

Research Update:

Instituto de Credito Oficial Outlook Revised To Negative After Same Action On Spain; 'A/A-1' Ratings Affirmed

September 22, 2020

Overview

- We revised our outlook on Spain to negative from stable on Sept. 18, 2020.
- We equalize our ratings on Instituto de Credito Oficial (ICO) with those on Spain since we consider that ICO has an integral link with and a critical role for the Spanish government.
- We are revising our outlook on ICO to negative from stable and affirming our 'A/A-1' ratings.

Rating Action

On Sept. 22, 2020, S&P Global Ratings revised its outlook on Spanish state-owned financial institution Instituto de Credito Oficial (ICO) to negative from stable. At the same time, we affirmed our 'A/A-1' long- and short-term ratings on ICO.

Rationale

We revised our outlook on ICO because we equalize our ratings on ICO with those on Spain (unsolicited, A/Negative/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 ICO's:

- 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 specifically to carry out key financial aspects of national

PRIMARY CREDIT ANALYST

Marta Saenz
Madrid
+ 34 91 788 7231
marta.saenz
@spglobal.com

SECONDARY CONTACTS

Miriam Fernandez, CFA
Madrid
(34) 91-788-7232
Miriam.Fernandez
@spglobal.com

Alejandro Rodriguez Anglada
Madrid
(34) 91-788-7233
alejandro.rodriguez.anglada
@spglobal.com

economic policies on behalf of the Spanish government.

ICO's mandate is to provide financial backing to small and midsize enterprises (SMEs) and, to a lesser extent, large corporations. To this end, ICO channels mediation loans to the Spanish banking system, which then lends these funds to companies. Each bank absorbs the credit risk arising from the final loan. ICO also offers direct 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. Therefore, ICO's role is critical during an economic crisis or other shocks.

As a response to the COVID-19 pandemic, the central government mandated ICO to manage and provide guarantees on its behalf and, in collaboration with Spanish financial institutions, to grant and preserve productivity and financial support to SMEs, self-employed, larger entities, and residential tenants. Providing these guarantees will have no credit implications for ICO's risk profile or financial accounts. ICO is only in charge of managing the program and acting as an intermediary with Spanish financial institutions, which are responsible for providing the loans. Ultimately, Spain's central government bears the risk of the guarantees.

Since March 2020, ICO has launched three specific guarantee lines, two totaling €140 billion to provide funding to enterprises and one of €1.2 billion to support Spanish tenants in financial stress. ICO has also expanded its financing line, established by the central government, to €400 million from €200 million to support tourism entities affected by the bankruptcy of Thomas Cook.

The largest guarantee line (up to €100 billion) set up by the central government, through ICO, to fight the consequences of COVID-19 for the Spanish economy was put in place on March 17, 2020. These guarantees are to be distributed to Spanish financial institutions according to their market share. The purpose of the line is to support entities that lend to SMEs and the self-employed (€67.5 billion) and larger entities (€25 billion), to guarantee issuances in alternative fixed-income markets (€4.5 billion), finance companies' acquisition of transport vehicles (€0.5 billion), and aid entities exposed to the tourism sector (€2.5 billion).

As of Aug. 31, 2020, the total amount guaranteed is €75.1 billion, of which 87% is for SMEs, with entities in Madrid receiving the highest portion (20%) followed by Catalonia (19%) and Andalusia (13%), reflecting their relative contributions to national GDP. The sectors benefitting the most from these guarantees are tourism, leisure, and culture, which accounted for 15% of the guarantees distributed, followed by construction (11%). The guarantee line has allowed a large number of enterprises to receive €98.8 billion to help fund their liquidity needs. On July 29, the central government announced another guarantee line of €40 billion to continue supporting the investments of SMES and the self-employed. The first tranche has a ceiling of €8 billion, of which €5 billion will be channeled to SMEs, and the rest to larger enterprises.

ICO has played a role in managing central government liquidity support to Spain's local and regional governments since 2012. In this regard, ICO acts as a payment agent of the regional governments' financing fund, which covers regional debt maturities and budgetary deficits. As of Dec. 31, 2019, ICO managed financing funds worth €26 billion on behalf of the state (but off ICO's balance sheet), corresponding to the regional financing fund. This central government support is crucial for the regions to finance their needs and deficits during 2020; as of June 30, 2020, about €31 billion of the regional liquidity facilities was used.

ICO is smaller than domestic banks, ranking number 15 by total assets in 2019. Its balance sheet continued to shrink in 2019, reaching €32 billion from a peak of €115 billion in 2012, and stood at €34 billion as of March 31, 2020. The decline reflects ICO's countercyclical role, whereby it expands credit concessions during an economic crisis and winds them down as credit conditions improve. We expect only a minor increase of ICO's balance sheet due to an increase in direct

funding activity. ICO's direct funding almost doubled as of June 30, 2020, compared with that as of June 2019, and now represents almost 60% of its credit activity. The remainder corresponds to mediation loans. COVID-19-related guarantee lines are not included because they have no impact on ICO's financial accounts.

Moreover, ICO's nonperforming loan (NPL) ratios declined to 4.4% at year-end 2019 from 6.3% in 2018, and its NPL coverage ratio remains comfortably above 123%. 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. ICO's return on equity stood at 2% in 2019 compared with the domestic banking system average of 6.4%.

ICO's funding profile is diversified, with about 60% of total liabilities in the form of bonds issued, 28% loans from the European Investment Bank, and 6% interbank funding. ICO's funding needs in 2020 are expected to reach about €5 billion. The central government initially increased ICO's debt capacity by €10 billion at the beginning of the pandemic. However, we do not expect ICO's debt to reach this limit since the central government's model to support Spanish entities focuses on guarantees. ICO's investment strategy includes social and green bonds. Last year, it issued its first green bond of €500 million and we expect it will issue another before the end of the year. In May 2020, ICO was the first Spanish entity to issue a COVID-19 social bond of €500 million, which was well received and has allowed ICO to reach a wider investor base.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Health and safety
- Strategy, execution, and monitoring

Outlook

The negative outlook reflects that on Spain.

Downside scenario

We could lower the ratings on ICO during the next 24 months if we took the same action on Spain. We could also lower the rating on ICO if we assess that its role and link with the Spanish government and, in turn, the likelihood of ongoing or extraordinary central government support, had weakened. 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, however.

Upside scenario

We could revise our outlook on ICO to stable in the next 24 months if we took the same action on Spain, assuming we still regard ICO as having a critical role for and integral link with Spain's government.

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 Of Credit Ratings, Feb. 16, 2011

Related Research

- Spain Outlook Revised To Negative From Stable On Mounting Fiscal And Structural Challenges; Affirmed At 'A/A-1', Sept. 18, 2020
- Instituto de Credito Oficial Assigned 'A/A-1' Ratings In Line With Ratings On Spain; Outlook Stable, Sept. 26, 2019

Ratings List

	To	From
Ratings Affirmed; Outlook Action		
Instituto de Credito Oficial		
Issuer Credit Rating	A/Negative/A-1	A/Stable/A-1
Ratings Affirmed		
Instituto de Credito Oficial		
Senior Unsecured	A	
Senior Unsecured	Ap	
Commercial Paper	A-1	

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