FitchRatings

Fitch Rates Flemish Community 'AA'; Outlook Stable

Link to Fitch Ratings' Report(s):

Rating Action Report - The Flemish Community

Fitch Ratings - Paris - 06 March 2020:

Fitch Ratings has assigned the Flemish Community a Long-Term Foreign Currency Issuer Default Rating (IDR) of 'AA' with a Stable Outlook and a Short-Term Foreign Currency IDR of 'F1+'.

Fitch assesses the Flemish Community's stand-alone credit profile (SCP) at 'aa+', reflecting the combination of a 'Stronger' risk profile and debt sustainability assessed in the upper end of the 'a' category under Fitch's rating-case scenario. The IDR of 'AA' is one notch above the rating of Belgium (AA-/Stable) and reflects Fitch's view that the Flemish Community would have the ability in some scenarios to continue servicing its debt, despite a default of the sovereign.

The Stable Outlook reflects that of Belgium, and also Fitch's expectation that the Flemish Community's debt metrics will remain in line with our 'AA' rating-case scenario.

Key Rating Drivers

Risk Profile: 'Stronger'

The 'Stronger' risk profile reflects our 'Stronger' assessment of most of Flemish Community's six key risk factors.

Revenue Robustness: 'Stronger'

The Flemish Community's operating revenue is mostly made up of predictable and growing tax resources. In 2019, 58% of estimated operating revenue was taxes collected at the national level and transferred by the federal government, with a low counterparty risk due to Belgium's high sovereign rating. The calculation of these revenues is based on various demographic and economic indicators, especially regional population growth and national GDP growth. As a result, the revenues received may decrease if national GDP declines, as was the case in 2009, but they also increase in line with population and economic growth, which allows the Flemish Community to cover growing spending needs.

The Flemish Community's own fiscal instruments accounted for 33% of estimated operating revenue in 2019. This included the surcharge tax of the personal income tax (PIT) and a large scope of regional taxes. Some tax items, especially the PIT, are linked to the economic cycle and may decrease in economic downturns. However, the risk of volatility remains limited, in Fitch's view, due to the soundness of the Flemish Community's economy.

Revenue Adjustability: 'Stronger'

Fiscal flexibility remains legally high. In Fitch's view, additional revenue stemming from an increase in tax rates to their legal ceiling would cover more than 200% of a reasonable decline in revenue in an economic downturn, estimated at around 2% by Fitch.

As with other Belgian regions, the Flemish Community determines the tax rate and tax base on 12 specific taxes, including the property tax, the inheritance tax, transfer duties, the car registration tax and the betting and gaming tax. These tax items together accounted for 15% of the Flemish Community's operating revenue in 2019. We estimate that an increase of these tax rates could represent an increase of more than 4% of operating revenue. In addition, since the sixth State Reform, regions have the power to determine the rate for about one-quarter of the PIT, through a surcharge system, which significantly increases their tax autonomy. In 2019, the regional share of PIT represented 18% of the Flemish Community's operating revenue. Increase of PIT could raise operating revenue by a few additional percentage points.

In Fitch's view an increase in tax rates would be politically sensitive, given the level of taxation is already high in Belgium. However, we still view the affordability of additional taxation as strong by international comparison, reflecting a sound local economy and wealth indicators that are above the national and European average.

Expenditure Sustainability: 'Stronger'

The Flemish Community exercises tight control over expenditure and has a record of budgetary discipline as it has been able to restore budget balance following periods of economic downturn. Belgium is currently subject to the EU's fiscal pact and a cooperation agreement was signed to introduce annual budgetary targets across different levels of government, including Flanders. Accordingly, we expect it will be able to maintain tight control over operating spending in the coming years.

The Flemish Community's responsibilities are mostly non-cyclical, especially education, health, or transportation, and Fitch sees a low risk of rising expenditure during economic downturns. An increase in the poverty rate would likely increase spending on certain social subsidies; however, this would not have an immediate impact on finances and the overall impact on expenditure growth would remain limited, in our view.

Capital expenditure has significantly increased in recent years and we expect it to be maintained at similar levels in the coming years. This reflects a shift in debt management, with the Flemish Community now directly financing public entities such as social housing, schools and care facilities, rather than guaranteeing their debt. This is to reduce its level of contingent liabilities, especially guaranteed debt, and achieve better cost efficiency at the region's consolidated level.

Expenditure Adjustability: 'Midrange'

Fitch considers the Flemish Community's share of mandatory or committed expenditure as moderate, which we estimate at 70%-90%.

The Flemish Community has a large share of subsidies over which it has discretionary power. Unlike local and regional governments (LRGs) in decentralised countries, it has extensive abilities to modify spending and it does not face the same high level of committed spending items. Some spending items are fairly rigid, such as staff costs or social subsidies but represent a modest share of total spending.

By contrast, the share of capital expenditure in total spending remains modest, at an estimated 7% in 2019. It is likely to increase in the coming years due to the Flemish Community's large investment programme, with a significant part being committed to one infrastructure project (Antwerp Ring Road), which will partially erode expenditure flexibility. The project is currently expected to cost the Flemish Community EUR3.6 billion overall, including EUR2 billion until 2024, which is included in our projections.

Fitch deems the existing level of services and investments as high in the Flemish Community, and hence the scope for expenditure reduction as large in an international context.

Liabilities and Liquidity Robustness: 'Stronger'

The Flemish Community operates under a robust national and individual debt management framework. At end-2019, direct debt totalled EUR6.7 billion and was 98% fixed-rate. It does not include any structured products and is not subject to currency risk. Its debt amortisation schedule shows large peak repayments (2025, 2026, 2036 and 2042) as debt is mostly recently issued bonds. However, the risk of large bullet repayments is mitigated, in Fitch's view, by the modest amount of these maturities in absolute terms and as a proportion of the Flemish Community's cash flows. The Flemish administration's plan is to smooth out debt repayment in the coming years.

Off-balance sheet liabilities (Fitch-adjusted) are large and totalled EUR13.3 billion at end-2019, but Fitch assessed their risk as low. They are mainly guarantees to a self-supporting social housing sector (EUR9.1 billion), to local authorities, and the debt of public-entities owned by the Flemish Community.

Liabilities and Liquidity Flexibility: 'Stronger'

The Flemish Community has strong access to liquidity under various forms. Its liquidity is substantially backed by its bonds' eligibility to the ECB's PSPP programme. It has also contracted a EUR3.75 billion of committed bank line with ING Belgium (A+/Stable) for four years, with scope for extension up to another four years. It has also access to institutional lenders, such as the European Bank of Investment (EIB; AAA/Stable) to finance part of its capital expenditure programme.

Debt sustainability: 'a' category

This assessment reflects a debt payback ratio (net adjusted debt / operating balance) that the Fitch rating-case scenario estimates at slightly below 9x in the medium term, at the lower end of the 'aa' category (2019: 4.2x estimated), and a debt coverage ratio (operating balance / debt service; Fitch's synthetic calculation) estimated at around 1.4x in the medium term, equivalent to the 'bbb' category. Its fiscal debt burden (net adjusted debt / operating revenue) would remain low, at around 40%, or compatible with a 'aaa' category, but has a lower weight in our final assessment. Overall, the combination of debt metrics leads us to our 'a' debt sustainability assessment.

The Flemish Community's net adjusted debt grew to an estimated EUR11.2 billion in 2019, from EUR8.6 billion at end-2015. This mainly reflects a switch in debt management in recent years, with the Flemish Community now directly financing some social housing and public-sector entities rather than guaranteeing their debt. In our rating-case scenario, which factors in an economic downturn, we expect net adjusted debt to further increase to close to EUR20 billion at end-2024. This reflects the impact of the shift in debt management, the high level of capex expected, and our prudent assumptions on revenue growth.

The Flemish Community's operating balance is estimated at close to EUR2.7 billion in 2019 and we expect it to remain above EUR2.3 billion in the coming years in our rating-case scenario. It will mainly depend on GDP growth, which has a direct impact on the Flemish Community's revenues, and on the LRG's ability to maintain tight control over operating spending.

The Flemish Community is classified by Fitch as a 'type B' LRG. It shares key attributes of sovereignty and has the ability to incur structural deficits. Belgian federated entities also represent a material and growing share of Belgium's general government expenditure. However, their share in the general government debt remains low, at 13% at end-2018. This is because most of the LRGs' counter-cyclical expenditure, such as unemployment benefits, is carried out by the Federal government and also due to the absence of large fiscal imbalances, in turn leading to moderate levels of regional debt.

The Belgian federal state consists of two types of federated entities: three communities (Flemish, French and German-speaking) and regions (Flemish, Walloon, and Brussels-Capital). On the Flemish side, the Community and the region are combined into one Flemish federated entity, with one Flemish Parliament and one Flemish Government. As a result, it covers a large scope of responsibilities, including economy, employment, transportation, education, health care, or housing.

Derivation Summary

The Flemish Community's SCP is assessed at 'aa+' reflecting the combination of a 'Stronger' risk profile and debt sustainability metrics assessed in the upper end of the 'a' category under Fitch's rating case scenario. The SCP also reflects peer comparison.

The Flemish Community's SCP of 'aa+' is two notches above the Belgian sovereign rating. In Fitch's view the Flemish Community meets the conditions for it to be rated above the sovereign, including institutional recognition and financial and fiscal autonomy. A change in the responsibilities would not be possible without a constitutional change, which requires a two-third majority in each House (House of Representatives and Senate), and hence the approval of a majority of Flemish members. As a result, the central government does not have the power to unilaterally change the powers exercised by the Flemish Community, which protects the latter against any legal interference.

The revenues transferred by the national government to the Flemish Community are also protected by the Special Finance Act. An amendment of this Act requires a two-thirds majority in the Federal Parliament, as well as a majority in each language group. Accordingly, it may not be amended without the consent of the Flemish members of federal parliament. As a result, Fitch estimates that the federal government is prevented from making unilateral decisions that might alter the Flemish Community's finances and this offers the latter high visibility over time. The Flemish Community also benefits from significant fiscal autonomy as regional taxes and the regional share of PIT represented more than 30% of its operating revenue in 2019. Regional taxes are directly collected by the Flemish administration and we expect them to represent around EUR7 billion-EUR7.5 billion a year in our rating-case scenario.

In a stressed situation affecting the sovereign, Fitch believes that the Flemish Community would be able in some scenarios to continue servicing its debt despite a default from the sovereign, which is reflected in the one-notch differential between their ratings.

Fitch believes that a sharp deterioration of sovereign finances would likely have an impact on the Flemish Community, and that a default from the sovereign would have a significant impact on the Flemish Community, including a sharp increase of its cost of borrowing, although not necessarily leading to an immediate default by the Flemish Community itself. Fitch also considers that Flanders has a strong incentive to support the federal government due to the importance of the services provided by the latter to the population, including unemployment benefits. As a result, we consider that the Flemish Community may not be rated at more than one notch above the sovereign, and that a downgrade of the sovereign would be reflected in the ratings of the Flemish Community.

Key Assumptions

Qualitative Assumptions and assessments and their respective weight in the rating decision:

Risk Profile: Stronger

Revenue Robustness: Stronger

Revenue Adjustability: Stronger

Expenditure Sustainability: Stronger

Expenditure Adjustability: Midrange

Liabilities and Liquidity Robustness: Stronger

Liabilities and Liquidity Flexibility: Stronger

Debt sustainability: 'a' category

Support: N/A

Asymmetric Risk: N/A

Sovereign Cap Or Floor: None (one notch above the sovereign)

Quantitative assumptions - issuer-specific

Fitch's rating case scenario is a "through-the-cycle" scenario, which incorporates a combination of revenue, cost and financial risk stresses. It is based on the 2015-2019 figures and 2020-2024 projected ratios. The key assumptions for the scenario include:

- 2% increase in operating revenue on average in 2020-2024;

- 2.2% increase in operating spending on average in 2020-2024;

- Net capital balance of minus EUR3.8 billion on average in 2020-2024;

- 1.6% cost of debt and 15-year maturity for new debt

Quantitative assumptions - sovereign-related (no weights are included as none of these assumptions was material to the rating action)

Figures as per Fitch's sovereign actual for 2018 and forecast for 2020, respectively:

- GDP per capita (US dollar, market exchange rate): 47,195 and 46,060

- Real GDP growth (%): 1.5 and 1.3

- Consumer prices (annual average % change): 2.3 and 1.7

- General government balance (% of GDP) : -0.7 and -1.8

- General government debt (% of GDP) : 100 and 99.5

- Current account balance plus net foreign direct investments (% of GDP) : -3 and -3.2

- Net external debt (% of GDP): -5.1 and 2.7

- IMF Development Classification: DM

- CDS Market Implied Rating: n/a

RATING SENSITIVITIES

A negative rating action on Belgium would be reflected in the Flemish Community's Long-Term IDRs as the latter may not be rated at more than one notch above the sovereign.

The Flemish Community's ratings could be downgraded if the region's debt payback ratio exceeds 10x on a sustained basis in our rating case scenario. This could happen in an economic downturn that would affect the operating revenue growth more than already factored in in our rating case scenario, or in case of an unexpected increase in expenditure.

Summary of Financial Adjustments

The analysis is based on the Flemish Community's consolidated operating revenue and expenditure. It includes the Flemish Community's general budget and some public institutions that are largely financed by the Flemish Community, such as universities for instance. These institutions account for less than 10% of total operating revenue and spending of the consolidated accounts.

Fitch's adjusted debt includes the Flemish Community's direct debt (EUR6.738 billion at end-2019) and 'other Fitch-classified debt' items, totalling EUR4.463 billion at end-2019. The latter comprised EUR2.1 billion in public-private partnership debt, EUR1.45 billion of consolidated public institutions' debt, and EUR918 million that the Flemish Community will repay to the federal state over a 16-year period. However, in contrast with European System of Accounts (ESA) rules, it does not include the guaranteed debt of social housing companies, which we view as self-supporting, nor that of hospital infrastructure.

Sources of Information

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity.

COMMITTEE MINUTE SUMMARY

Committee date: 5/03/2020

There was an appropriate quorum at the committee and the members confirmed that they were free from recusal. It was agreed that the data was sufficiently robust relative to its materiality. During the committee no material issues were raised that were not in the original committee package. The main rating factors under the relevant criteria were discussed by the committee members. The rating decision as discussed in this rating action commentary reflects the committee discussion.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
The Flemish Community	LT IDR AA New Rating		WD
	ST IDR F1+ New Rating		WD
	LC LT IDR AA New Rating		WD
	LC ST IDR F1+ New Rating		
senior unsecured	LT AA New Rating		
senior unsecured	ST F1+ New Rating		

Additional information is available on www.fitchratings.com

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Applicable Criteria

Rating Criteria for International Local and Regional Governments (pub. 13 Sep 2019)

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