FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Andorra at 'BBB+'; Outlook Stable

Fri 29 Jan, 2021 - 16:01 ET

Fitch Ratings - Frankfurt am Main - 29 Jan 2021: Fitch Ratings has affirmed Andorra's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BBB+' with a Stable Outlook.

KEY RATING DRIVERS

Andorra's credit profile is supported by high GDP per capita (more than three times the 'BBB' median), favourable governance indicators, high debt affordability and a track record of fiscal prudence. The Stable Outlook reflects Fitch's expectation that Andorra's public debt ratio, which was relatively low at the onset of the pandemic, will stabilise in 2021 at a level still below the 'BBB' peer median, and return to a downward trajectory over the medium term.

Andorra's tourism-dependent economy has been hit hard by the second wave of the coronavirus pandemic that began last autumn across Europe. The resurgence of coronavirus infections has led to mobility restrictions across EU national borders, The rise in unemployment has been modest, despite the depth of the economic contraction. The unemployment rate rose to 3.3% as of 3Q20 compared with 1.4% a year before, contained in part by the extension of government short-term work allowances and the high share of foreign labour, especially seasonal workers in Andorra during the peaks of the tourist season.

Our projections remain subject to risk and uncertainty owing to the trajectory of the pandemic, the rise of new coronavirus strains and potential delays in the rollout of vaccination programmes, all of which may limit the recovery in tourist arrivals. Risks of second-round effects of the virus on corporate insolvencies and larger increases in unemployment also remain.

Despite the substantial economic contraction, Andorra's general government fiscal deficit of 4% of GDP in 2020 (government's estimate) was materially lower than rating peers ('BBB' median at 6.9% of GDP) and well below our initial projections (8% of GDP). Pent-up demand for goods resulted in a boost in tax receipts from foreign trade. Expenditure growth was limited (6% increase compared to 2019), despite the sizable fiscal stimulus package (around EUR90 million or 3.7% of GDP, excluding tax deferrals and loan guarantees), owing to reallocation from capital to current spending. A recovery in GDP growth and continued but shrinking fiscal support for the economy in 2021 and 2022 should result in narrower fiscal deficits of 2.4% and 1.2% of GDP, respectively.

Andorra's gross general government debt (GGGD)-to-GDP rose to 48.0% in 2020, according to Fitch's estimates, from 35.4% in 2019 (against the 2020 'BBB' median of 52.9%), and we expect it to stabilise this year before starting to fall gradually in 2022. In our projections, we assume crystallisation of around EUR27 million (1.1% of GDP) in contingent liabilities from the government's loan guarantee scheme (so-called soft loan programme), split equally between 2021 and 2022. Up until now, EUR133 million (5.2% of GDP) of loans were guaranteed by the government out of the total EUR230 million available in the soft loan programme.

The sovereign's balance sheet is cushioned by a large stock of liquid social security assets, equivalent to 57% of GDP (based on official estimates as of end-November 2020), and central government cash deposits of 6.2% of GDP (up from 0.8% of GDP in 2019). The average interest rate on government debt is low (0.9% as of end-2020 according to official data), and interest payments constitute only 1.3% of revenue. Andorra also has scope for domestic financing, as bank holdings of government debt are only 2%-3% of total banking-sector assets, and demand from retail investors appears strong.

Progress on Andorra's financial diversification strategy has succeeded in broadening financing sources and will help lengthen the average maturity of its debt. Following a EUR100 million loan contract with a foreign bank (Crédit Agricole, A+/Negative) the government made a private placement of EUR200 million with two foreign banks (Crédit Agricole and Banco Santander, A-/Negative), which is a stepping stone to Andorra's first Eurobond issuance planned for later this year. In addition, membership of the Council of Europe Development Bank (CEB, AA+/Stable) has resulted in favourable financing opportunities, and we expect further financing options to arise from the collaboration with European Investment Bank (EIB, AAA/Stable).

External borrowing, while helping to diversify financing sources and lengthen the debt maturity, has also led to a deterioration of the sovereign net foreign asset position, projected at -20.8% of GDP this year, from a balanced position before the pandemic.

Andorra became an official member of the IMF as anticipated in October 2020, gaining access to the fund's financial resources and technical assistance, which could help address some of Andorra's long-term credit challenges. Although we do not anticipate the need for IMF financing in the near term, access to emergency financing mitigates some of the risks associated with the lack of a lender-of-last-resort for Andorra's large banking sector (whose assets amount to around 600% of GDP). We also expect IMF membership and technical assistance to help address key data gaps in the development of balance of payments and external balance statistics. The dissemination of these statistics could significantly improve transparency.

We believe the Andorran banking sector has adequate headroom to withstand a deterioration in revenues and asset quality, although the economic fallout from the pandemic represents a medium-term risk to banks' ratings. The banking sector maintains satisfactory capital buffers over the regulatory thresholds, with the phased-in common equity Tier 1 ratio at 17.5% as of 3Q20. There is a stable customer deposit base that comfortably funds the loan book (loan-to-deposit ratio at 55.3% as of 3Q20) and liquidity positions are conservatively managed (liquidity coverage ratio at 200% as of 3Q20).

The non-performing loan ratio at 8.0% as of 3Q20 has declined from 8.6% at the end-2019 but remains relatively high. We expect an increase in impaired loans as the financial position of Andorran borrowers is set to worsen in 2021 and asset quality remains sensitive to single-name and sector concentrations, given the small size and structure of Andorran economy. However, the sector's high loan impairment reserve coverages and relatively high share of secured lending provide some cushion against a deterioration in asset quality.

ESG - Governance: Andorra has an ESG Relevance Score (RS) of 5 for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Andorra has a high WBGI ranking at 91.4 percentile, well above the 'BBB' median, reflecting strong institutional capacity and effective rule of law.

RATING SENSITIVITIES

The main factors that could, individually or collectively, lead to positive rating action/upgrade are:

Macro: Greater confidence in the outlook for a sustained economic recovery sufficient to place the public debt/GDP ratio on a faster downward path than Fitch's baseline forecasts.

External Finances: Greater confidence in the strength of the external position, evidenced, for example, in the construction and publication of balance of payments and international investment position statistics.

Structural Features: Improved resilience of the banking sector and associated vulnerabilities of the sovereign balance sheet, evidenced for example through tangible improvements to the banking supervision framework and sufficient access to financing facilities to mitigate the lack of a credible lender-of-last-resort.

The main factors that could, individually or collectively, lead to negative rating action/downgrade:

Macro: Severe and prolonged economic weakness, for example due to a longer and deeper than expected contraction in the tourism sector.

Public Finances: Failure to stabilise general government debt/GDP, for example due to lack of fiscal consolidation after the initial Covid-19 shock subsides, or materialisation of contingent liabilities.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Andorra a score equivalent to a rating of 'BBB+' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to SRM data and output, as follows:

- Structural factors: -1 notch, to reflect the relatively large banking sector and lack of a credible lender-of-last-resort that makes the economy and the sovereign balance sheet vulnerable to a banking crisis. While access to emergency financing from the IMF mitigates these risks to some extent, we note that the banking supervision standards are still lagging behind regional and rating peers and banks' asset quality remains sensitive to high single-name concentrations given the banks' exposure to Andorra's small economy.

- Macro: +1 notch, to offset the deterioration in the SRM output driven by the pandemic shock, including from the growth volatility variable. The deterioration of the GDP growth and volatility variables reflects a very substantial and unprecedented exogenous shock that has hit the vast majority of sovereigns, and Fitch believes that Andorra has the capacity to absorb it without lasting effects on its long-term macroeconomic stability.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

KEY ASSUMPTIONS

- Fitch expects the global economy to perform in line with Fitch's Global Economic Outlook (7 December 2020), which projects the eurozone to expand by 4.7% in 2020 and 4.4% in 2021.

- Fitch has not included potential costs of financial damages from the lawsuit brought by Banca Privada d'Andorra's former owners against the government in its public finance projections.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

The principal sources of information used in the analysis are described in the Applicable Criteria.

A number of data series that feed into our credit analysis are not available for Andorra, principally on the Balance of Payments and External Balance Sheet. This is addressed by the use of estimates of key data items, and conservative assumptions e.g. on sovereign external debt, augmented by qualitative discussions with the Andorran authorities and independent banking sector analysts. These give us sufficient information to assess with reasonable confidence the impact of Andorra's External Finances on the overall rating. The main data adjustments made are:

- Current account plus FDI: assumed to be 0% of GDP (a conservative assumption, given that Andorra's tourism sector implies a structural current account surplus);

- External interest service: assumed to be the same as the 'BBB' median projections for the three-year average centred on 2020 (4.3% of current account receipts);

- Broad money estimates are unavailable; we have used information from the consolidated balance sheets of Andorran banks as a proxy.

ESG CONSIDERATIONS

Andorra has an ESG Relevance Score of 5 for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are highly relevant to the rating and a key rating driver with a high weight.

Andorra has an ESG Relevance Score of 5 for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight.

Andorra has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as strong social stability and voice and accountability are reflected in the World Bank Governance Indicators that have the highest weight in the Sovereign Rating Model (SRM). They are relevant to the rating and a rating driver.

Andorra has an ESG Relevance Score of 4 for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Andorra, as for all sovereigns.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Andorra	LT IDR	BBB+	Affirmed	BBB+
•	ST IDR	F2	Affirmed	F2
•	Country Ceiling	A+	Affirmed	A+

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Oct 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.1 (1)

Debt Dynamics Model, v1.2.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Andorra	EU Issued, UK Endorsed

DISCLAIMER

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS. IN ADDITION, THE FOLLOWING

READ MORE

COPYRIGHT

READ MORE

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.
