



RATING ACTION COMMENTARY

Fitch Affirms Andorra at 'BBB+'; Outlook Stable

Fri 31 Jul, 2020 - 4:02 PM ET

Fitch Ratings - Frankfurt am Main - 31 Jul 2020: Fitch Ratings has affirmed Andorra's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BBB+' with a Stable Outlook.

A full list of rating actions is at the end of this rating action commentary.

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.

As a small, highly concentrated economy with a large dependence on tourism, Andorra will experience a deep recession this year. Fitch forecasts real GDP to contract by 11.4% in 2020 from 1.8% growth in 2019. We expect GDP to recover only gradually as the pandemic will continue to weigh on growth prospects in

neighbouring countries and tourism inflows. Under our baseline scenario, the economy will recover to 4.3% in 2021 and 3.4% in 2022. However, the recent resurgence of the coronavirus in Catalonia pose downside risks to the outlook, and uncertainty around Andorra's growth trajectory remains high.

As a result of virus containment measures, particularly border closures by Spain and France, the number of visitors to Andorra contracted by 71% year-on-year in 2Q. Single-day visitor numbers have rebounded since the border openings in June (+5.7% year-on-year), but the number of tourists is picking up only gradually (-73.5% year-on-year in June, up from -100% in May). We project the number of tourists to decline by around 50% for the whole year.

The high share of foreign labour in the workforce (77% as of end-2019) will support flexibility in the labour market. An expected outflow of foreign labour will help lower the unemployment rate through the crisis, but will have a further negative effect on private consumption. We expect the unemployment rate to increase to 6.3% in 2021, from 2.1% at end-2019, contained in part by the extension of government short-term work allowances through the end of the year.

The coronavirus pandemic will also weaken Andorra's public finances and aggravate challenges stemming from narrow reliance on domestic financing sources. We expect the general government fiscal balance to swing into a deficit of 8.0% of GDP in 2020 from a surplus of 2.2% last year, driven by automatic stabilisers and a sizable stimulus package, which we estimate to add EUR130 million (5.2% of GDP) to expenditure this year. In addition to the short-time work allowance scheme, measures in response to the pandemic mainly consist of subsidies for rents and social contributions as well as paid leave for employees in quarantine.

Fitch forecasts gross general government debt (GGGD)-to-GDP to rise to 47.9% in 2020, from 35.4% in 2019 (and against the projected 'BBB' median of 51.7%), and to start falling gradually from 2022. In our projections, we assume crystallisation of around EUR27 million (1% of GDP) in contingent liabilities from the government's loan guarantee scheme (so-called soft loan programme) in 2021. As of July, EUR133 million (5.3% of GDP) of loans were guaranteed by the government out of the total EUR230 million available in the soft loan programme.

A short average debt maturity (2.4 years, estimate as of mid-2020) coupled with widening deficits will increase refinancing risks. We expect gross borrowing requirements (maturing debt plus general government fiscal deficit) to increase to

around EUR800 million (29.2% of GDP) in 2022 from EUR350 million (12.4%) in 2019. However, these risks are mitigated by the remaining depth of the domestic financing market. Bank holdings of government debt represent only 3% of the total banking assets, and demand from individual investors still appears strong.

In response to growing financing needs, the government has embarked on a diversification strategy, which should broaden financing sources and lengthen the average maturity of debt. At the core of the strategy is a EUR100 million loan with a foreign bank (Crédit Agricole, A+/Negative), which may help pave the way for Andorra's first international bond issuance in the coming years. Other financing sources include a EUR50 million credit line with Andorran banks, EUR30 million in reserves from the state-owned enterprises (Andorra Telecom and FEDA) and EUR5 million from citizen solidarity and emergency funds. Recent membership with Council of Europe Development Bank (CEB, AA+/Stable) and collaboration with European Investment Bank (EIB, AAA/Stable) should also result in additional financing opportunities.

Fitch understands that Andorra's membership request with the IMF is on track, and may be concluded as soon as October, somewhat earlier than we previously anticipated. Membership will not only provide Andorra with the safety net of access to the IMF's financial resources, but should also improve transparency and the quality of reported data. In particular, we anticipate the publication of balance of payments and external balance statistics, which would help address a key data gap.

The sovereign's balance sheet is enhanced by a large stock of liquid assets in the social security sector, equivalent to 50% of GDP, and the central government's deposits at 4% of GDP. The average interest rate on government debt is low at 1.3% as of end-2019, and interest payments constitute only 1.2% of revenue.

The large size of Andorra's banking sector (assets are equivalent to 556% of GDP) and lack of a lender of last resort pose contingent liability risk for the sovereign. The banking sector outlook has deteriorated from the COVID-19 shock, as the deep recession is amplifying credit quality risks and pressuring earnings and profitability. Accordingly, Fitch recently revised the outlook on the banks' operating environment to negative. Asset quality remains sensitive to high single-name concentrations given the banks' exposure to Andorra's small economy. These risks are mitigated by the high share of private banking and asset management operations as well as household and corporate liquidity, which have been supported by government programme's in response to the pandemic shock.

The banking sector's credit fundamentals are adequate, with the average bank Viability Rating at 'bbb'. Banks maintain adequate capital buffers, with the phased-in common equity Tier 1 ratio at 17.5% as of end-2019. There is a stable customer deposit base that comfortably funds the loan book (loan-to-deposit ratio at 59.7% as of end-2019) and liquidity positions are conservatively managed. However, the non-performing loan ratio at 8.6% at end-2019 remains higher than peers, even without taking into account Vall Banc's portfolio in runoff (5.3% as of end-2019).

ESG

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 (WBI) have in our proprietary Sovereign Rating Model. Andorra has a high WBI ranking at 90.3 percentile, well above the 'BBB' median, reflecting strong institutional capacity and effective rule of law.

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 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.

- Macro: +1 notch, we have introduced a new positive notch adjustment 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.

RATING SENSITIVITIES

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

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.

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.

Public Finances: Higher confidence in improvement in debt sustainability, for example through a significant narrowing of the primary deficit or successful diversification of financing sources that would substantially lengthen the average debt maturity.

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.

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 (29 June 2020), which projects eurozone growth at -8% in 2020 and 4.5% 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.

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 (3.8% 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			PF
Andorra	LT IDR	BBB+ Rating Outlook Stable	Affirmed	BE Ot St

ENTITY/DEBT	RATING			PF
●	ST IDR	F2	Affirmed	F2
●	Country Ceiling	A+	Affirmed	A+

[VIEW ADDITIONAL RATING DETAILS](#)

FITCH RATINGS ANALYSTS

Malgorzata Glowacka

Associate Director

Primary Rating Analyst

+49 69 768076 279

Fitch Ratings – a branch of Fitch Ratings Ireland Limited Neue Mainzer Strasse 46 -
50 Frankfurt am Main D-60311

Greg Kiss

Director

Secondary Rating Analyst

+49 69 768076 198

Stephen Schwartz

Senior Director

Committee Chairperson

+852 2263 9938

MEDIA CONTACTS

Peter Fitzpatrick

London

+44 20 3530 1103

peter.fitzpatrick@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

[Sovereign Rating Criteria \(pub. 27 Apr 2020\) \(including rating assumption sensitivity\)](#)

Country Ceilings Criteria (pub. 01 Jul 2020)

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, v1.2.0 ([1](#))

Macro-Prudential Indicator Model, v1.4.0 ([1](#))

Sovereign Rating Model, v3.12.0 ([1](#))

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Andorra

EU Issued

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Sovereigns Europe Andorra



