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Research Update:

Ratings On Andorra Affirmed At 'BBB-/A-3'; Outlook Still Negative

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Overview

- Andorra's response to the crisis at Banca Privada d'Andorra (BPA), including legal reforms and an orderly resolution process for the bank, has so far contained the ensuing risks to the financial system and the impact on the broader economy.
- We consider that Andorra has stable political institutions and strong fiscal and debt positions, but information gaps regarding the country's external data and our view on limited growth prospects and economic concentration risk constrain the ratings.
- We are affirming our 'BBB-/A-3' ratings on Andorra.
- The negative outlook indicates that we may lower the ratings on Andorra over the next 18-24 months if BPA's resolution fails to stabilize the bank, reforms in Andorra slowed, or other Andorran banks experienced financial distress, with knock-on effects for the principality.

Rating Action

On Sept. 25, 2015, Standard & Poor's Ratings Services affirmed its 'BBB-/A-3' long- and short-term sovereign credit ratings on the Principality of Andorra. The outlook remains negative.

Rationale

The affirmation reflects our view that the crisis at Banca Privada d'Andorra (BPA) has so far not destabilized Andorra's financial sector. We see no evidence of deposit outflows at a scale that could lead to capital controls at other financial institutions in the country. Moreover, we expect that BPA's ongoing resolution, announced on June 15, 2015, will continue to be executed broadly in line with the initial timetable.

As foreseen in Andorra's Law on Restructuring and Resolution of Banking Entities, dated April 2, 2015, Andorra's banking resolution authority AREB has constituted a "bridge bank," named Vall Banc, where BPA's cleared assets and liabilities will be transferred. We understand that after the transfer, FAREB, the government's banking resolution fund endowed by the remaining Andorran Banks, will provide €27 million (1.1% of GDP) to AREB, which AREB will inject as capital to Vall Banc, fully funded by the other Andorran banks. Given that Vall Banc currently has €3 million in capital, we expect that the banking regulator could then declare Vall Banc to be in compliance with the €30 million legal minimum capital requirement.

We understand that AREB has already contacted investors that might be interested in acquiring Vall Banc, and that once the perimeter of assets and liabilities to be transferred becomes clear, AREB will formally launch the sale of Vall Banc, aiming to reach an agreement on the sale with the buyer by year-end 2015. In the meantime, BPA's depositors remain subject to a withdrawal limit of €2,500 per account per week, and we do not expect this will be lifted until the accounts are transferred and Vall Banc starts normal operations, or possibly until Vall Banc is sold.

Although BPA's resolution has made progress, we think it remains subject to meaningful operational, regulatory, organizational, and legal risks that could still weigh on Andorra's creditworthiness. First, we have uncertainty about the successful conclusion of AREB's ongoing negotiations with correspondent banks abroad establish relations with Vall Banc, which would allow the entity to access BPA's assets abroad in order to restore normal operations. Second, the creation of the new bank is subject to complex administrative and organizational processes, such as the definition of its organizational structure, the size and determination of its workforce, adaptation of information technology systems, and the redesign of its compliance function. While we acknowledge that AREB has made progress on all these tasks since our last review, the new structures of the bank have yet to be finalized and tested. Third, it is unclear whether the currently foreseen loss-absorption buffers would be sufficient after Vall Banc's eventual sale, or whether the Andorran government may be called upon to contribute additional resources to the bank. Lastly, we currently have limited visibility on whether the resolution process will be subject to legal risks, for example as a result of lawsuits filed by BPA's former shareholders, which may delay the resolution process.

In terms of BPA's direct budgetary impact on the sovereign this year, we expect the Andorran government will advance the costs of legal and professional services related to BPA's resolution (shown in AREB's budget), which total about €22 million, less than 1% of GDP. To offset these costs in the budget, the authorities have cut other expenditures and postponed capital projects, while benefiting from an extraordinary dividend from state-owned telecommunications company Andorra Telecom. Consequently, amid somewhat lower tax receipts, we project a moderately higher central government deficit in 2015 of 1.3% of GDP compared with a deficit of 0.2% in 2014. However, we understand the government may recover all or part of the direct costs of the BPA resolution if Vall Banc is sold.

We continue to consider that Andorran banks' relatively large size and international expansion expose Andorra to potential external shocks, elevating the risks to the country's banking sector. Financial institutions' claims on the resident nongovernment sector, at about 198% of GDP in 2014, are among the highest of of all the sovereigns we rate. We estimate that off-balance-sheet assets under management at Andorran banks and their subsidiaries amount to about €36 billion, or 14x domestic GDP. Andorra's financial sector represents about 20% of total GDP, and approximately 5.4% of employment, which highlights the country's vulnerability to any turbulence in this sector.

In our opinion, banks' operations in several jurisdictions (like Spain, the U.S., Switzerland, Panama, or the Bahamas) increases their complexity, putting additional demands on supervisory activities and, in particular, those of the country's financial intelligence unit. We understand Andorra is seeking to enhance its institutions' resources and capabilities, while advancing toward international standards of legislation on anti-money laundering. Progress on this front is monitored and supervised through successive rounds of review of the Council of Europe's committee on the evaluation of anti-money laundering legislation (Moneyval).

Andorra has no monetary flexibility. Under a 2011 monetary agreement with the EU, Andorra can use the euro as its official currency. However, the principality has no central bank or other lender of last resort to provide emergency financing to its large banking system. Without liquidity access to the European Central Bank or eligibility for the EU's nascent banking resolution fund, Andorra's government is the de facto financial backstop for Andorran banks, and this constitutes an important contingent liability for the country.

Following the economic recovery in Andorra in 2014, we have revised downward our expectation of real and nominal GDP growth in 2015. This is due to the combination of the moderately negative impact of the BPA situation on consumption and investment, and a downward revision of our inflation estimates, due partly to lower energy prices. We expect that economic growth may pick up modestly in 2016, absent further destabilizing factors.

We forecast a general government surplus of about 1.2% of GDP in 2015, down from 3.2% in 2014. We expect that this performance will be supported by the surpluses of the local and regional governments, which will continue reducing their debt levels, and by the social security system, which should continue accumulating reserves. We therefore expect the general government's net asset position, which stood at about 2% of GDP in 2014, could reach about 6% of GDP by 2017.

We estimate that the Andorran government's financing needs for 2015 amount to about €365 million (15% of GDP), of which €100 million were already covered by a bond issue in April. Most of the remainder corresponds to a bond maturing in December 2015, held by domestic banks. We expect the banks to refinance the bond. If necessary, Andorra could also use the cash reserves of state-owned enterprises. We estimate that these reserves exceed €180 million, although we understand that only about one-half would be immediately available. Additionally, Andorra's social security reserves had a market value of about €1.1 billion (43% of GDP) as of midyear 2015, and comprise predominantly liquid assets. However, we understand that the use of these reserves to service government debt would require new legislation. Our baseline assumption is that, if required, a law could be enacted relatively quickly.

Our ratings on Andorra are supported by the country's stable political institutions. Andorra is a parliamentary co-principality. Two princes hold the joint and indivisible position of Head of State: the Bishop of La Seu d'Urgell (Spain) and the President of France. Following elections in March 2015, the center-right party Democrates per Andorra (DA) remained in office for another four years with an absolute majority. Andorra's DA-led government has pursued a comprehensive reform agenda, including overhauling the tax system, opening the economy to foreign investment, reforming the social security system to ensure its sustainability, and exercising tighter control over local finances.

Andorra's GDP per capita, at about $36,000 in 2015, is relatively high, but in our opinion the country's growth prospects are still limited, and the economy is vulnerable to its concentration in financial services and tourism.

Andorra's authorities do not publish a complete balance of payments statement or data regarding its international investment position. The ad hoc publication of economic indicators can influence our credit appraisal more markedly than when dissemination of economic data is more frequent and plentiful.

Outlook

The negative outlook on Andorra reflects our view that there is at least a one-in-three likelihood that we may lower the ratings within the next 18-24 months if we considered that any of following scenarios would materialize:

- The resolution of BPA would fail to stabilize the bank and this triggered turbulence in Andorra's financial sector, meaningfully affecting the government's finances or the country's economic growth prospects;
- Andorra was likely to deviate from its current path of legal and institutional reforms, which aim at gradual convergence toward international standards of banking supervision; or
- There was, in our opinion, an increased likelihood that other Andorran banks might face reputation issues similar to those affecting BPA, and we anticipated an erosion of Andorran banks' long-term viability as a result.

Conversely, we could revise the outlook to stable within the next 18-24 months if all the following occurred:

- The resolution plan for BPA culminated in the sale of the bridge bank Vall Banc and led to normal operations, without any additional meaningful impact on Andorra's government finances;
- Andorra showed, in our view, a clear commitment and progress with a reform agenda that strengthened the ability of the country's institutions to monitor and manage risks associated with the country's banking sector, while converging with international standards of financial reporting; and
- Andorra's economic prospects stabilize, possibly supported by improving economic performance of its main trading partners, Spain, and France.

Key Statistics

Table 1

Principality of Andorra Selected Indicators

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	3.0	3.0	2.0	2.0	2.0	3.0	3.0	3.0	3.0	3.0
Nominal GDP (bil. $)	4.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
GDP per capita (000s $)	43.7	39.5	44.1	41.5	43.1	43.6	36.2	35.3	36.2	37.0
Real GDP growth	(3.7)	(5.4)	(4.6)	(1.6)	0.4	2.3	0.7	0.7	1.2	1.4
Real GDP per capita growth	(3.2)	(6.4)	3.8	0.8	0.5	1.1	0.7	0.5	1.0	1.2

Real investment growth	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Investment/GDP	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Savings/GDP	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Exports/GDP	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Real exports growth	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Unemployment rate	3.4	2.8	3.8	3.5	3.5	3.5	3.9	3.6	3.2	3.2
EXTERNAL INDICATORS (%)										
Current account balance/GDP	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Current account balance/CARs	N.M.	N.M.	N.M.	N.M.	N.A.	N.A.	N.A.	N.A.	N.M.	N.M.
Trade balance/GDP	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Net FDI/GDP	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Net portfolio equity inflow/GDP	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Gross external financing needs/CARs plus usable reserves	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Narrow net external debt/CARs	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Net external liabilities/CARs	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Short-term external debt by remaining maturity/CARs	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Reserves/CAPs (months)	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
FISCAL INDICATORS (%, General government)										
Balance/GDP	(1.9)	0.8	0.2	(0.1)	4.9	3.2	1.2	1.6	0.6	0.6
Change in debt/GDP	4.4	3.5	1.6	3.2	(0.1)	0.3	(1.5)	(0.7)	0.4	0.4
Primary balance/GDP	(1.1)	1.4	1.1	1.3	6.0	4.1	2.1	2.5	1.5	1.4
Revenue/GDP	17.9	19.4	19.2	22.5	24.2	19.8	20.8	21.3	20.7	20.7
Expenditures/GDP	19.8	18.6	19.1	22.6	19.3	16.6	19.5	19.7	20.1	20.2
Interest /revenues	4.6	2.9	4.8	6.1	4.7	4.7	4.5	4.2	4.1	4.1
Debt/GDP	31.1	35.8	38.3	41.7	41.4	40.9	39.4	38.2	37.6	37.1
Net debt/GDP	1.6	3.0	2.9	3.2	(0.1)	(2.1)	(4.2)	(5.8)	(6.3)	(6.7)
Liquid assets/GDP	29.5	32.9	35.3	38.5	41.6	43.0	43.6	43.9	43.9	43.8
MONETARY INDICATORS (%)										
CPI growth	(1.2)	1.6	2.5	1.6	0.5	0	(0.7)	0.8	1.1	1.1
GDP deflator growth	0	1.6	2.5	1.1	0	(0.1)	(0.7)	0.8	1.1	1.1
Banks' claims on resident private sector growth	(1.3)	3.9	0.7	(5.4)	(5.3)	(2.6)	(1.0)	0.5	1.0	1.5
Banks' claims on resident private sector/GDP	208.2	224.9	231.7	220.4	207.9	198.1	196.1	194.2	191.7	189.8
Foreign currency share of claims by banks on residents	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant,

Ratings Score Snapshot

Table 2

Principality of Andorra Ratings Score Snapshot	
Key rating factors	
Institutional assessment	Neutral
Economic assessment	Weakness
External assessment	Weakness
Fiscal assessment: flexibility and performance	Strength
Fiscal assessment: debt burden	Neutral
Monetary assessment	Weakness

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Research Update: Ratings On Andorra Affirmed At 'BBB-/A-3'; Off CreditWatch On Banca Privada d'Andorra Resolution Progress; Outlook Neg, June 24, 2015
- Default, Transition, and Recovery: 2014 Annual Sovereign Default Study And Rating Transitions, May 18, 2015
- Research Update: Andorra Ratings Lowered To 'BBB-/A-3' On Risk Of Contingent Liabilities Materializing; Still On CreditWatch Negative, March 27, 2015
- Research Update: Principality of Andorra Rating Lowered To 'BBB' And Placed On CreditWatch Negative, March 12, 2015
- Global Sovereign Debt Report 2015: Borrowing To Drop By 5.7% To US$6.7 Trillion, March 5, 2015
- Research Update: Principality of Andorra Ratings Lowered To 'BBB+/A-2' On Increased Risk Profile Of Banking Sector; Outlook Stable, Oct. 3, 2014

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the economic risk assessment had deteriorated, while the debt burden assessment had improved all other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

	Ratings	
	To	From
Andorra (Principality of)		
Sovereign credit rating		
Foreign and Local Currency	BBB-/Negative/A-3	BBB-/Negative/A-3
Transfer & Convertibility Assessment	AAA	AAA
Senior Unsecured		
Local Currency	BBB-	BBB-

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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