Andorran Banking
Associació de Bancs Andorrans

THE ROLE OF BANKING IN ANDORRA'S SOCIO-ECONOMIC GROWTH

Andorran Banking Observatory

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Having its own financial system is essential for the development of a country's economy

Banks are institutions which, in a free market economy, help to connect savings and investment and therefore play a crucial role in a country's economic development. On the one hand, they have the ability to stimulate and hold a society's wealth, and on the other hand, distribute it among the individuals and enterprises that need it for their **spending and investment** activities. They also play a role in providing public administrations with the financing they need to implement the development plans for their **territories**. In addition to its financing activities, the banking sector is also responsible for providing the secure payment systems that people use in their daily lives, starting with credit cards. Although these services are often undervalued by users, they require constant investments in technology and resources to keep up with their rapid evolution towards sophistication, digitalisation and efficiency. An agile payment system is also essential to allow money to move rapidly. This means that transactions can be settled faster, which frees up money more quickly for reinvestment in new projects.

Banking is to the economy what the bloodstream is to the human body: banks help money flow through the market, they help to **channel this money efficiently**, and to find productive projects with economic and social potential. One of the causes of the economic difficulties experienced by developing countries is precisely the lack of banking pervasiveness and the difficulty their citizens have in accessing banking services, which results in many delays in starting businesses and undertaking projects.

The role played by Andorran banks in the country's economy is even more paradigmatic. The importance of the private banking sector, which attracts a great deal of funds from foreign customers, is such that when compared with any other territory of a similar size, has a much greater **liquidity surplus**, which has clearly helped and continues to aid in the development of the country's economic and social fabric. Also worth noting is just how important it is for a country to have its own financial system: if the decision-making centres of the banks that operate in a country are located far away, it is very difficult for them to understand the idiosyncrasies of a society and its financing needs. As a result, the local economy loses momentum.

This support for a country's prosperity becomes even more evident in situations of crisis like the one we are currently experiencing. Faced with the public health crisis caused by COVID-19, the five Andorran banks, under the umbrella of the Andorran Banking Association, have worked in collaboration with the government to implement measures to **minimise the effects** of the pandemic on the country's economy.

A banking sector that has grown stronger in the face of current challenges

Before discussing the details of how Andorran banks contribute to the country's socio-economic development, let's analyse the current banking sector in Andorra and the challenges it faces. Obviously, the sweeping changes that the Principality's banks have undergone mean that the way banking is done today is completely different to the way it was done just ten years ago.

On the one hand, the international regulatory context that followed the 2008 financial crisis led to the disappearance of a part of the historical private banking business, which was very profitable, and has forced banks to **change their business model** in order to implement all the regulations and adopt the same standards as other European banks in terms of regulation, supervision and transparency. The process was completed faster by Andorran banks than by other European banks, despite the fact that they are much smaller institutions, and has resulted in a situation where banks now must have many more resources at their disposal that are not dedicated to customer services but rather to internal controls. Tighter regulation means that more capital is needed to perform the same activity so banks -not only in Andorra but throughout Europe- are now less profitable from the shareholder's point of view. However, there are positive aspects to the new regulatory requirements: banks are stronger, with the ability to absorb losses and to prevent a problem at one bank from having a negative impact on other economic sectors.

Another factor that has influenced the change in the business model is the reduction in margins in private banking but, above all, in commercial banking, due to low interest rates and heavy competition, both locally and internationally.

Negative interest rates, a situation that has persisted since 2016, are a clear cause of lower yields for banks. This is a monetary policy of the European Central Bank which aims to reduce the cost of credit to stimulate the economy but is particularly detrimental to banks. On the one hand, not only because deposits no longer provide a return, but also because banks now have to pay to deposit their customers' money on the international interbank market. On the other hand, negative interest rates reduce the margins on bank loans. This situation, which the banks believe will continue for several years to come, affects commercial banking more directly than private banking. This is because in private banking capital is not raised to lend it but to manage and invest it, in exchange for fees that are not linked to current interest rates. Therefore, as long as the bank is able to secure favourable conditions in the financial asset market, it can continue to operate without being affected by lax monetary policies.

Despite the change in their business model, the assets managed by Andorran banks have grown by 80% since 2010

But the challenges faced by the banking sector in the 21st century do not end there. The banking sector must adapt to **new customer demands** and the emergence of new technological companies offering digital financial services. Users of banking services are now much more digitally savvy, more demanding and less patient, and this is pushing banks to develop technologies to meet these demands for immediacy, agility and personalised service at any time of the day. Twenty years ago, private banking customers had total confidence in the bank because their investment knowledge was generally limited, but now they are much more demanding in terms of products, returns and the type of service they want to receive.

In a society where the digital maturity of the population is on the rise and where cash is used less and less, customers, whether private individuals, enterprises or wealth management firms, need increasingly sophisticated digital tools: electronic banking, mobile banking, payment gateways, online sales solutions, increasingly innovative payment systems, digital wallet management applications, etc. All of this is accelerating the technological transformation of banks, which is in turn helping to move society towards digitalisation, and making it necessary to have more open core banking architectures that can accommodate the integration of new applications.

Some of these new applications are coming from new technological competitors who are specialising in business segments that until recently had been controlled by banks, especially those related to payment services, and traditional institutions must find a **way to intelligently co-exist** with them. The Andorran financial market believes it is a mistake to pretend they do not exist, but also that it is wrong to fight against them, because banks will always provide a more personalised service with more added value than the so-called *fintechs*. Banks need to cooperate with these new companies, either by investing in technology in order to offer the same service or by forming partnerships to provide these services through them, viewing it as an opportunity to gain efficiency and agility. One example of this are the payment applications offered by the major mobile device brands (Apple Pay, Google Pay, etc.), which require banks to make significant investments in order to partner with these operators and be able to integrate their services. What is clear is that these new competitors are also changing the business model, which is moving from a traditionally well-integrated banking sector to a much more decentralised service scenario.

Resilience, personalised services and high liquidity and solvency ratios are the keys to adapting to the new scenario

All of these changes in recent years have caused Andorran banks to lose customers, but also to seek new ones, thanks in large part to the **international expansion** that many institutions have undertaken. For these banks, the business focus is not limited to Andorra; it is global. In fact, despite the unfavourable environment, in the last ten years assets under management have increased from approximately €27.5 billion in 2010 to €50 billion in 2020.

Over the same period of time, however, earnings have been reduced by almost half (from €200 million in 2010 to €112 million in 2019). This loss of profitability has been offset by refining internal management, with major investments in the digitalisation of processes to reduce service costs, the restructuring of non-performing businesses and **charging fees for certain services that had previously been complimentary**. On this last point, there is a trend in this direction among European banks which is necessary in order to stay profitable, despite the difficulties involved in making customers see that these services provide added value. With the change of their business model, banks operating in the market have become more highly specialised, each one focusing on the areas where it has the most experience, and this has had a positive impact on effectiveness and quality.

Above all, though, the reason why the Andorran banking sector of today is still going strong, with the same number of banks, and that none of them has had to merge with others in order to survive is largely due to its ability to offer a **differentiating service with added value** for each consumer segment. The sector is well aware that a company that merely seeks to survive through cost savings has no future. The key is to give customers what they need, make them feel special, provide them with quality services and offer them cutting-edge tools.

In fact, one of the strengths of the Andorran banking sector is its **resilience and ability to overcome difficulties**, in line with the rest of the country's economic sectors. With more than 85 years of experience, the banking sector's knowledge of the business and the valuable service it provides have allowed it to maintain its share of the private banking business and to expand in international markets where it has positioned itself for future growth. In commercial banking, Andorran banks are on a par with other European banks, as they provide the same services at similar or lower prices, with substantially better customer service.

Finally, another differentiating factor of the Andorran banking sector is that it is made up of small, efficiently managed institutions, with **solvency and liquidity figures that are higher** than those of the banking systems in neighbouring countries.

The high level of solvency maintained by Andorran banks is largely explained by the need to compensate for the absence of a **lender of last resort**, i.e. the fact that they do not have access to the European Central Bank funding.

Essential role in stimulating the economy

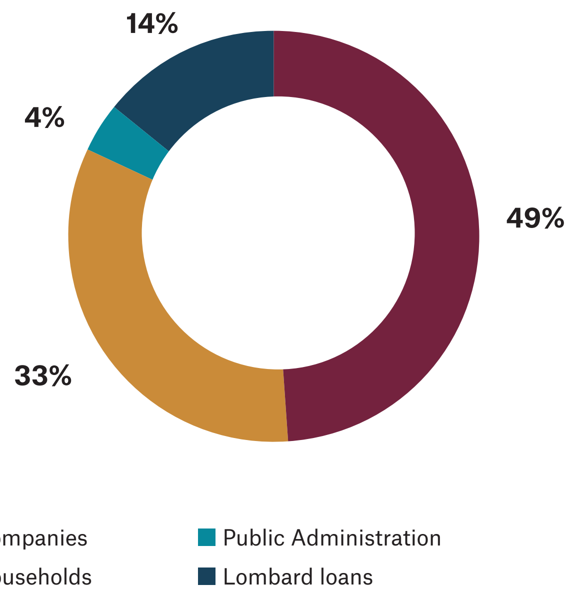
Throughout its history, the Andorran banking sector has played an essential role in driving and accompanying the country's economic development. Andorra's historical development would certainly not have been the same without the banks' financing capabilities, which have been enhanced precisely because they have not limited themselves to remaining local entities serving local customers but have developed a private segment that has attracted a large number of international customers.

Banking contributes to economic development on three levels: **by financing the real economy, by creating skilled jobs, and through the taxation of the sector**. The sector contributes to the domestic economy through the loans granted to individuals and enterprises to fund their purchases and undertake new projects and investments, while at the same time boosting the real estate sector through mortgage loans. Furthermore, until 2010 banks were the exclusive sources of financing for the Public Administration, having contributed in this way to the country's major investments.

The banks' investment loan volume is **€6 billion**, approximately twelve times the government's budget, which were injected into the country's economy to create jobs, projects and prosperity. It is worth noting that credit investment is still a line of business for banks, who are well aware that the demand for financing of interesting and viable projects is in their best interest. The reason that the numbers are not higher for this line of business is not because of a liquidity shortage but because the market is very small compared to the assets they manage, and loans are granted based on strict risk assessments to ensure that they can be repaid, since the resources are not owned by the bank. In addition, the new regulatory framework has led to stricter lending regulations. The distinguishing feature is that since it is a very small market the banks know their customers well and this allows them to gain a thorough understanding of their customers' businesses and financing needs.

Of the €6 billion in credit investment, **49% are business loans**, 33% are household loans and 4% are loans to the Public Administration. The remaining 14% are Lombard loans, a type of loan granted by private banks to invest in securities. In the last four years, the total number of mortgages issued by the country's five banks has grown by 34%, totalling 711 in 2019. The pandemic caused a 10% drop in the total number of mortgages, compared to a 2% increase in volume in 2019. By the end of 2020, 640 mortgages had been granted, for an amount of €286 million, the vast majority of which (85%) were residential mortgages.

Credit investment

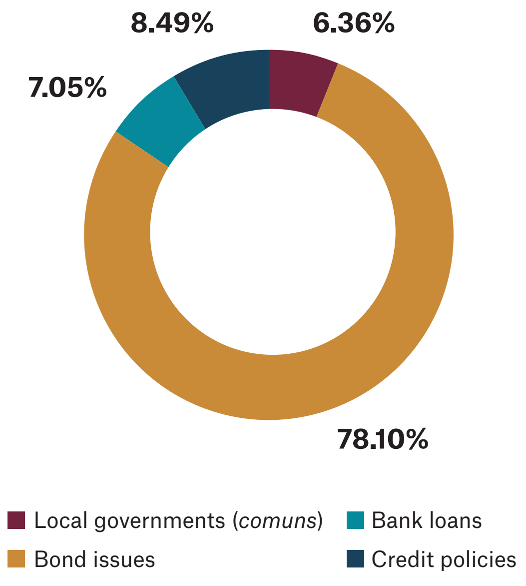


The diversification of Andorra's indebtedness has reduced the loan underwritten by the country's banks to 51.8%

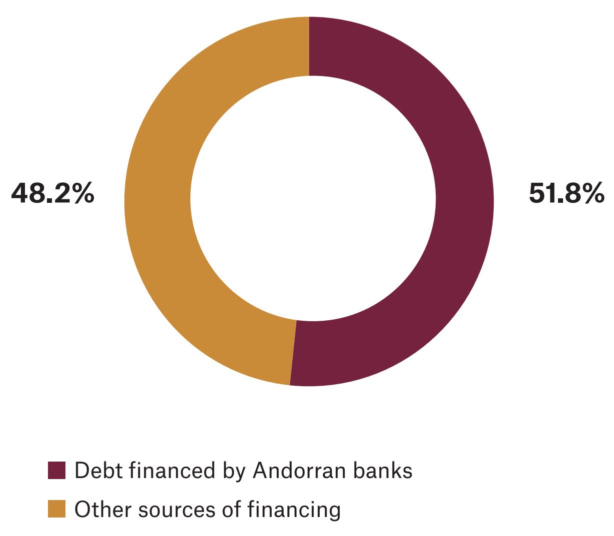
Until ten years ago, the public administration was financed exclusively by the country's banks. In 2010, following the recommendations of the rating agencies that assess the financial health of states, the government began to diversify its public debt, first with issues of government bonds open to the private sector, which are also channelled through domestic banks and, more recently -in mid-2020- with its first bond issues on the international market and loan agreements with foreign institutions. The Andorran banking sector views this as a positive measure, not because it does not have sufficient liquidity and solvency to assume all the debt, but because it is healthy for a country to have more financing options, especially in the current crisis situation brought about by COVID-19. The banks take a positive view of this management of public finances and the fact that low debt levels are being maintained, which represents a guarantee for the banks and the country's solvency.

As a result, despite the pandemic Andorra's debt is still at a very reasonable level: at the end of 2019 it represented 35.4% of Gross Domestic Product (GDP), and the forecast for the 2020 year-end is to reach 43.76%. €75 million of the €1,178 million in total debt refers to the local governments (*comuns*) which are financed entirely by Andorran banks, and the rest is government debt, mostly in the form of bond issues by the Principality (€920 million), although there are also €83 million in bank loans and €100 million in lines of credit. As a result of this diversification of the debt, the country's banks currently finance **51.8% of Andorra's debt**, including loans, credit facilities and bond issues in the Principality's own portfolio. It should also be highlighted that September saw the first issue of Andorran bonds, worth a total of €180 million, earmarked for the international market that were very well received by international investors.

Public debt



Public debt financed by Andorran banks



The financial sector represents almost 20% of GDP and provides direct employment to 5% of the country's workforce

Aside from the direct contributions to the country's economic system, the impact of the Andorran financial sector on society goes much further. The sector represents almost **20% of the GDP and provides direct, qualified and permanent employment to 5% of the country's total salaried workers**, with above-average salaries and a skilled and qualified workforce. Moreover, despite the change in the business model in recent years, not only has the number of professionals working in the financial sector not declined; it is 7% higher than in 2010 and if we count both Andorran and foreign professionals, the number jumps to 50%. Both the purchasing power of the workforce and the so-called "financial tourism" that Andorran banking has historically generated have had a positive impact on the rest of the country's economic sectors.

The banking sector also contributes to societal improvements by reinvesting part of its profits in the form of social support. As a profitable sector with the means to dedicate resources to the social welfare of the community and to ensure a prosperous and sustainable environment, it is something that has always been part of its DNA. In addition to contributing to the projects and causes that are important to Andorran society and ensuring that there are opportunities for everyone, the sector also strives to minimise the environmental impact of its business, to ensure that it operates in a socially responsible manner, and to channel its customers' capital towards sustainable projects, in order to hand down a society that is at least a little better than it was before.

Banking as part of the solution to the public health crisis

Since the outbreak of the public health crisis brought on by COVID-19, the Andorran banking sector has acted as a facilitator to ensure Andorra's stability. When the public health crisis broke out, the Andorran banking sector was in the process of transforming and bolstering its solvency. That allowed the banks to support their customers as they confronted the difficulties of the pandemic, guaranteeing a prosperous environment and a better society.

First of all, the banks have worked with the government on the process of implementing measures to tackle the consequences of the crisis, processing soft **loans and a moratoria on capital and interest payments**, which made it possible to freeze customers' loan repayments for up to 12 months. Compared to other countries, these measures were implemented expeditiously to ensure that the aid reached the beneficiaries quickly. And all five banks, on their own initiative, supplemented these measures with sectoral moratoriums with a slightly wider scope to reach more struggling families and businesses. The government-backed guarantee of soft loans was critical in avoiding any impact on the regulations and provisioning system of the financial sector. The Executive's effort to help the real economy of the Principality by extending the different measures will be an essential element of the post-pandemic recovery.

By 30 November 2020, the banks had arranged more than 1,800 **soft loans for a total of €134 million**, all guaranteed by the Government. Regarding the moratorium on monthly loan and mortgage payments, as of that date some **350 requests had been processed for loans totalling an outstanding balance of nearly €122 million**. Of that amount, 20% are legislative moratoria, i.e., the ones approved under the government's law, while the remaining 80% are sectoral moratoriums offered by the banks as a supplemental measure.

The banks have made themselves available to the authorities since the beginning of the crisis. Considering their knowledge of international markets and the regulations governing them, they -along with other institutions- helped to implement new measures that had previously not existed in the country, such as temporary workforce adjustment plans. They also granted a new €50 million credit facility to the Government and coordinated a new public debt offering to meet the immediate needs of the pandemic. In addition, the banks made a **direct contribution of €430,000** through the solidarity accounts that were opened to channel donations from the public and took other specific actions to provide resources for infrastructures such as *stop-labs* (*Covid testing*), all of which contributed to stabilising the crisis.

Banks have applied a moratoria to the repayment of loans totalling an outstanding balance of €122 million

Internally, Andorran banks have not made use of the temporary workforce adjustment plans or laid off any employees and most of them have not requested the rent reductions decreed by the government. Thus, whilst the environment is complex, an attempt has been made to avoid taking measures that could be detrimental to workers in the sector or to the country's public resources.

As soon as the pandemic was declared, banks were quick to take the necessary actions to preserve the health and safety of both staff and customers. Thanks to the digitalisation process that began years ago and which brought about a profound internal transformation, it has been possible **to continue working remotely** to serve the customer and satisfy its needs. Once the period of total confinement was over, employees were offered maximum flexibility and the possibility of continuing to work from home. Today, a high percentage of employees continue to work remotely, having all the necessary resources to do so at their disposal, and banking operations have not suffered as a result. However, what the pandemic has shown is that just a few years ago it would not have been possible to keep the business running remotely and that the digitalisation process must be accelerated, not only in the banking sector but in all sectors of the economy.

What is clear from the sector's involvement in alleviating some of the burden which the State has had to bear in order to minimise the economic consequences of the pandemic is that **banking has been and is part of the solution to this crisis**, unlike other global economic crises where the financial sector was actually part of the problem. The sector is demonstrating that it can work with one voice and in collaboration with the government to mitigate the impact of the pandemic and contribute to the country's recovery process. The sector views this facilitating role as completely logical and necessary, because if the country has a problem, so does the financial sector. When faced with a crisis such as this one, the banking sector could not conceive of a more appropriate response than understanding and generosity.

The future challenges Andorran banks are facing

The economic crisis caused by the pandemic has highlighted the importance of having our own banking sector which is on the side of the country and its people, to provide liquidity and facilitate solutions. The stability of the Andorran financial sector is therefore of paramount importance, not only for economic growth and development but also to guarantee the sustainability and sovereignty of Andorra.

In order to maintain the stability and competitiveness of the banking sector, and thus continue to make a positive contribution to the Andorran economy, the sector needs to **gain access to the European Central Bank's liquidity provision** so that it can act as the system's lender of last resort. This, in addition to facilitating access to financing, would improve the international perception of the Andorran market and allow it to compete at arm's length with the rest of Europe's banks.

The need to compete on an equal footing in the European environment takes on even greater importance in the context of the Association's Agreement with the European Union. In this scenario, and even if extended transitional periods were established to moderate the initial impact of this integration, European institutions could start operating in Andorra immediately, since the "freedom to provide services" would allow them to offer and provide financial services without having an establishment.

Access to the European Central Bank's liquidity provision is a necessity, but it is not enough. In the negotiation of the Association's Agreement, it must be ensured that the Andorran financial system has the requisite mechanisms to continue to be competitive in the new environment. One of the elements needed to preserve the stability of the sector is the **exclusion of banking activity from the EU passporting system** as long as it is not possible to guarantee adequate competitive capacity vis-à-vis the large European banking institutions.

The Andorran banking sector has been able to anticipate and adapt to changes throughout its more than eighty-year history. It is a sector that is prepared and qualified to turn challenges into opportunities, even in the worst scenarios. **The sustainability and diversity of the Andorran financial system** is not only a *sine qua non* for the economic prosperity of Andorra, but also an essential condition for social stability and for the economic and political sovereignty of our country. This is an area where the **Andorran Banking Association** is working to help make the Andorran banking system more competitive, with the aim of ensuring that it can continue to be an economic and social driving force in our country.

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