FITCH AFFIRMS 11 GERMAN LAENDER AT 'AAA'; OUTLOOK STABLE

Fitch Ratings-Frankfurt/London-02 November 2018: Fitch Ratings has affirmed the Long-Term Foreign- and Local-Currency Issuer Default Ratings at 'AAA' with Stable Outlooks of 11 German federated states (Laender): Berlin, Bremen, Hamburg, Lower Saxony, Mecklenburg Western-Pomerania, North Rhine-Westphalia, Rhineland-Palatinate, Saarland, Saxony-Anhalt, Schleswig-Holstein and Thuringia. Fitch has also affirmed the Short-Term Foreign- and Local-Currency IDRs at 'F1+' and senior unsecured debt ratings at 'AAA' and short-term senior unsecured ratings at 'F1+'.

Fitch also affirmed the Foreign- and Local-Currency IDRs of HSH Finanzfonds AoeR and HSH Portfoliomanagement AoeR at 'AAA' with Stable Outlooks, Short-Term Foreign- and Local-Currency IDRs at 'F1+' and senior unsecured debt ratings at 'AAA' and the short-term senior unsecured ratings at 'F1+' based on the unconditional and irrevocable guarantee issued by the two Laender (Hamburg and Schleswig-Holstein) owning the AoeRs.

The rated outstanding bonds of the Bund-Laender-Anleihe 1 and the German Laender's rated joint bond issues (Laender 32 and 40-55) have also been affirmed at 'AAA'.

The affirmations and Stable Outlooks reflect the unchanged assumptions of Fitch's rating approach for the German Laender, under which the ratings are equalised with those of the Federal Republic of Germany (Bund; AAA/Stable/F1+).

KEY RATING DRIVERS
The ratings are driven by the strong institutional framework under which the German Laender operate and issue debt.

The Laender's ratings reflect the stability of the solidarity system that underpins the creditworthiness of all Laender. The solidarity system is enshrined in the German constitution and reflects the institutional framework of the Laender. According to the German constitution, all member states 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 Laender and the Bund. This principle has been reaffirmed by the constitutional courts on more than one occasion in the past, most recently in 2006.

Extensive equalisation systems and a broad-based solidarity pact compensate for financial disparity. This equalisation framework requires financially stronger Laender to transfer part of their above-average tax proceeds to the financially weaker ones. The framework partly offsets the differences among Laender's tax revenue base and their financial strength.

Fitch also recognises the reforms of the approved Federalism Reform II, which require the Laender to achieve balanced budgets without taking on new debt from 2020. Fitch considers that these reforms will improve the budgetary discipline of the Laender as constitutionally they will not be allowed to increase debt from this date. In Fitch's view, this change should make extreme budgetary hardship less likely, following the Laender's implementation of appropriate cost-cutting measures to consolidate their budgets to comply with the debt brake.

Moreover, the well-established and active liquidity management system that is in place, together with the Laender's solid access to capital markets and corresponding strong refinancing capacity as well as appropriate treasury facilities should prevent any temporary delays in the provision of

support. The liquidity risk of a single Land is avoided through bilateral and mutual agreements linking all Laender as well as the Bund, and ensuring their ability to assist one another. Liquidity would only fail to be forthcoming for any given Land in the event of a complete federal breakdown, in which neither the other Laender nor the Bund itself could provide liquidity.

According to 1H18 figures, the German Laender aggregate capital market debt decreased by 1.2% to about EUR515.1 billion compared with 1H17, which remained large in proportion to their revenues (145% of current revenue at end-2017). Debt servicing costs vary by issuer, but lengthy maturity structures and low interest rates (predominantly fixed interest rates debt) currently support the Laender's efforts of cost consolidation.

Fitch views the large stock of publicly issued debt (equivalent to around half of Germany's central government capital market debt amounting to about EUR1.04 trillion in 2017) as a distinctive feature of the Laender, which should reinforce their efforts to comply with the debt brake.

The Laender also face large contingent liabilities. This is the debt they guarantee on behalf of their development banks and former Landesbanks, as well as their largely unfunded pension liabilities. The risk stemming from their commitments provided to banks is mitigated by adequate assets and the conservative business profiles of their development banks and the overall amount of contingent liabilities stemming from the deficiency guarantees provided to the former Landesbanks is largely declining.

According to the most recent tax estimate of October 2018 provided by the working group "tax estimates" (Arbeitskreis Steuerschaetzungen), the Laender's tax revenues are expected to increase by 4.4% in 2018 and 2.7% in 2019, underpinned by Fitch's current forecast that Germany's GDP will grow by 1.8% and 1.9%, respectively.

Compared with the last tax estimate of May 2018, Laender taxes are estimated to be EUR1.3 billion higher in 2018 and could amount to EUR311.6 billion. Taxes of the Bund are expected to be EUR2.5 billion higher and taxes of the municipalities EUR1.1 billion. This should help support the Laender's efforts to consolidate their budgets, in addition to measures aimed at limiting expenditure growth and also partly compensating for additional costs following the significant number of immigrants (support for the municipalities).

Cost consolidation efforts realised so far allowed 14 Laender to report a surplus before debt variation at end-2017. Moreover, the accumulated net funding surplus improved to EUR15.6 billion in 1H18 from EUR5.2 billion in 1H17. Given the current tax estimate and the progress of Germany's economy, Fitch expects the Laender's cumulated surplus to further improve by end-2018. Based on Fitch's rating approach for the German Laender, the improving fiscal performance of Laender is not in itself a direct driver of their ratings, but only through its contribution to the general government finances, which is a rating factor for the sovereign, which we last affirmed on 3 August 2018 (www.fitchratings.com/site/pr/10040470).

HSH Finanzfonds AoeR and HSH Portfoliomanagement AoeR benefit from a deficiency guarantee (Gewaehrtraegerhaftung) and a maintenance obligation (Anstaltslast) from the states of Hamburg and Schleswig-Holstein. Moreover, both states provided an unconditional, irrevocable and unsubordinated guarantee to secure any debt issued by both entities. This means that the guaranteed debt of the two issuers ranks equally with all guarantors' other unsubordinated and unsecured liabilities. Both guarantors are equally and severally, but not jointly, liable.

RATING SENSITIVITIES

A downgrade of the sovereign ratings would lead to a downgrade of the Laender and their debt ratings and consequently the ratings of HSH Finanzfonds AoeR and HSH Portfoliomanagement AoeR. An adverse change to any of the important institutional features - solidarity principle,

equalisation system, liquidity exchange mechanism - which is currently unlikely in Fitch's view, could also lead to a downgrade of the Laender's ratings. Any change to the legal status of the two AoeRs or the existing guarantee scheme will result in a review of their ratings.

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Applicable Criteria
International Local and Regional Governments Rating Criteria - Outside the United States (pub. 18 Apr 2016)
https://www.fitchratings.com/site/re/878660

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