



## RATING ACTION COMMENTARY

# Fitch Affirms Andorra at 'BBB+'; Outlook Stable

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Fitch Ratings - Frankfurt am Main - 23 Jul 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 record of fiscal prudence. These positive credit features are set against risks to the economy and sovereign balance sheet from a very large banking sector and the absence of a lender-of-last-resort.

The Stable Outlook balances the government's progress in addressing refinancing risks and balance of payments data gaps, against downside risk from the evolution of the coronavirus and its effect on the tourism sector and public finances.

We expect real GDP growth to recover by 4.5% in 2021 and 5.2% in 2022 following a deep contraction of 12.0% in 2020 (by far the sharpest in western Europe and almost twice as deep as the 'BBB' median of 6.5%). Economic performance in 1Q21 was better than expected (but still recorded a 9.3% contraction year-on-year), given a strong expansion in construction (23.4% year-on-year) that offset some of the weakness in tourism-related sectors amid a very poor ski season and limited tourist arrivals due to mobility restrictions at EU borders. However, tourist arrivals recovered quickly in 2Q21, reaching their 2019 levels in June as the second wave of Covid-19 infections subsided and mobility restrictions were eased.

Unemployment remains contained, supported by the extension of government short-term work allowances, a high share of seasonal foreign workers and a lowering of the government's foreign worker quotas. Consequently, the unemployment rate continued to decline from its peak of 3.3% in 3Q20 to 3.1% in 1Q21, compared with 1.9% a year earlier. At the same time, the return of tourists allowed for a roll-back of government support, with the number of employees on the wage subsidy scheme dropping to 70 in July 2021 from a peak of around 9,000 at the start of the pandemic.

Our projections remain subject to downside risk owing to the uncertain trajectory of the pandemic and new variants. As a service-oriented economy (more than 80% of gross value added), Andorra is highly susceptible to the pandemic.

The very weak ski season earlier this year has put a strain on the public finances on both the revenue and expenditure side. We expect the general government deficit to widen to 3.4% of GDP in 2021 from 1.1% of GDP in 2020, still within the projected 'BBB' median at 5.5% of GDP. The relative resilience of Andorra's public finance amid the pandemic stems from buoyant tax receipts from foreign trade and the reallocation of capital to current spending. We expect the recovery in GDP growth and decline in fiscal support to underpin a return of the general government fiscal balance to positive territory in 2023.

We expect the gross general government debt (GGGD)-to-GDP ratio to increase temporarily to 60.3% of GDP in 2021, based on our assumption that the government may pre-finance borrowing needs with a EUR300 million (11.4% of GDP) Eurobond. This would reflect a rise in the debt ratio from 46.7% in 2020 and 35.4% in 2019 (against the 2020 'BBB' median of 54.2%). We expect the debt ratio to stabilise in 2022 and to begin gradually declining in 2023. Our projections also assume crystallisation of around EUR29.2 million (1.2% of GDP) in contingent liabilities from the government's loan guarantee scheme (so-called soft loan programme), split equally between 2021 and 2022. Until now, EUR146 million (5.9% of GDP) of loans have been guaranteed by the government out of the total EUR230 million available in the soft loan programme.

The government has accelerated plans to broaden its financing sources amid the pandemic shock. It placed a first-time international bond issuance in April 2021. The 10-year EUR500 million (18.9% of GDP) Eurobond with a 1.25% coupon was heavily oversubscribed and attracted a geographically diverse investor base. This access to global capital markets has helped reduce government refinancing risks by reducing funding reliance on relatively short-term domestic bank sources (the average maturity of public debt has been extended to 5.1 years from 2.2 years without an increase in average financing costs). In preparation for the April Eurobond issuance, the government also established access to other external funding sources, such as loans and private placements with foreign banks and multinational financial institutions.

After achieving IMF membership in October 2020, Andorra took steps towards filling in data gaps by publishing a snapshot of its external current account statistics. According to these figures, the economy recorded a large current account surplus in 2019 of 18% of GDP, much more favourable than the -0.4% of GDP 'BBB' median in that year. The surplus was driven in equal parts by a positive balance on the trade of goods and services and the primary balance, reflecting Andorra's large tourism and banking sectors. Andorra also produced an initial estimate of its international investment position (IIP), at 210% of GDP in 2019. If confirmed, Andorra's net IIP position would stand well above the current 'BBB' median of -40% of GDP.

We believe the Andorran banking sector has adequate headroom to withstand pressures on revenues and asset quality due to the pandemic, although the latter is subject to risks over the medium term from a scenario of a weaker economic recovery. The banking sector maintains satisfactory capital buffers above the regulatory thresholds, with the sector average phased-in common equity Tier 1 ratio at 18% as of end-2020. There is a stable customer deposit base that comfortably funds the loan book (the sector's average loan-to-deposit ratio was 55.0% at end-2020) and liquidity positions are conservatively managed (sector liquidity coverage ratio at 187.1% on average at end-2020).

The banking sector's impaired loan ratio of 7.3% at the end-2020 (4.4% excluding Vall Banc's portfolio in run-off) declined from 8.6% at the end-2019 but remains relatively high by European standards. 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 the Andorran economy. At end-2020, stage 2 loans stood at 13.2% of the loan book. However, the sector's high loan impairment reserve coverages and a 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**

### **FACTORS THAT COULD, INDIVIDUALLY OR COLLECTIVELY, LEAD TO NEGATIVE RATING ACTION/DOWNGRADE:**

- Macro: Severe and prolonged economic weakness, for example due to a resurgence of the pandemic that would lead to a renewed contraction in the tourism sector.
- Public Finances: Failure to stabilise general government debt/GDP, for example due to another severe shock to the tourism sector, or materialisation of contingent liabilities, for example relating to Covid-19 loan guarantees.

### **FACTORS THAT COULD, INDIVIDUALLY OR COLLECTIVELY, LEAD TO POSITIVE RATING ACTION/UPGRADE:**

- Public Finances: Confidence in the debt-to-GDP falling faster than Fitch's baseline forecasts, for example through a sustained economic recovery.
- External Finances: Greater confidence in the strength of the external position, evidenced, for example, in the construction and publication of additional balance of payments and IIP 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.

### **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.

In accordance with its rating criteria, Fitch's sovereign rating committee decided not to adopt the score indicated by the SRM as the starting point for its analysis. The SRM output has migrated to 'BBB' from 'BBB+', but in our view this is a temporary deterioration. Consequently, the committee decided to adopt 'BBB+' as the starting point for its analysis, unchanged from the prior committee.

Fitch's sovereign rating committee adjusted the output from the adopted SRM score 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 leaves the economy and the sovereign balance sheet vulnerable to shocks.

- 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**

The global economy performs in line with Fitch's latest Global Economic Outlook published on 15 June 2021. Eurozone GDP is expected to expand 5% this year. GDP growth is then expected to be 4.5% in 2022 and 2.2% in 2023.

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 or only partially 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, the IMF 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 are:

- CAB: Data quality is improving as we now have 2019 data following the recent publication and we have supplemented this with estimates for 2020 provided by the IMF;
- FDI: assumed to be 0% apart from the 2019 year, for which the statistics are available, given that high volatility of FDI flows;
- External interest service: assumed to be the same as the 'BBB' median projections for the three-year average centred on 2020 (4.6% 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. As Andorra has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

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. As Andorra has a percentile rank above 50 for the respective Governance Indicators, this has a positive impact on the credit profile.

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. As Andorra has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

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. As Andorra has track record of 20+ years without a restructuring of public debt and captured in our SRM variable, this has a positive impact on the credit profile.

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, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

## RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Andorra	LT IDR	BBB+ Rating Outlook Stable	Affirmed	BBB+ Rating Outlook Stable
●	ST IDR	F2	Affirmed	F2
●	Country Ceiling	A+	Affirmed	A+
● senior unsecured	LT	BBB+	Affirmed	BBB+

[VIEW ADDITIONAL RATING DETAILS](#)

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

Country Ceiling Model, v1.7.2 (1)

Debt Dynamics Model, v1.2.1 (1)

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

Sovereign Rating Model, v3.12.2 (1)

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Andorra

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Sovereigns

Europe

Andorra

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