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CREDIT OPINION

25 March 2024

Update

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Instituto de Credito Oficial

Update following rating action

Summary

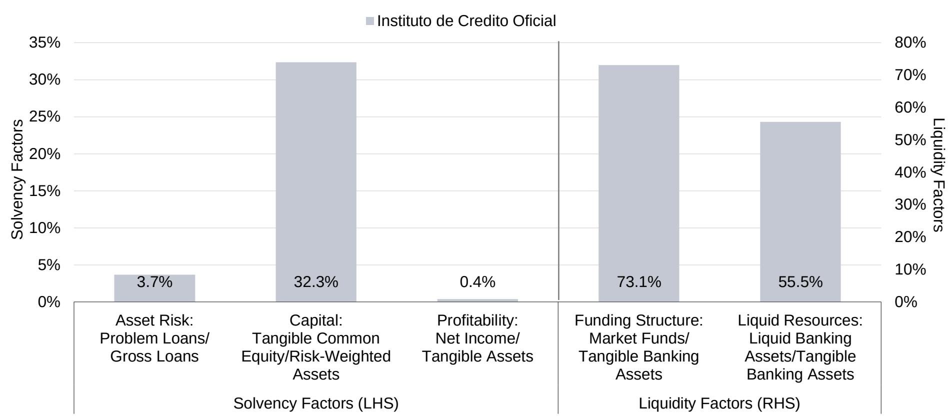
On 19 March, we affirmed Instituto de Credito Oficial's (ICO) Baa1/P-2 senior unsecured debt ratings and changed the issuer outlook to positive.

ICO's Baa1/P-2 senior unsecured debt ratings are based on the guarantee extended by the Government of Spain (Baa1/(P)P-2 stable) over ICO's liabilities. In light of this guarantee, the bank's ratings qualify for a credit substitution approach that is based on a full-risk transfer to the guarantor. This approach also takes into account ICO's very high level of dependence on the Spanish government. ICO fulfills 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 select economic activities.

The issuer outlook on ICO is positive, reflecting the positive outlook on the Government of Spain as a guarantor.

ICO is 100% owned by the Spanish government. It reports to the Ministry for Digital Transformation and of Civil Service and is regulated as a financial institution by the Bank of Spain. Per 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
As of year-end 2022



Source: Moody's Ratings

RATINGS

Instituto de Credito Oficial

Domicile	Madrid, Spain
Long Term CRR	Not Assigned
Long Term Debt	Baa1
Type	Senior Unsecured - Fgn Curr
Outlook	Not Assigned
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.

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Credit strengths

» Statutory ownership and full guarantee of its liabilities by the Spanish government

» Strong capitalisation, supported by the Spanish government's capital injections

» Credit risk in the loan book mitigated by sizeable loan loss reserves

Credit challenges

» Large borrower concentration

» Modest recurrent profitability, underpinned by its public policy role

Outlook

The issuer outlook on ICO is positive, reflecting the positive outlook on Spain's sovereign as a guarantor.

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 lead to a downgrade of ICO's ratings. Furthermore, the suppression of the guarantee or reduced commitment from the Spanish government could lead to a downgrade of ICO's ratings. However, these developments are unlikely because of the nature of the bank and its function (see the "Profile" section below).

Key indicators

Exhibit 2

Instituto de Credito Oficial (Consolidated Financials) [1]

	12-22[2]	12-21[2]	12-20[2]	12-19[2]	12-18[2]	CAGR/Avg.[3]
Total Assets (EUR Million)	29,802.9	37,790.4	34,406.9	31,841.7	36,251.0	(4.8)[4]
Total Assets (USD Million)	31,807.1	42,820.6	42,098.7	35,742.2	41,440.2	(6.4)[4]
Tangible Common Equity (EUR Million)	5,435.4	5,410.6	5,339.4	5,366.3	5,313.4	0.6[4]
Tangible Common Equity (USD Million)	5,800.9	6,130.8	6,533.1	6,023.7	6,073.9	(1.1)[4]
Problem Loans / Gross Loans (%)	3.5	3.6	3.9	4.4	5.8	4.2[5]
Tangible Common Equity / Risk Weighted Assets (%)	32.3	33.6	32.1	33.8	31.9	32.7[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	6.2	6.8	7.9	8.1	10.3	7.9[5]
Net Interest Margin (%)	0.4	0.3	0.1	-0.1	-0.2	0.1[5]
PPI / Average RWA (%)	1.1	1.0	0.4	0.3	0.1	0.6[6]
Net Income / Tangible Assets (%)	0.5	0.4	0.2	0.3	0.2	0.3[5]
Cost / Income Ratio (%)	22.0	23.1	43.6	43.3	71.8	40.8[5]
Market Funds / Tangible Banking Assets (%)	73.1	79.4	78.5	79.8	79.9	78.1[5]
Liquid Banking Assets / Tangible Banking Assets (%)	55.5	65.6	61.5	62.6	65.2	62.1[5]
Gross Loans / Due to Customers (%)	2941.8	1346.1	855.7	1581.1	1104.1	1565.8[5]

[1] All figures and ratios are adjusted using Moody's standard adjustments. [2] Basel III - fully loaded or transitional phase-in; IFRS. [3] May include rounding differences because of the scale of reported amounts. [4] Compound annual growth rate (%) based on the periods for the latest accounting regime. [5] Simple average of periods for the latest accounting regime. [6] Simple average of Basel III periods.

Sources: Moody's Ratings and company filings

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: the financial agency of the Spanish government, whereby the institution offers financing in accordance with government instructions; and a development bank or specialised credit institution. Financing for this second category is carried out through either second-floor loans, which constituted 22% of ICO's total assets as of year-end 2023 and in which borrower risk is transferred to cooperating banks (which also act as intermediaries for distribution); or direct loans, which constituted 39% of ICO's total assets as of the same date and entail higher credit risk because they expose the institution to end-borrower risk. In addition to direct loans, ICO makes direct investment in corporates through the purchase of corporate debt instruments (3.6% of total assets as of year-end 2023). For further details on ICO's activities, see the company profile on its issuer page on www.moodys.com.

ICO's total assets were €32 billion as of year-end 2023, representing around 1% of Spain's total domestic banking system assets. ICO's financing activity has remained subdued in recent years, particularly in terms of second-floor loans given the competing funds provided by the European Central Bank (ECB) to Spanish banks through its TLTRO program. In turn, ICO has played a more active role as the financial agent of the public credit facilities granted to support enterprises. Combined with other funds and instruments that ICO manages on behalf of the state, the total volume of assets managed by ICO as of year-end 2023 amounted to €323 billion, a 50% increase from year-end 2019.

Going forward, we expect ICO to benefit from more favorable financing dynamics, boosted by the end of the ECB's TLTRO program and the approval in October 2023 of a €40 billion fund under the European Union Next Generation and Repower programs, which will be channelled through ICO into the Spanish economy.

Detailed credit considerations

Risk profile characterised by large borrower concentration and sizable loan loss reserves

We calculate ICO's problem loan ratio taken into consideration just direct loans, which expose the bank to the default of the end borrower. Second-floor loans, which ICO extends to financial institutions, have historically shown null arrear levels.

ICO's asset quality stays at comparable levels with the Spanish system average, despite its role as development bank. Excluding loans granted to the public sector and individuals, on which ICO does not engage, the bank's reported problem loan ratio was 4.2% as of December 2023, in line with the system average of 4.1% (as of 3Q 2023, latest data available). As we anticipated, the problem loan ratio increased in 2H 2023 amid deteriorating credit conditions and inflationary pressure on corporate margins, deteriorating from 3.4% as of June 2023.

Asset risk is mitigated by ICO's very high loan loss coverage ratio (calculated as loan loss reserves/problem loans). Despite the release of provisions (see the section on profitability below), the ratio was a high 128% as of the end of 2023.

One key element constraining ICO's standalone risk position is its large borrower concentration, especially in Spanish financial institutions, as part of its lending activity through second-floor loans[1]. This concentration risk in financial institutions is mitigated by the fact that second-floor loans granted since 2016 are secured by the loan granted to the final borrower (that is, ICO has recourse to the final borrower in case of a default by the intermediary bank). The institution is exempted from the fulfilment of regulatory limits on borrower concentrations.

ICO's exposure to market risk, which is primarily linked with interest-rate risk and foreign-currency risk, is low and hedged through derivatives. Foreign-currency risk at ICO arises because the bank 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 small exposure to equity instruments (around 4.5% of total assets as of year-end 2022). Fixed-income securities amounted to 27% of total assets as of the end of December 2022, mainly comprising Spanish sovereign bonds.

Strong capitalisation, supported by the Spanish government's capital injections

As a financial institution regulated by the Bank of Spain, ICO is subject to the central bank's regulatory capital requirements. The bank's capital ratios remain very solid, with its Common Equity Tier 1 capital ratio at 26.5% as of December 2023, significantly above the minimum requirement set by the regulator at 17.05%. Our preferred capital metric, tangible common equity ratio, also was at a very high 32.3% as of year-end 2022. ICO has a simple capital base, mostly comprising capital and reserves, and with a 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. Capital increases have also aimed at aligning ICO's regulatory capital ratios with those of its European peers and ensuring adequate capitalisation to face any upcoming stress episode. Given the banks' solid capitalisation, ICO has not received any public capital injection since 2016.

Modest recurrent profitability, underpinned by its public policy role

ICO's profitability is modest because, given its public role, profit maximisation is not its primary goal. In recent years, the bank's return on assets ratio (net income/tangible assets) has remained below 0.5%.

Given the characteristics of its business model, the bulk of ICO's operating revenue stems from net interest income (NII) and fee and commission (F&C) income, with the latter being largely prescribed by the Spanish government who establishes the fee paid to ICO as manager of public funds. The bank's NII started to benefit from the increase in interest rates in 2022, with higher yields stemming from the bank's loan book and financial investments, while funding costs grew more modestly. ICO's average annual cost of market debt issuances, net of accounting hedges, even declined to 0.51% in 2022 from 0.59% in 2021. ICO's NII needs to be read in conjunction with the gains recorded from foreign-exchange income, which correspond to fair value adjustments on hedging instruments that ICO uses to cover foreign-currency risk on its funding operations. The strong increase in NII and a moderate increase in net F&C income drove a 13% growth in net revenue in 2022 to €234 million.

On top of this recovery on operating revenue, ICO's bottom-line earnings have benefited for a number of years from the release of loan loss provisions — with 2020 being the only exception when the provisions grew to cover potential deterioration in asset quality from the pandemic — driven by the improvement in asset quality. The release was nevertheless less significant in 2022, as the most substantial decline in nonperforming loans was achieved in preceding years. Still ICO released €23.5 million loan loss provisions in 2022, which contributed to an increase in reported net profit to €147 million from €140 million in 2021.

High structural reliance on market funding, with market access supported by the state's guarantee

ICO is not allowed by law to collect customer deposits, which translates into a high reliance on market funding. The bank has adequate liquidity management, underpinned by conservative management of the maturity profile of its market funds, a good match between its assets and liabilities, and the availability of liquid assets on its balance sheet. The Spanish government unconditionally and irrevocably guarantees all funds borrowed by ICO, which translates into a high correlation between both issuers' ability to tap funding markets.

In common with the Spanish sovereign, ICO has broad access to a diversified international investor base. Funds raised in capital markets amounted to €7.3 billion in 2023, which the bank expects to reduce to €5-6 billion in 2024. ICO has been very active in promoting green and social bonds, having issued €1 billion of such instruments annually since 2019 and a total €7.5 billion (15 issuances) since ICO launched its first social bond in 2015.

In addition to capital market funds as of year-end 2022, ICO's funding structure comprised €4.7 billion of interbank funds (22% of total funding) and €3.0 billion of ECB's TLTRO III funds (14% of total funding) as of year-end 2022. Interbank funds are primarily borrowed from the European Investment Bank (Aaa stable). ICO's access to loans from multilateral institutions has allowed the bank to diversify its funding sources and benefit from lower funding costs, especially to borrow at long maturities.

ESG considerations

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

In terms of social considerations, ICO's role as the government's financial agency makes it susceptible to politically and socially motivated decisions that could affect its financial profile. ICO is focused on the promotion of economic growth and the development of select economic activities according to the government's mandate. It also provides finance in accordance with government instructions for victims of serious economic crises, natural disasters and similar situations. Given its public policy role, profit maximisation is not the bank's primary goal, and its profitability has traditionally been modest compared with the Spanish banking system. Likewise, policy considerations can lead the bank to issue riskier loans, impairing its asset risk. Nevertheless, those loans granted according to the government's mandate, which are not in accordance with ICO's underwriting criteria, benefit from a public guarantee. Other social risks in terms of customer relations or change in consumer preferences, which are generally relevant for the banking industry, are less important for ICO, because the bank does not engage in retail activities.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

Ratings

Exhibit 3

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

Source: Moody's Ratings

Endnotes

1 In second-floor loans the credit risks of the final borrower is borne by Spanish financial institutions that are ICO's counterparties.

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Americas	1-212-553-1653
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Japan	81-3-5408-4100
EMEA	44-20-7772-5454

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