FitchRatings

Fitch Affirms Andorra at 'BBB+'; Outlook Stable

Fitch Ratings - London - 31 January 2020:

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 'BBB+' rating is supported by high GDP per capita (more than three times the 'BBB' median), favourable governance indicators, low and improving net public indebtedness, and a track record of fiscal prudence. This is set against Andorra's small and undiversified economy, gaps in the availability of economic data, and risks associated with a large financial sector (consolidated bank assets are close to 500% of GDP) without a credible "lender of last resort".

Fitch forecasts a reduction in the general government surplus to 1.8% of GDP in 2020 and 1.4% in 2021, from an estimated 2.1% in 2019 (and an average 2.9% in 2015-2018). This is driven by smaller local government and social security surpluses, with the central government position expected to remain close to balance. We estimate the 2019 central government surplus at 0.1% of GDP, a 0.2pp improvement on 2018 and outperforming the government target of a 0.8% of GDP deficit due to recurrent expenditure restraint and a boost to direct taxes from stronger economic growth. December's updated budget plan does not include any sizeable new fiscal measures and leaves all headline tax rates unchanged. More generally, there has been a relatively high degree of policy continuity since the new coalition government came to power last May.

General government debt has continued to fall gradually to 35.3% of GDP at end-2019 since peaking at 41.9% in 2012, and is below the current 'BBB' median of 41.1%. Fitch forecasts a further reduction to 33.5% in 2021 on the back of sustained primary surpluses and moderate GDP growth. One and three-year domestic bond issuances in 2H19 (at 0.45% and 0.90%, respectively) lowered average debt interest costs to an estimated 1.3% of revenues, from 1.4% in 2018, compared with the peer group median of 7.1%. However, the average maturity of debt reduced to 2.7 years, from 3.0 years at end-2018 ('BBB' median 6.7 years). The sovereign's balance sheet is enhanced by a large stock of liquid assets in the social security sector, which rose 3.1pp in 2019 to 50.0% of GDP. The annual social security surplus has averaged 2.0% of GDP in 2017-2019, but is projected by the government to move into deficit by 2025.

Progress towards an EU association agreement continues, although it slowed somewhat last year, partly due to the elections. The chapter on the free movement of goods is complete and Fitch expects the remaining three pillars will take several years to conclude, after which there will be a confirmatory referendum. The government applied for IMF membership in January 2020, with the aim of joining by year-end, which we view as an ambitious timetable. This process could lead to the development of balance of payments statistics, which would help address Andorra's main data gap from a sovereign rating perspective. Some further steps have been made in Andorra's alignment with international standards of financial regulation and tax transparency. Following last year's removal from the EU "grey list" of non-cooperative tax jurisdictions, December's Moneyval anti-money-laundering evaluation was generally positive.

GDP growth quickened to an estimated 2.4% in 2019, from 1.6% in 2018, on the back of firm private consumption, and construction growth of close to 6%. Domestic demand is supported by further, albeit moderating, employment growth of 1.9% in the first 10 months of 2019 (from 3.0% in 2018) and a pick-up in

FDI, of 7.8% of GDP (from 5.5% in 2018). Tourism was affected by unfavourable weather conditions, with visitor days falling 1.8% to 13.9 million in 2019, but has recovered strongly this month. Closure of the border with France for two weeks due to landslides also weighed on tourism and trade, with export growth slowing 4.3pp in 2019 to 1.4% and imports by 4.0pp to 0.7%. Fitch forecasts a moderation in GDP growth to 1.9% in 2020, partly due to cooling activity in Spain (which accounts for 62% of exports and 41% of FDI), and 1.5% in 2021, which is in line with our assessment of the trend rate.

Overall inflation remains muted at 0.6% in the year to November, similar to 2018, and Fitch forecasts a gradual increase to 1.0% this year and 1.3% in 2021. This partly reflects expectations of stronger average wage growth, which slowed to 0.9% in 2019, from 2.7% in 2018, despite ongoing labour market tightness and a 10-year low annual unemployment rate of 1.7%. House prices are recovering, up 9.2% in the year to 3Q19, but this still leaves them 29.3% below their 2011 level. Credit growth has also started to revive, following an average annual real contraction of 4.7% in 2017-2018 (which was partly due to the collapse of the Banca Privada d'Andorra), and we expect an increase to 1.5% in 2019, broadly in line with GDP growth.

The size of the banking sector and the lack of a lender of last resort mean the sector represents a large contingent liability for the sovereign. However, credit fundamentals have been resilient to the transition to a more tightly regulated, competitive, and lower-margin private banking business model. The average bank Viability Rating is 'bbb', and the main credit metrics are broadly stable. Fitch anticipates a modest improvement in profitability (return on equity was 7.3% in 2018), driven by increased revenues from international operations, and for capital buffers to be maintained following last year's introduction of Basel III (the phased-in CET1 ratio at end-2018 was 16.3%). The NPL ratio (8.6% at end-2018, including foreclosed assets) is higher than peers, but this is mitigated by improved loan coverage (at 81.5%). There is a stable customer deposit base that comfortably funds the loan book and liquidity positions are conservatively managed.

Sovereign Rating Model (SRM) and Qualitative Overlay (QO)

Fitch's proprietary SRM assigns Andorra a score equivalent to a rating of 'A-' 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 rated peers, as follows:-

- Structural factors: -1 notch, to reflect the relatively large banking sector and lack of a credible lender-of-last-resort that would make the economy and the sovereign balance sheet vulnerable to a banking crisis.

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.

RATING SENSITIVITIES

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

- Reduced risk of contingent liabilities from the banking sector materialising on the sovereign balance sheet

- More rapidly declining government debt/GDP, for example due to fiscal consolidation or improved GDP growth prospects

- Greater confidence in the strength of the external sector, for example through the development of robust balance of payments statistics

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

- Rising government indebtedness, for example due to fiscal slippage or worsening economic prospects

- Increasing risk of contingent liabilities from the banking sector crystallising on the sovereign's balance sheet

Key Assumptions

- 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.

- Our public debt projections assume remaining annual social security fund surpluses are rolled up in the fund, rather than being used to pay down public debt.

- Global macroeconomic developments are in line with Fitch's Global Economic Outlook (December 2019).

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 2019 (4.0% 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.

RATING ACTIONS

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

Additional information is available on www.fitchratings.com

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Applicable Criteria

Sovereign Rating Criteria (pub. 26 May 2019)
Country Ceilings Criteria (pub. 05 Jul 2019)

Additional Disclosures

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