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Research Update:

Instituto de Credito Oficial Assigned 'A/A-1' Ratings In Line With Ratings On Spain; Outlook Stable

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Overview

- We consider Spain's financial agency Instituto de Crédito Oficial (ICO) to be a government-related entity, with an almost certain likelihood of receiving support from the government in case of financial distress.
- We therefore equalize our long-term rating on ICO with that on Spain.
- We are assigning our 'A/A-1' long- and short-term ratings on ICO.
- The stable outlook mirrors that on Spain.

Rating Action

On Sept. 26, 2019, S&P Global Ratings assigned its 'A/A-1' long- and short-term issuer credit ratings to Spanish state-owned financial agency Instituto de Crédito Oficial (ICO). The outlook is stable.

Rationale

The rating reflects that we equalize our long-term rating on ICO with that on Spain (unsolicited A/Stable/A-1), given our opinion that there is an almost certain likelihood that the Spanish government would provide timely and sufficient extraordinary support to ICO in the event of financial distress.

We consider ICO to be a government-related entity. Our expectation of ICO receiving sufficient and timely government support stems from our view of its:

- Integral link with the Spanish government. Endowed with a special public status, ICO functions, in our view, as the central government's financial arm, and is fully owned and controlled by it. In turn, the government has historically granted ICO strong support in the form of a wide direct, irrevocable, and unconditional guarantee covering all of ICO's debt; and
- Critical role as an entity created especially to carry out key financial aspects of national economic policies on behalf of the Spanish government.

The government mandates that ICO provide financial backing for small and midsize enterprises (SMEs). To this end, ICO channels loans (mediation loans) to the Spanish banking system, which then lends these funds to SMEs. Each bank absorbs the credit risk linked to the final SME loan. ICO also offers long-term lending to companies operating in sectors of national interest and manages financial instruments linked to export promotion, as well as concessionary lending programs for developing countries on the government's behalf.

ICO would also be mandated to grant financial support if it became necessary in the event of natural disasters or economic crises.

ICO's role was reinforced in 2012, when Spain's central government set up mechanisms to support the liquidity of local and regional governments. In this regard, ICO plays a key role as a payment agent of the regional governments' financing fund, which covers regional debt maturities and budgetary deficits. As of June 30, 2019, ICO managed financing funds worth €193 billion on behalf of the state (but off ICO's balance sheet), of which €179 billion corresponds to the regional financing fund. We believe ICO has a competitive advantage compared with private entities in terms of managing these funds because of its relationship with the central government.

ICO's balance sheet has continued to shrink, reaching €36 billion in December 2018 from a peak of €115 billion in 2012. The decline reflects ICO's countercyclical role, expanding credit concession during the height of Spain's economic crisis, and returning to previous levels as credit conditions improved. We think ICO's balance sheet size is close to the historical minimum as the economy starts to decelerate. In our view, ICO is following this policy in order to be ready for any potential future economic shocks.

ICO's nonperforming loan (NPL) ratios have moderated to about 6.3% as of Dec. 30, 2018 from 9% in 2017. ICO's coverage ratios remain comfortably above 100% of NPLs, which may lead to some future upside to its accounts if recoveries exceed expectations.

In contrast with commercial banks, ICO's strategy is not to maximize profit, but to fulfill its public service mandate. Consequently, its profitability remains low, although positive. In 2018, ICO posted pre-tax profits of €113 million compared with €146 million the year before. These results were largely driven by the release of credit provisions, owing to the bank's conservative risk management culture that led it to overprovision in previous years. On the revenue side, a stable contributor across years have been fee income generated from management of the regional financing fund. ICO's solvency ratio has continued to increase, reaching 40.5% at year-end 2018 from 32.9% in 2017.

Following legal reforms enacted on Oct. 2, 2015, four independent members (out of 10) were added to ICO's board, following the EU's recommendations on good governance of similar institutions. The four independent members of the board come from the public sector, academia, and some of Spain's largest credit institutions. In our view, their participation on the board may help strengthen internal lending practices and decision-making procedures without compromising the central government's ability to control ICO and direct its strategy.

Outlook

The stable outlook on ICO mirrors that on Spain.

If we raised our rating on Spain, we would likely take the same action on ICO, assuming we continued to have the same opinion of ICO's critical role for and integral link with Spain's government.

If we lowered our rating on Spain, we would lower our rating on ICO. We could also lower the rating on ICO if we assessed that its role for and link with the Spanish government and, in turn, the likelihood of central government support, had weakened, indicating a lower likelihood of extraordinary government support. This could be the case if the central government were to change ICO's special public status, withdraw capital from ICO, or stop guaranteeing its debt. We see this scenario as very remote.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Sovereign Risk Indicators, July 11, 2019. An interactive version is also available at http://www.spratings.com/sri
- Spain Ratings Raised To 'A/A-1' From 'A-/A-2' On Economic Resilience; Outlook Stable, Sept. 20, 2019

Ratings List

New Rating	
Instituto de Credito Oficial	
Issuer Credit Rating	A/Stable/A-1