MOODY'S
INVESTORS SERVICE

CREDIT OPINION
20 April 2018

Update

Rate this Research

RATINGS

Instituto de Credito Oficial

Domicile	Spain
Long Term Debt	Baa1
Type	Senior Unsecured - Fgn Curr
Outlook	Stable
Long Term Deposit	Not Assigned

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

Analyst Contacts

Alberto Postigo 34-91-768-8230
VP-Sr Credit Officer
alberto.postigoperez@moodys.com

Maria Cabanyes 34-91-768-8214
Senior Vice President
maria.cabanyes@moodys.com

Carola Schuler 49-69-70730-766
Managing Director - Banking
carola.schuler@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

Instituto de Credito Oficial

Update following sovereign upgrade

Summary

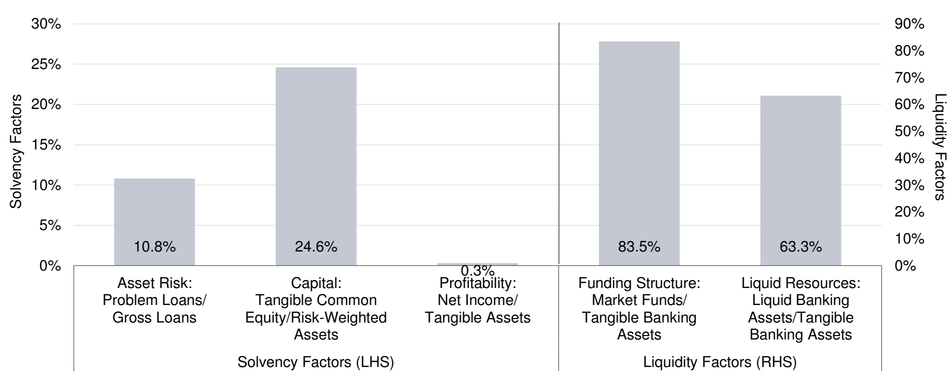
On 17 April 2018, we upgraded Instituto de Credito Oficial's (ICO) long-term senior debt ratings to Baa1 from Baa2 with a stable outlook. The short-term debt ratings were affirmed at Prime-2. The rating action was prompted by the upgrade of Spain's government bond rating to Baa1 from Baa2 on 13 April 2018.

ICO's Baa1/Prime-2 senior debt ratings with a stable outlook reflect a combination of the following inputs: (1) the Government of Spain's rating of Baa1/Prime-2, with a stable outlook; (2) the very high interdependence between ICO and the Spanish government; and (3) the guarantee extended by the Spanish government over ICO's liabilities.

ICO's level of dependence on the Spanish government is very high. ICO fulfils a public-policy role, acting as a specialised lending institution and the state's financial agency. The institution is primarily focused on the promotion of economic growth and the development of selected economic activities.

ICO, which is 100% owned by the Spanish government, reports to the Ministry of Economy and Finance, and is regulated as a financial institution by the Bank of Spain. As detailed in Spanish law (Royal Decree 706/1999 of 30 April 1999), ICO benefits from a direct, explicit, irrevocable and unconditional state guarantee on its liabilities. Given the statutory nature of this guarantee, any modification would need to be passed by law.

Exhibit 1
Rating Scorecard - Key financial ratios



Source: Moody's Financial Metrics

Credit strengths

» ICO's statutory ownership and full guarantee of its liabilities by the Government of Spain

» ICO's franchise value is underpinned by its role as the government's specialised lending institution and financial agency

» Strong capitalisation supported by Spanish government's capital injections

» ICO's liquidity profile benefits from relatively low market funding risk and reduced refinancing needs

Credit challenges

» Large borrower concentration constrains ICO's stand-alone risk profile

» Weak recurrent earnings, with the release of provisions supporting net profits

» Recent improvement in its problem loan ratio, although it remains above the system average

Rating outlook

The outlook on ICO's ratings is stable, in line with the outlook on Spain's sovereign rating.

Factors that could lead to an upgrade

An upgrade of the Spanish government's rating would lead to an upgrade of ICO's ratings.

Factors that could lead to a downgrade

A downgrade of the Spanish government's rating would also lead to a downgrade of ICO's ratings.

Key indicators

Exhibit 2

Instituto de Credito Oficial (Consolidated Financials) [1]

	12-16[2]	12-15[2]	12-14[2]	12-13[3]	12-12[3]	CAGR/Avg.[4]
Total Assets (EUR million)	48,865	62,185	84,009	102,220	115,248	-19.3[5]
Total Assets (USD million)	51,541	67,551	101,655	140,854	151,941	-23.7[5]
Tangible Common Equity (EUR million)	5,548	5,254	4,906	4,513	4,052	8.2[5]
Tangible Common Equity (USD million)	5,851	5,707	5,936	6,218	5,342	2.3[5]
Problem Loans / Gross Loans (%)	10.8	10.2	8.2	5.8	2.8	7.6[6]
Tangible Common Equity / Risk Weighted Assets (%)	24.6	26.0	18.5	13.6	10.5	23.1[7]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	22.5	23.4	24.7	26.0	22.8	23.9[6]
Net Interest Margin (%)	0.0	0.1	0.6	0.7	0.7	0.4[6]
PPI / Average RWA (%)	-0.5	0.2	2.0	2.2	2.2	0.5[7]
Net Income / Tangible Assets (%)	0.6	0.1	0.1	0.1	0.1	0.2[6]
Cost / Income Ratio (%)	-66.7	52.9	7.1	4.8	4.9	0.6[6]
Market Funds / Tangible Banking Assets (%)	83.5	86.7	87.8	90.2	85.7	86.8[6]
Liquid Banking Assets / Tangible Banking Assets (%)	63.3	60.3	61.2	62.1	56.2	60.6[6]
Gross Loans / Due to Customers (%)	1,504.0	1,619.8	778.7	1,632.0	572.3	1,221.3[6]

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] May include rounding differences due to scale of reported amounts [5] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime [6] Simple average of periods presented for the latest accounting regime. [7] Simple average of Basel III periods presented

Source: Moody's Financial Metrics

Profile

ICO is the Spanish government's specialised lending institution and the country's central financial agency. ICO takes on various important functions in the Spanish economy aimed at ensuring access to financing.

ICO's activities can be split into two business lines: (1) as the financial agency of the Spanish government, whereby the institution offers financing in accordance with government instructions; and (2) as a development bank or specialised credit institution. Financing for this second category is carried out either through (1) mediation loans, which comprised 36% of ICO's total assets as of the end of September 2017, and in which borrower risk is transferred to cooperating banks, which act as intermediaries for distribution; or (2) direct loans, which comprised 26% of total assets as of the end of September 2017 and entail higher credit risk because they expose the institution to end-borrower risk. For further details on ICO's activities, see the Company Profile on its issuer page on www.moodys.com.

ICO's total assets stood at €45 billion as of September 2017, representing around 1.8% of Spain's total banking system assets. As a consequence of its countercyclical role, ICO's balance sheet grew significantly throughout the past economic crisis, peaking in March 2013 at €117 billion, and reducing since then. In addition, the European Central Bank's (ECB) targeted long-term refinancing operations have affected ICO's lending activity and accelerated the shrinkage in ICO's balance sheet. This is a result of the relative substitutability between the ECB and ICO lending, and the more favourable pricing conditions of the ECB funds. This substitution effect is primarily concentrated in mediation loans for time horizons below four years.

Detailed credit considerations

Large borrower concentration constrains ICO's stand-alone risk profile

One key element constraining ICO's risk positioning is its large borrower concentration, especially in Spanish financial institutions, as part of its lending activity through mediation loans, and Spanish regions. There are however some mitigants to the concentration risk, namely: (1) a large part of the institution's exposure to Spanish regions is guaranteed by the Spanish government; and (2) mediation loans granted since 2016 are secured by the loan granted to the final borrower (i.e. ICO has recourse to the final borrower in case of default of the intermediary bank). The institution is exempted from the fulfilment of regulatory limits on borrower concentrations.

ICO's direct lending business exposes the bank to the default of the end borrower, while in case of indirect lending, the credit risk of the final borrower is typically borne by Spanish financial institutions that are ICO's counterparties. Therefore, this exposes ICO to the risk of default of these financial institutions.

ICO's exposure to market risk, which is primarily linked to interest-rate risk and foreign-currency risk, is low and hedged through derivatives. The bank's foreign-currency risk arises because ICO obtains funding in international capital markets in currencies other than the euro. The institution does not engage in any speculative trading activities, thereby limiting market risk, and has a negligible equity exposure. Fixed-income securities amounted to 26% of total assets as of the end of September 2017, mostly comprising exposures to the Spanish sovereign and Spanish credit institutions.

Recent improvement in ICO's problem loan ratio, although it remains above the system average

We only consider direct loans in ICO's problem loan ratio, but not mediation loans which are granted to financial institutions and reported as loans to credit institutions. Mediation loans have historically shown negligible arrears levels.

ICO's asset quality started recovering at a later stage than the Spanish banking system, which since 2014 has witnessed a decline in the problem loan ratio (on average terms), parallel with the improvement in the Spanish economy. This difference in trend has been mainly caused by the sharp deleveraging that the bank initiated in 2013 (i.e. denominator effect), driving ICO's problem loan ratio above the system average, while traditionally, it has been placed well below the system average. We, nevertheless, acknowledge a material improvement in the bank's asset quality in the first nine months of 2017, with problem loans declining by almost one-third and the problem loan ratio reducing to 8.3% from 10.8% over this period. The difference in asset-quality performance relative to the system is consequence of ICO's problem-loan concentration in a relatively small number of large single names.

Despite the release of provisions (see the Profitability section below), the ratio of loan-loss reserves to problem loans stood at a high 122% as of the end of September 2017, which compared very favourably with the system average of 58% as of the same date.

We expect ICO's asset-quality indicators to continue with the improving trend started in 2017 owing to more favourable operating conditions in Spain. Nevertheless, the extent and pace of improvement will be influenced by the work-out process of a relatively small number of large problem loans.

Strong capitalisation, supported by Spanish government's capital injections

As a financial institution regulated by the Bank of Spain, ICO is subject to bank's regulatory capital requirements. Its regulatory capital ratios remain very solid, with its Common Equity Tier 1 capital ratio reaching 32.6% as of the end of September 2017. ICO's regulatory capital has hardly been affected by the introduction of Basel III capital rules, given the quality of its capital base, mostly comprising capital and reserves, and the negligible impact of capital deductions.

The Spanish government is committed to preserving ICO's strong capitalisation. This commitment has been particularly important in years of strong asset growth and has allowed ICO to report strong capital ratios following several capital injections by the Spanish government. More recently, capital increases have aimed to align ICO's regulatory capital ratios with those of its European peers and ensure adequate capitalisation to face any upcoming stress episode.

Weak recurrent earnings, with the release of provisions supporting net profits

Given the characteristics of its business model, ICO's profitability has traditionally displayed modest diversification, with the bulk of its operating revenue stemming from net interest income. Driven by the low interest rate environment, the amortisation of high-yielding operations granted in 2012 and the low level of lending activity, this earnings source is on a sharp declining trend, with a drop of 74% in 2016 from that in 2015, and even turned negative in the first nine months of 2017.

In the context of low recurrent earnings, the bank's profitability is being supported by the release of loss provisions. Such release was very significant in 2016, amounting to €554 million and stemming primarily from the new provisioning framework introduced in the last quarter of 2016. The release of provisions has been less significant in the first nine months of 2017, but still material at €127 million, allowing the bank to report a net profit of €67 million despite a negative pre-provision income of €32 million.

Disregarding the positive impact of the release of provisions, ICO typically displays weak profitability because, given its public service role, profit maximisation is not its primary goal. Therefore, its profitability indicators have traditionally been modest compared with the Spanish banking system average. For 2018, we expect the bank's profitability to remain weak and, to a large extent, supported by the release of provisions.

ICO's liquidity profile benefits from good market access and reduced refinancing needs

Despite ICO's status as a predominantly wholesale-funded institution, the institution displays adequate liquidity management, underpinned by (1) conservative management of the maturity profile of its market funds, (2) a good match between its assets and liabilities, and (3) the availability of liquid assets on its balance sheet.

The risk of market funding interruption has materially declined compared with that in past stress episodes, benefitting from the improvement in market access for the Government of Spain, and we expect the favorable conditions to remain broadly unchanged over the next 12 months. ICO's market issuance strategy is shifting towards increased international diversification and the use of shorter maturity instruments from exceptionally long maturities used in recent years, with the aim of matching asset and liability maturities. ICO foresees a negative net market issuance activity in 2018, as has also been the case in 2016 and 2017, in light of the expected decline in the business volume.

In addition to capital market funds as of the end of September 2017, ICO's funding structure comprised €11.6 billion of interbank funds (30% of total funding), primarily borrowed from the European Investment Bank. ICO's resort to loans from multilateral institutions allows the bank to diversify its funding sources and benefit from lower funding costs, especially to borrow at long maturities.

Ratings

Exhibit 3

Category	Moody's Rating
INSTITUTO DE CREDITO OFICIAL	
Outlook	Stable
Bkd Senior Unsecured	Baa1
Bkd Commercial Paper -Dom Curr	P-2
Bkd Other Short Term -Dom Curr	(P)P-2

Source: Moody's Investors Service

REPORT NUMBER 1121176

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

MOODY'S INVESTORS SERVICE