MOODY'S
INVESTORS SERVICE

Credit Opinion: Instituto de Crédito Oficial

Global Credit Research - 20 Oct 2011

Madrid, Spain

Ratings

Category	Moody's Rating
Outlook	Negative
Senior Unsecured -Dom Curr	A1
Bkd Commercial Paper -Dom Curr	P-1
Bkd Other Short Term -Fgn Curr	P-1
Bkd Other Short Term -Dom Curr	(P)P-1

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Key Indicators

Instituto de Credito Oficial (Consolidated Financials)[1]

	[2]**12-10**	[2]**12-09**	[2]**12-08**	[3]**12-07**	[3]**12-06**	**Avg.**
Total Assets (EUR million)	**77,866.2**	**60,356.2**	**52,969.9**	**39,883.0**	**32,322.9**	[4]**24.6**
Total Assets (USD million)	**104,460.9**	**86,595.6**	**73,630.6**	**58,311.1**	**42,622.7**	[4]**25.1**
Tangible Common Equity (EUR million)	**3,053.1**	**2,865.3**	**2,696.3**	**2,187.2**	**1,442.9**	[4]**20.6**
Tangible Common Equity (USD million)	**4,095.8**	**4,111.0**	**3,748.0**	**3,197.8**	**1,902.7**	[4]**21.1**
Net Interest Margin (%)	**0.5**	**0.3**	**0.6**	**0.6**	**0.6**	[5]**0.5**
PPI / Avg RWA (%)	**1.5**	**0.9**	**1.2**	**1.0**	**1.1**	[6]**1.2**
Net Income / Avg RWA (%)	**0.1**	**0.1**	**0.3**	**0.4**	**0.6**	[6]**0.2**
(Market Funds - Liquid Assets) / Total Assets (%)	**16.3**	**25.7**	**42.4**	**46.9**	**21.1**	[5]**30.5**
Core Deposits / Average Gross Loans (%)	**32.6**	**28.3**	**16.0**	**21.3**	**19.7**	[5]**23.6**
Tier 1 Ratio (%)	**11.3**	**11.5**	**10.2**	**10.2**	**--**	[6]**11.0**
Tangible Common Equity / RWA (%)	**11.4**	**11.6**	**10.5**	**10.6**	**9.1**	[6]**11.2**
Cost / Income Ratio (%)	**10.6**	**16.1**	**12.1**	**18.3**	**18.3**	[5]**15.1**
Problem Loans / Gross Loans (%)	**4.2**	**3.0**	**2.0**	**2.4**	**4.0**	[5]**3.1**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**24.8**	**17.4**	**12.8**	**13.8**	**24.2**	[5]**18.6**

Source: Moody's

[1] All ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Basel I; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel II & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

In accordance with Moody's rating methodology for government-related issuers (GRIs), the A1/Prime-1 debt ratings of Instituto de Credito Oficial (ICO) reflect a combination of the following inputs: (i) a baseline credit assessment (BCA); (ii) the A1 government bond rating of the Government of Spain; (iii) high dependence between ICO and the Government of Spain; and (iv) a very high likelihood of support in case of need. The debt and deposit ratings carry a negative outlook, in line with the outlook on Spain's sovereign rating.

Since ICO's liabilities are explicitly, irrevocably, directly and unconditionally guaranteed by the Government of Spain (A1/Prime-1, with a negative outlook), the BCA does not have any impact on the rating outcome and is therefore unpublished.

The level of dependence on the Spanish government is very high. ICO continues to fulfill an important public policy role, as it carries out a variety of important functions for the Spanish economy and acts as a specialised lending institution and the state's financial agency. The institution's purpose is primarily focused on the promotion of economic growth and on improving the distribution of national wealth in Spain.

ICO, which is 100% owned by the Government of Spain, 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 (Real Decreto 706/1999 of 30 April 1999), ICO benefits from a direct, explicit, irrevocable and unconditional state guarantee on its liabilities. Given the guarantee's statutory nature, any modification of it would need to be passed by law and there is little political pressure to remove or alter the Government of Spain's guarantee on ICO's obligations. It is also important to note that, under the current guarantee, any change in the ratings of the Government of Spain would be reflected in those of ICO.

Credit Strengths

- Statutory ownership and full guarantee of its liabilities by the Government of Spain

- Key public role as a specialised lending institution and as Spain's financial agency

- Adequate risk management and limited market risk appetite

- Funding and liquidity profile underpinned by the Government of Spain's guarantee

- Sound capitalisation

Credit Challenges

- Very high borrower risk concentrations

- Low profitability indicators, although consistent with its public policy role

- Historically high level of problem loans - albeit currently below the Spanish system`s average - mainly related to its public lending role

Rating Outlook

ICO's long-term debt ratings carry a negative outlook, in line with the outlook on Spain's sovereign rating.

What Could Change the Rating - Up

An upgrade of the Government of Spain's rating would lead to an upgrade of ICO's debt ratings.

What Could Change the Rating - Down

A termination of the government guarantee of ICO's liabilities would likely drive the rating downwards, although this appears unlikely in the foreseeable future. A downgrade of the Government of Spain's debt ratings would also lead to a downgrade of ICO's debt ratings.

Recent Events

On 19 October 2011, Moody's downgraded to A1 from Aa2 all the rated debt of Instituto de credito Oficial (ICO). Since ICO's liabilities are explicity, irrevocably, directly and unconditionally guaranteed by the government of Spain, the rating action is triggered by the two-notch downgrade of the sovereign's ratings. This rating action followed the downgrade of the Kingdom of Spain's government bond rating to A1 from Aa2.

On 29 July 2011, Moody's placed on review for downgrade the rated long-term debt of ICO, subsequent to the rating agency's announcement on 29 July 2011 that the Aa2 bond rating of the government of Spain was being placed on review for possible downgrade. The corresponding P-1 short-term rating was unaffected.

On 24 March 2011, Moody's concluded the review for possible downgrade, initiated on 20 December 2010, on Spanish banks that resulted in multiple rating actions, including downgrades by one or more notches of the senior debt and deposit ratings of 30 banks. The rating actions follows the downgrade of the debt rating of the Government of Spain and also reflects a reassessment of the extraordinary level of systemic support that had been embedded in many Spanish banks' ratings, limiting support to more normalised levels. The key drivers for the rating actions included (i) the combination of heightened financial pressures on the sovereign and many weak banks; (ii) declining systemic importance of many smaller and regional banks as the sector consolidates; and (iii) weakening future support environment for banks across Europe. The outlook on most banks' senior debt and deposit ratings remains negative, reflecting the negative outlook on the sovereign rating and the negative outlook on banks' standalone credit profiles, given the challenging operating environment in Spain. Some bank ratings remain under review, mainly because these banks are currently involved in consolidation efforts that may affect their standalone credit strength and the systemic support which might be available to them. Additional information can be found on the Special Comment "Key Drivers of Moody's Rating Action on Spanish Banks".

In particular, ICO's long-term debt rating was downgraded to Aa2 from Aa1, with a negative outlook. ICO's ratings are based on the unconditional and irrevocable guarantee from the Spanish Government.

Recent Results

At year-end 2010, ICO reported net interest income of EUR 353 million, a 79% year-on-year increase, largely explained by the 37% increase in gross loans and the positive impact of the low interest rate environment on funding costs during the H1 2010, which was not offset by the higher risk premiums paid in the last months of the year. ICO's sharp lending growth throughout 2010 illustrates the Spanish government's efforts to promote access to credit for the corporate and SME segments.

Efficiency indicators further strengthened, with a cost-to-income ratio of 10.6% as of year-end 2010, below the 16.1% reported, on the back of stronger recurrent revenue and good cost control systems. Capital ratios have remained broadly stable, with total capital and Tier 1 ratios of 12.39% and 11.29%, respectively as of year-end 2010, compared with 12.73% and 11.51% respectively, at year-end 2009.

ICO is currently immersed in its 2006-2012 strategic plan, which outlines the institution's long-term objectives. According to the plan, ICO is focused on fostering lending activity both in mediation (indirect lending, for example to small- and medium-sized enterprise) and in direct loans, with the ultimate aim of generating sufficient results to be self-funded in terms of capital from 2012 onwards. In addition, ICO intends to improve its efficiency levels above the European-peer average. ICO is keen in achieving these strategic objectives, especially in terms of preserving sound capital adequacy ratios, and with that purpose balance sheet growth in 2011 will stabilise relative to 2010.

DETAILED RATING CONSIDERATIONS

Detailed considerations for ICO's currently assigned ratings are as follows:

Qualitative Rating Factors

Factor 1: Franchise Value

Trend: Neutral

As ICO is the Government of Spain's sole specialised lending institution and the country's central financial agency, it possesses a dominant franchise in Spain. ICO takes on various important functions for the Spanish economy including acting as:

(i) the financial agency of the Spanish government. The government can instruct ICO to provide financing as it deems necessary; for example, in the event of a natural disaster. In such cases, the government takes on ICO's losses.

(ii) a development bank or specialised credit institution. As such, it provides medium and long- term financing to support and promote economic activities in Spain and abroad, which according to its statutes, "due to their social, cultural, innovating or environmental transcendence, merit their being fostered." Sectors specified by the government as priority targets include SMEs, domestic companies' investments abroad, regional development, renewable energy sources, research and development, telecommunications and other infrastructure and social housing. An important part (67% as of year-end 2010) of ICO's lending, particularly to SMEs, is carried out indirectly through Spanish commercial and savings banks (see `Asset Quality' below); and

(iii) ICO also manages three foreign policy instruments on a purely administrative basis (see Issuer Profile for details), mostly designed to promote Spanish exports and foster economic growth in less developed countries.

The institution has a nationwide presence through its indirect lending via the banks' branch network, which ensures a certain degree of geographical diversification. It also finances activities outside of Spain - through the support of Spanish companies abroad - although its international presence is very limited.

Factor 2: Risk Positioning

Trend: Neutral

In terms of risk management, ICO has structures and processes that are commensurate with the amount of risk undertaken. Credit risk is most notable in direct lending, while in the case of indirect lending, the borrower risk is transferred to commercial or savings banks (see "Asset Quality" section for details), which act as intermediaries for the distribution of ICO loans. Credit risk is therefore represented by Spanish financial institutions that are ICO counterparties.

One key element constraining the institution's risk positioning is its large borrower concentration, which is directly related to ICO's mandate in supporting Spain's economic growth and key strategic sectors. Moody's notes that the risks associated to the entity's high borrower concentration are partially mitigated by the sound credit profile (above A3 rating) of a large number of its top exposures.

ICO's market risk appetite is very low. The trading book solely comprises derivatives, which are in fact held for hedging purposes. Moreover, ICO does not engage in any speculative trading activities, thereby limiting market risk. The institution holds liquid fixed income securities for an amount of around 7% of its total assets as of year-end 2010, which are accounted under its held-to-maturity and available for sale investment portfolios. ICO's fixed income exposure is largely composed by Aaa paper of its own securitisation and sovereign debt (mostly from the Spanish government and the remaining of Aaa-rated countries).

Market risk is primarily linked to interest rate risks and foreign currency, as ICO obtains funding in international capital markets in currencies other than the euro. However, these risks are very limited and are monitored with set limits in place and are mostly hedged as well.

We believe that ICO has adequate liquidity management. It is a wholesale-funded institution, with market funds representing around 90% of total funding. Most of its market funding is long term, with senior bonds comprising more than 86% of total funding, while its reliance on short-term funding is very limited, which ICO uses to adjust its temporary liquidity needs. Since the beginning of the financial crisis and despite the downward rating migration of the Spanish government bond ratings (guarantor of ICO's liabilities), ICO has been able to tap the capital markets on a regular basis to raise long-term funding. Given the close interlinks between ICO and the Government of Spain, it is very likely that further pressures at the sovereign level will continue to translate into higher market risk premiums for ICO. For 2011, ICO has around EUR 20 billion of medium and long-term refinancing needs, of which almost 50% have been already addressed in Q1 2011. As a result, we do not expect that the entity will face major problems in meeting its funding requirements.

We also note that ICO's lending portfolio represents the bulk of its balance sheet, with a ratio of gross loans-to-total assets of 86% (including mediation and interbank loans) as of year-end 2010. Moreover, the institution's balance sheet is fairly well matched with regard to maturities of the assets and liabilities, enhancing its liquidity profile.

Factor 3: Regulatory Environment

Trend: Neutral

Refer to Moody's Banking System Outlook on Spain, published in December 2010, to obtain a detailed discussion on the regulatory environment.

Factor 4: Operating Environment

Trend: Neutral

This factor does not address bank-specific issues; instead it evaluates whether regulatory bodies are independent and credible, demonstrate enforcement powers and adhere to global standards of best practices for risk control. Refer to Moody's most recent Banking System Outlook on Spain, published in December 2010, to obtain a detailed discussion of the operating environment.

Quantitative Rating Factors

Factor 5: Profitability

Trend: Weakening

As owner of ICO, the Government of Spain does not require the institution to maximise profits given its public service role. As a result, ICO's profitability indicators have historically compared modestly with the average for Spanish commercial and savings banks. At year-end 2010, the net interest margin increased to 0.51% from 0.35% in 2009, and the pre-provision income as percentage of risk-weighted assets improved to 1.47% from 0.92% a year earlier. The very challenging operating environment in Spain has restricted access to funding for the corporate sector and therefore demand for ICO loans has increased since the beginning of the crisis.

Given its remit, ICO's profitability displays little diversification, with approximately 80% of its total revenue stemming from net interest income as of year-end 2010. Fee and commission income represented 11% of total revenue as of end-December 2010. Net income, as percentage of risk-weighted assets, was 0.11% by year-end 2010, broadly in line with year-end 2009's ratio.

Going forward and given ICO's plans to stabilise balance-sheet growth, we expect that the increased pressure on funding costs combined with the very weak operating environment in Spain will exert downward pressure on the entity's recurring profitability. Moreover, we expect further deterioration of ICO's bottom-line results, based on our forecasts that the level of loan loss provisions will continue to increase throughout 2011.

Factor 6: Liquidity

Trend: Neutral

Please see Risk Positioning section above.

Its liquidity profile is additionally enhanced by a 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.

In addition, ICO retains on its balance sheet EUR 14.865 billion of bonds that were issued through the securitization fund "ICO-Mediación II AyT" in July 2010, that could be repo'ed at the ECB providing an additional liquidity buffer in case of need.

Factor 7: Capital Adequacy

Trend: Neutral

In its capacity as a financial institution regulated by the Bank of Spain, ICO is obliged to fulfill the central bank's regulatory capital requirements. At year-end 2010, the institution presented sound solvency levels, with Total Capital and Tier 1 ratios of 12.39% and 11.29%, respectively, which were broadly in line with the ratios reported at year-end 2009.

The Spanish government is committed to preserving ICO's strong capitalisation, establishing by law that the institution's regulatory capital ratio will not be able to fall below 9.5%. This fact is particularly important taking into consideration the deterioration in ICO's capital ratios in the past due to strong asset growth, and which were restored thanks to several capital increases made by the Spanish government. In 2010, the Spanish government made a EUR 140 million capital increase and for 2011 it has committed further capital injections amounting to EUR 340 million, of which EUR 170 million have already been provided.

Factor 8: Efficiency

Trend: Neutral

ICO's efficiency indicators have improved over the last few years, with a cost-to-income ratio of 10.62% as of end-December 2010, compared with 16.12% a year earlier. This improvement reflects the institution's efforts to contain its operating costs as well as by the positive trend in revenues. We also note that the good efficiency indicators are derived from its lack of a branch network and its strong commitment to continue improving efficiency levels included in its long-term strategic plan.

A greater effort in containing costs should help to maintain current efficiency levels. That said, we believe that it will be challenging for ICO to achieve significant efficiency gains going forward, in light of our expectation of weaker revenue generation capacity.

Factor 9: Asset Quality

Trend: Weakening

ICO's problem-loan ratio deteriorated to 4.23% at year-end 2010, compared with 3.03% in 2009. ICO's asset quality indicators have traditionally been relatively higher than the Spanish system average, as is expected of a public policy institution. However, in the context of the very weak economic environment and negative credit trends in Spain, the problem-loan ratio compares favourably with the Spanish system's average that stood at 5.8% as of year-end 2010. If we exclude the loans that are mandated by the Spanish government, which some become doubtful shortly after they are granted, ICO's problem loans ratio would be around 4.18%. The institution's problem-loan ratio considers only direct loans as gross loans, while indirect loans, typically granted to financial institutions are reported as loans to banks.

The ratio of loan loss reserves-to-problem loans decreased to 79.6% as of end-December 2010 (113.7% at year-end 2009), and compares favourably with the system average of 63.3% as of end-December 2010. Additionally, ICO has a provision fund for contingent risks and commitments for EUR 349 million as of year-end 2010, the main provisions of this fund relate to loans that are granted according to government mandate (EUR 134.8 million) and liquidity lines provided through direct loans (EUR 144.2 million).

The loan book comprises the following:

(i) indirect lending mainly to SMEs and to other target sectors in Spain, comprising around 67% of the loan book as of year-end 2010. The borrower risk on these loans is transferred to commercial and savings banks in Spain, which act as intermediaries for distribution. Therefore, the credit exposure represents counterparty risk for ICO.

(ii) direct loans (domestic and international) comprise 33% of the loan book as of year-end 2010. These are typically larger loans, which are more profitable for ICO, but also entail higher credit risk as they expose the institution to the end-borrower.

(iii) Loans to former state-owned banks, now merged into Banco Bilbao Vizcaya Argentaria (BBVA, Aa2/P-1/B-; negative outlook), comprised EUR 300 million as of end-April 2011. Such loans are being gradually paid off and will not be replaced once they will mature in 2013.