Fitch downgrades 8 Spanish regions

- **In its resolution of the watch negative status, which had been awarded on 9 March 2012, Fitch downgraded eight Spanish regions and affirmed one region.** All outlooks are now negative. After the downgrades, the long-term ratings for the normal-status regions are in the BBB category, while the Basque Country is rated A+ and thus above the sovereign owing to its special status providing the region with a greater degree of financial autonomy. According to Fitch, the actions reflect the economic and market environment in Spain resulting in depressed fiscal revenues and structural fiscal deficits in the regions. Considerable effort will be required to turn the situation around, magnified by the difficulties of accessing long-term funding.

FITCH: RATING CHANGES

Region	Old Fitch rating	New Fitch rating
Andalucía	A wn	BBB n
Asturias	A wn	BBB+ n
Basque Country	AA wn	A+ n
Canary Islands	A wn	BBB n
Cantabria	A wn	BBB+ n
Castilla-La Mancha	BBB- wn	BBB- n
Catalunya	BBB- wn	BBB+ n
Madrid	A wn	A- n

Source: Fitch, UniCredit Research

- **In its review, Fitch focused on the following factors:**

  – **Under-funding of the regions by the state in 2011:** This contributed to a worsening of the regional budgetary results. Large extraordinary expenditures that should have been recorded in previous years also played a role.

  – **The introduction of the Budgetary Stability and Financial Sustainability Law.** This is a positive step from the central government to enforce budgetary discipline in the regions, by establishing severe penalties for non-compliance and allowing the central government to intervene directly in the regions' finances if they fail to meet budget deficit targets. The ratings also factor in the significant efforts made by the regions to meet budgetary goals.

  – **The approval of the economic and financial plans of all regions, except for Asturias, on 17 May.** The non-approval of Asturias' plan has not yet given Fitch any cause for concern. Most of the plans show a projected decline in current revenue for 2012 and a strong recovery in 2013. However, despite reducing operating expenditure, most regions expect to report a negative operating balance this year. Although many austerity measures have been introduced, to date only limited structural reforms have been implemented to address the sustainability of basic services funded by the regions (in particular, healthcare and education).

  – **Significant financing pressure in 2012:** A large proportion of debt falls due in 2H12. Fitch understands that the central government is actively seeking ways to ease liquidity for the regions and is also looking at setting up instruments to facilitate long-term funding at more affordable rates.

RATINGS OF SPANISH REGIONS

Autonomous Community	Moody's	S&P	Fitch
Andalucía	Baa2 n	BBB n	BBB n
Aragón	--	BBB n	--
Asturias	--	--	BBB+ n
Baleares	--	BBB- n	--
Canarias	--	BBB+ n	BBB n
Cantabria	--	--	BBB+ n
Castilla La Mancha	Ba2 n	--	BBB- n
Castilla y León	A3 n	--	--
Catalunya	Ba1 n	BBB- n	BBB- n
Extremadura	Baa1 n	--	--
Galicia	A3 n	BBB+ n	--
La Rioja	--	--	--
Madrid	A3 n	BBB+ n	A- n
Murcia	Ba1 n	--	BBB n
Navarra	--	A n	--
País Vasco	A2 n	A n	A+ n
Valencia	Ba3 n	BB n	--
Kingdom of Spain	**A3 n**	**BBB+ n**	**A n**

Source: Rating agencies

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Control and monitoring by the central government

Fitch notes that the intrinsic rating of the weakest regions could be lower than their actual rating, but the control and monitoring measures introduced by the central government and the fact that debt servicing is a priority expenditure item, all help to support at least an investment-grade rating. The central government has indicated that some mechanisms supporting liquidity and, more particularly allowing regions to pay their debt coming due in 2012, will soon be introduced. Fitch will continue to monitor the current willingness and the ability of the central government to support and control regional finances. Any weakening of this support would result in further negative rating actions.

The more severe downgrades of the regions of Andalucía, Murcia and the Canary Islands reflect their large refinancing pressures in 2012 and their weaker than national average economic environment, which will delay their financial recovery. The downgrade of Madrid to A- from A is in part due to the significant increase in debt incurred in 2010-12, which Fitch believes is very unlikely to be reduced, as well as the negative economic environment in Spain. Madrid is now rated one notch below the sovereign.

Outlook

The negative outlooks reflect the general market environment in Spain and the still weak economic and fiscal context for the regions, heightening the execution risk of implementing the austerity measures. Non-compliance with economic and financial plans, as well as increasing liquidity pressure, could lead to further negative rating action. The central government has presented its 2012 budget, and the reduction in funding for the regions led to current revenues being revised downwards, equal to an average 1.3% decline compared with 2011. Despite reductions in operating expenditure, most of the autonomous communities expect to report negative operating balances in 2012, which would represent about 6.2% of their combined operating revenues. Fitch believes that negative operating balances may persist over the medium term. **The agency takes some comfort from the recent legislation, which makes debt servicing a priority over commercial obligations.** Complying with the 2012 deficit target of 1.5% is still challenging, but may be attainable, thanks to a reduction in capital investment rather than as a result of successfully implementing structural reforms. According to Fitch, this will also depend on the willingness of central government to implement the Budgetary Stability and Financial Sustainability Law.

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