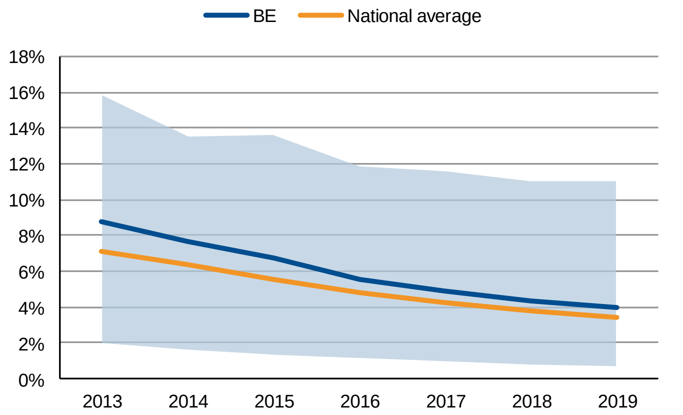
II. Appendix: Peer comparison

Figure 13: Operating balance/operating revenue, %



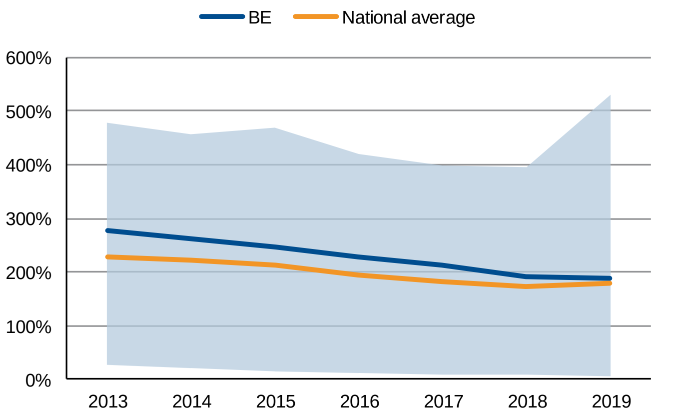
Source: Federal Ministry of Finance, Scope Ratings GmbH

Figure 14: Interest payments/operating revenue, %



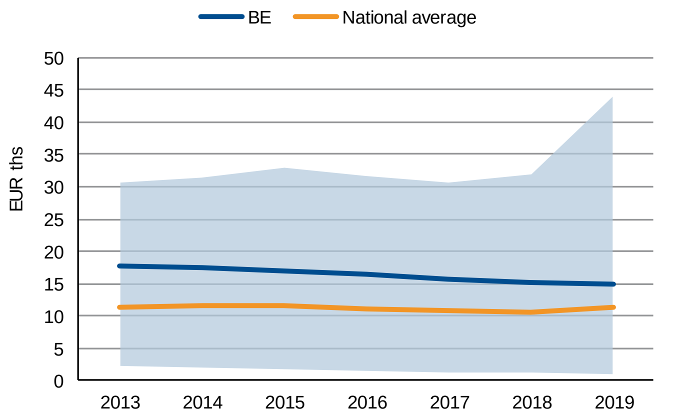
Source: Federal Ministry of Finance, Scope Ratings GmbH

Figure 15: Total debt/overall revenue, %



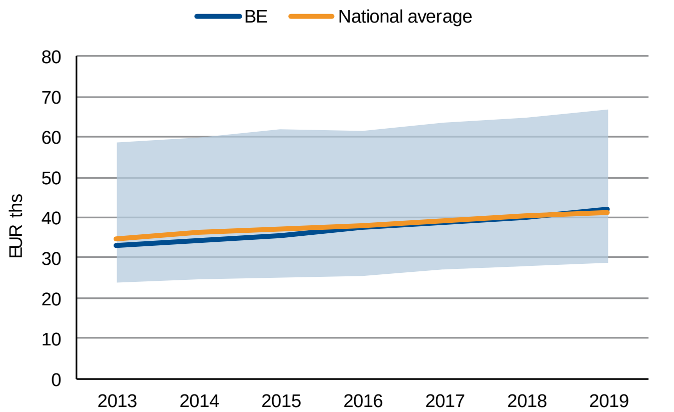
Source: Federal Ministry of Finance, Federal Statistical Office, Scope Ratings GmbH

Figure 16: Debt per inhabitant (EUR)



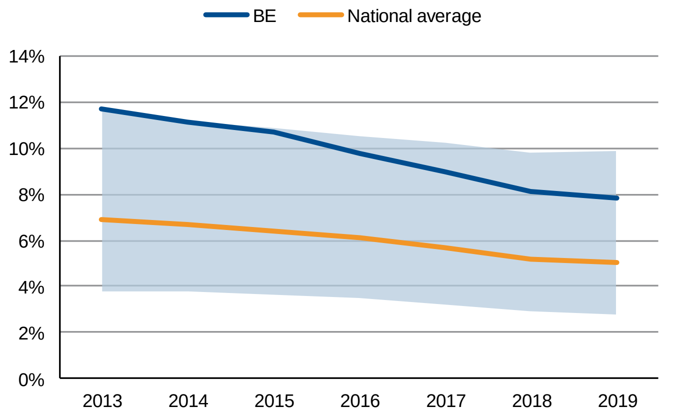
Source: Federal Statistical Office, Scope Ratings GmbH

Figure 17: GDP per capita (euros)



Source: Federal Statistical Office, Scope Ratings GmbH

Figure 18: Unemployment (% of labour force)



Source: Federal Statistical Office, Scope Ratings GmbH

III. Appendix: Statistical table

	2012	2013	2014	2015	2016	2017	2018	2019E
Financial performance	In EUR m (unless noted otherwise)							
Operating revenue	21,530	21,795	22,909	23,791	25,362	26,724	28,482	28,925
Operating revenue growth, %	*9.0%*	*1.2%*	*5.1%*	*3.8%*	*6.6%*	*5.4%*	*6.6%*	*1.6%*
Tax revenue	11,616	11,921	13,127	13,626	14,767	15,399	17,027	17,534
Allocations and grants	8,400	8,355	8,182	8,496	8,593	9,600	9,756	9,616
Other operating revenue	1,514	1,520	1,601	1,669	2,002	1,725	1,699	1,775
Operating expenditure	18,358	18,952	19,747	20,445	21,833	22,536	23,865	24,824
Operating expenditure growth, %	*1.6%*	*3.2%*	*4.2%*	*3.5%*	*6.8%*	*3.2%*	*5.9%*	*4.5%*
Personnel	6,759	6,938	7,207	7,487	7,807	8,221	8,854	9,310
Allocations and grants	5,879	6,088	6,290	6,452	6,755	6,923	7,215	7,370
Other operating expenditure	5,719	5,926	6,251	6,506	7,271	7,392	7,795	8,144
Operating balance	3,172	2,843	3,162	3.346	3,528	4,188	4,617	4,101
Net interest payments	2,097	1,921	1,759	1,607	1,385	1,306	1,229	1,148
Current balance	1,075	922	1,403	1,739	2,143	2,882	3,388	2,953
Capital balance	-425	-469	-549	-1,553	-2,026	-1,882	-1,879	-2,175
Balance before debt movement	650	453	854	187	118	1,000	1,509	778
New borrowing (credit market)	7,820	7,384	8,064	7,136	7,039	5,425	4,511	2,967
Debt redemption (credit market)	8,015	7,836	8,405	8,324	7,228	7,381	7,262	4,539
Financial ratios								
Balance before debt movement/total revenue, %	2.9%	2.0%	3.6%	0.8%	0.4%	3.6%	5.1%	2.6%
Operating balance/operating revenue, %	14.7%	13.0%	13.8%	14.1%	13.9%	15.7%	16.2%	14.2%
Interest payments/operating revenue, %	9.7%	8.8%	7.7%	6.8%	5.5%	4.9%	4.3%	4.0%
Current balance/operating revenue, %	5.0%	4.2%	6.1%	7.3%	8.5%	10.8%	11.9%	10.2%
Capital expenditure/total expenditure, %	6.6%	6.3%	6.4%	10.0%	11.2%	10.7%	9.8%	10.9%
Debt								
Direct debt	62,256	61,607	60,804	59,906	59,436	58,994	57,600	57,555
Guarantees	8,776	8,890	7,510	6,901	5,928	5,152	4,255	3,016
Overall debt risk (direct debt plus guarantees)	71,032	70,497	68,314	66,807	65,364	64,146	61,855	60,571
Debt ratios								
Direct debt/operating revenue, %	289.2%	282.7%	265.4%	251.8%	234.4%	220.8%	202.2%	199.0%
Overall debt risk (incl. guarantees)/operating revenue, %	329.9%	323.5%	298.2%	280.8%	257.7%	240.0%	217.2%	209.4%
Interest payments/direct debt, %	3.4%	3.1%	2.9%	2.7%	2.3%	2.2%	2.1%	2.0%
Debt per inhabitant (euros)	18,213	17,799	17,347	16,831	16,486	15,744	15, 008	14,773
Economic performance								
GDP at market prices	109,910	112,603	117,927	125,249	133,603	139,683	147,057	153,291
GDP per capita (euros)	32,803	33,133	34,223	35,837	37,662	38,864	40,568	41,967
% of Germany's GDP per capita	*95.6%*	*94.5%*	*94.3%*	*96.0%*	*98.2%*	*98.0%*	*99.3%*	*101.5%*
% of euro area average GDP per capita	*112. 0%*	*112.3%*	*113.7%*	*115.2%*	*118.4%*	*118.1%*	*119.7%*	*120.7%*
Population (thousands)	3,351	3,399	3,446	3,495	3,547	3,594	3,625	3,657
Real GDP growth, %			2.3%	3.3%	5.3%	3.3%	2.8%	3.0%
Unemployment rate, % of labour force	12.3%	11.7%	11.1%	10.7%	9.8%	9.0%	8.1%	7.8%

Source: Senatsverwaltung für Finanzen Land Berlin, Ministry of Finance, Federal Statistical Office, Scope Ratings GmbH

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