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Research Update:

Principality of Andorra Ratings Lowered To 'BBB+/A-2' On Increased Risk Profile Of Banking Sector; Outlook Stable

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Overview

- Andorra's economy is showing signs of a modest recovery, which, alongside the government's budgetary consolidation including tax reforms, is improving fiscal performance and the debt position, and the government is pushing forward with its reform agenda.
- However, we also see the Andorran financial sector elevating its risk profile because of international expansion.
- We are therefore lowering our long-term rating on Andorra to 'BBB+' from 'A-', and affirming our short-term rating at 'A-2'.
- The stable outlook reflects our expectation that Andorra's fiscal position will stabilize, and that we expect the banking sector's increased risk levels to become more manageable as the country fully adopts international standards of financial reporting and regulation.

Rating Action

On Oct. 3, 2014, Standard & Poor's Ratings Services lowered its long-term foreign and local currency sovereign credit ratings on the Principality of Andorra to 'BBB+' from 'A-'. The outlook is stable.

At the same time, the 'A-2' short-term foreign and local currency sovereign credit ratings were affirmed.

The transfer and convertibility assessment remains at 'AAA'.

Rationale

The downgrade reflects our view of increased risks stemming from Andorra's financial sector, which, in our view, outweigh the positive impact of the central government's successful implementation of a comprehensive reform agenda and its commitment to fiscal prudence.

Andorra's banking sector is very large relative to the size of the economy, with banks' total assets representing about 6x GDP and assets under management of 16x GDP at the end of 2013. Andorra's financial and insurance sector's share in the economy's gross value added rose to 21.7% in 2013 from 17.4% in 2010, highlighting increased dependence on this sector.

Andorran banks appear adequately capitalized, with reported capital adequacy ratios of about 21% and liquidity ratios of about 70% under Andorran accounting and regulatory standards at year-end 2013 (latest available information). At the same time, systemwide nonperforming loans as of year-end 2013 made up 5.1% of total credit, up from 4.3% in 2012. Nevertheless, performance has varied significantly across Andorra's banking groups.

We note that the Andorran banking sector continues to significantly trail international norms in terms of scale, scope, and timeliness of reporting and public disclosure of information and statistics. We acknowledge, however, that the national regulator, Institut Nacional Andorrà de Finances (INAF) is moving forward with the implementation of International Financial Reporting Standards and Basel III requirements in coordination with Andorra's banks. We also view positively the government's convergence with Organisation for Economic Co-operation and Development standards of transparency regarding the exchange of information for tax purposes.

We understand that INAF cooperates with international regulators in jurisdictions where Andorran banks operate. However, we believe the international expansion of Andorran banks, in particular into emerging market economies, will place additional demands on INAF.

Most importantly, in our opinion, international expansion and related exposure to potential external shocks are elevating the risk to the Andorran banking sector. We estimate that simultaneous operations in several jurisdictions increase the complexity of these entities, while exposing them to increased regulatory, operational, and reputational risks.

Andorran banks are currently pursuing a strategy of international expansion. Aside from Spain, Andorran financial institutions are now present in countries such as Luxembourg, Switzerland, and Monaco. They are also in Uruguay, the U.S., Panama, Mexico, Paraguay, Peru, Brazil, the Bahamas, and Dubai, focusing on wealth management services. Assets under management increased to $41.3 billion in 2013 from $25 billion in 2008, or a 63% increase, and rose by 18% in 2013 alone, mostly due to the expansion of banks' foreign operations, although we note that part of this expansion was due to acquisitions in Spain.

Andorra's monetary agreement with the European Union authorizes it to use the euro and mint euro coins, but does not grant Andorran banks direct access to European Central Bank (ECB) financing facilities from their head offices. However, Andorran banks can access the ECB through their subsidiaries in the eurozone to the extent that the subsidiaries have unencumbered eligible collateral. We also note that Andorra is not part of the European Banking Union, and its domestic banks are therefore not supervised by the ECB. This contrasts with eurozone banks. Besides ECB supervision, eurozone sovereigns are endowed with funding alternatives in case of banking sector stress, which, among others, include recourse to the European Stability Mechanism, the International Monetary Fund, or monetary policy actions by the ECB. Given the size of Andorra's banking system, we don't think that the government can act as a lender of last resort.

Our ratings on Andorra are supported by the country's stable political institutions and relatively prosperous economy. We estimate per capita GDP at about $42,700 in 2013. Andorra's credit profile also benefits from its low general government debt. In fact, we expect Andorra will become a moderate net creditor as of Dec. 31, 2014.

In recent years, Andorra's government has pursued a comprehensive reform agenda, which it has implemented according to schedule. Among other measures, the Andorran government has overhauled the tax system, opened the economy to foreign investment, reformed the social security system to ensure its sustainability, and brought local finances under tighter control.

On the other hand, our view on Andorra is tempered by our opinion that the country's growth prospects are still limited, and that Andorra's economy is vulnerable to its concentration in financial services and tourism.

We expect a moderate economic recovery, supported in part by the government's economic reforms to encourage foreign direct investment. We expect real GDP growth of 0.8% in 2014, and 1.4% in 2015. Employment growth figures are already reflecting a slight improvement, with a 0.4% year-on-year increase as of Aug. 31, 2014.

After posting a budgetary surplus of 1.5% of GDP in 2013, driven by extraordinary dividends from public companies, we expect the central government's position to be in balance in 2014, based on a stronger-than-expected performance in tax collection, along with continued spending control. We expect favorable performance in Andorra's social security system and for local governments to contribute to an overall general government surplus of about 1.2% of GDP on average over 2014-2017.

As a result, we expect general government debt to decrease to about 36% of GDP by year-end 2017, from 42% at year-end 2013. We now estimate that the sovereign will be in a small net creditor position as of year-end 2014, when also accounting for liquid government assets, mainly in the form of social security reserves.

Andorra's authorities do not publish a complete balance of payments or data regarding its international investment position. A sovereign's 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 stable outlook on Andorra reflects our view that the country's economic recovery and the government's reforms will support economic recovery and improve the budgetary position over 2014-2017.

However, in our view, this relative improvement is also balanced by the risks emerging from the Andorran banking sector. Nevertheless, we expect Andorran banking institutions' general adoption of international standards of financial reporting and oversight will gradually improve visibility about these risks.

We could raise our ratings on Andorra if:

- Its economy recovered more robustly than we currently expect, resulting in improved public finance metrics beyond our current expectations; and
- We estimated that Andorra's banking sector's accounting and regulatory practices had converged with international standards, saw an improvement in the asset quality of Andorra's banks, and considered that the risks associated with their international expansion were subsiding.

Conversely, we could lower our ratings on Andorra if:

- Its economy faltered, and the government failed to prevent a significant deterioration in public finance metrics;
- Its government wavered in its structural reform agenda, postponing the full adoption of international standards of financial reporting and regulation, and we expected negative repercussions on the country's relationships with key national and supranational stakeholders; or
- We estimated that the risks emanating from its financial institutions were increasing beyond our current expectations and negatively affecting the economy's credit conditions or the government's fiscal position.

Key Statistics

Table 1

Principality of Andorra Selected Indicators

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Nominal GDP (US$ bil)	4	4	4	3	3	3	3	3	3	3	3
GDP per capita (US$)	48,243	47,360	43,583	39,399	43,932	41,260	42,705	43,284	40,833	42,880	43,957
Real GDP growth (%)	0.1	(8.6)	(3.8)	(5.4)	(4.8)	(1.8)	(0.1)	0.8	1.4	1.6	1.6
Real GDP per capita growth (%)	(2.2)	(10.1)	(3.4)	(6.4)	3.6	0.7	0.1	0.8	1.2	1.4	1.4
Change in general government debt/GDP (%)	2.5	6.2	4.4	3.5	1.6	3.2	(0.2)	(2.5)	(0.2)	0.0	0.0
General government balance/GDP (%)	(2.7)	(5.8)	(1.9)	0.8	0.2	(0.1)	4.9	3.7	1.5	1.1	1.1
General government debt/GDP (%)	18.2	25.7	31.2	35.9	38.5	42.0	41.8	38.8	37.8	36.8	35.8
Net general government debt/GDP (%)	(7.5)	(0.3)	1.6	3.0	3.0	3.2	0.6	(1.9)	(2.0)	(1.9)	(1.9)
General government interest expenditure/revenues (%)	4.6	7.9	4.6	2.9	4.8	6.1	4.7	4.5	4.1	3.9	3.8
Other dc claims on resident non-govt. sector/GDP (%)	221.0	257.1	262.5	282.4	301.4	302.3	301.0	297.4	293.9	290.4	286.9
CPI growth (%)	2.6	4.6	(1.2)	1.6	2.5	1.6	0.6	0.4	0.8	1.1	1.1
Gross external financing needs/CARs + useable reserves (%)	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.

Table 1

Principality of Andorra Selected Indicators (cont.)											
Current account balance/GDP (%)	N.A.	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.A.	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.	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.	N.A.

Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments, plus short-term external debt at the end of the prior year, plus nonresident deposits at the end of the prior year, plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents, minus financial sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts. The data and ratios above result from Standard & Poor's own calculations, drawing on national and international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. N.A.--Not available.

Ratings Score Snapshot

Table 2

Principality of Andorra Ratings Score Snapshot	
Key rating factors	
Institutional and governance effectiveness	Strength
Economic structure and growth	Neutral
External liquidity and international investment position	Weakness
Fiscal flexibility and performance	Strength
Debt burden	Neutral
Monetary flexibility	Weakness

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional and governance effectiveness; (ii) economic structure and growth prospects; (iii) external liquidity and international investment position; (iv) the average of government debt burden and fiscal flexibility and fiscal performance; and (v) monetary flexibility. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Government Rating Methodology And Assumptions," published on June 24, 2013, 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

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Defaults And Rating Transition Data, 2013 Update, Sept. 17, 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 no rating factors had changed.

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

Downgraded; Ratings Affirmed

	To	From
Andorra (Principality of)		
Sovereign Credit Rating	BBB+/Stable/A-2	A-/Negative/A-2
Transfer & Convertibility Assessment	AAA	AAA
Senior Unsecured	BBB+	A-

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