

**Credit Opinion: Instituto de Credito Oficial**

**Instituto de Crédito Oficial**

*Madrid, Spain*

**Ratings**

Category	Moody's Rating
Outlook	Stable
Senior Unsecured	Aaa
Bkd Commercial Paper -Dom Curr	P-1
Bkd Other Short Term	P-1

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**Key Indicators**

**Instituto de Credito Oficial**

	[1]2007	2006	2005	2004	2003	Avg.
Total assets (EUR billion)	<b>39.88</b>	<b>32.30</b>	<b>26.96</b>	<b>24.56</b>	<b>26.42</b>	[2]10.01
Total capital (EUR billion)	<b>2.07</b>	<b>1.41</b>	<b>1.30</b>	<b>1.15</b>	<b>1.21</b>	[2]7.98
Return on average assets	<b>0.22</b>	<b>0.36</b>	<b>0.20</b>	<b>0.22</b>	<b>0.39</b>	<b>0.28</b>
Recurring earnings power [3]	<b>0.53</b>	<b>0.58</b>	<b>0.38</b>	<b>0.24</b>	<b>0.30</b>	<b>0.41</b>
Net interest margin	<b>0.59</b>	<b>0.68</b>	<b>0.35</b>	<b>0.36</b>	<b>0.42</b>	<b>0.48</b>
Cost/income ratio (%)	<b>18.16</b>	<b>18.34</b>	<b>26.01</b>	<b>35.55</b>	<b>32.90</b>	<b>26.19</b>
Problem loans % gross loans	<b>2.75</b>	<b>4.04</b>	<b>6.64</b>	<b>6.51</b>	<b>9.06</b>	<b>5.80</b>
Tier 1 ratio (%)	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>

[1] As of December 31. [2] Compound annual growth rate. [3] Preprovision income % average assets.

**Opinion**

**SUMMARY RATING RATIONALE**

In accordance with Moody's rating methodology for Government-Related Issuers (GRIs), the Aaa/Prime-1 debt ratings of Instituto de Credito Oficial (ICO) reflect the combination of the following inputs: (i) a Baseline Credit Assessment (BCA); (ii) the Aaa local currency deposit ceiling of the Kingdom of Spain; (iii) high dependence between ICO and the Kingdom of Spain; and (iv) very high support.

Since ICO's liabilities are explicitly, irrevocably, directly and unconditionally guaranteed by the Kingdom of Spain (Aaa), the BCA does not have any impact on the rating outcome and is therefore unpublished.

The level of dependence on the Spanish government is high. ICO continues to fulfil an important public policy role.

ICO is 100% owned by the Kingdom of Spain (rated Aaa). It 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 are currently no plans to remove or alter the Kingdom 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 Kingdom of Spain would be reflected in those of ICO.

## **Credit Strengths**

- Statutory ownership and full guarantee by the Kingdom of Spain
- Key public role as specialised lending institution and the Kingdom of Spain's financial agency
- Adequate risk management
- Funding and liquidity profile underpinned by the Kingdom of Spain's guarantee
- Strong capitalisation

## **Credit Challenges**

- Low, although consistent, profitability indicators, given its public policy role
- Relatively high, albeit decreasing, levels of problem loans - mainly due to its public lending role
- Limiting the impact on the risk profile of the planned increase in direct lending

## **Rating Outlook**

The stable rating outlook is predicated on ICO's continued role on behalf of the Kingdom of Spain and the maintenance of the Kingdom of Spain's guarantee of ICO's obligations.

## **What Could Change the Rating - Up**

As the debt ratings are currently Aaa/Prime-1, there is no further upside potential.

## **What Could Change the Rating - Down**

A termination of the government guarantee of ICO's liabilities would be likely to drive the rating downwards, though this appears unlikely in the foreseeable future.

## **Recent Results and Developments**

As of December 2007, ICO reported a net interest margin of EUR 209 million, up by 7% year-on-year. Its net profit decreased by 21% to EUR 82 million, mainly due to the recovery of impaired assets (EUR 91 million) that took place in 2006. Throughout 2007, ICO experienced a considerable growth in its loan book (+25.8%), including the establishment of the Securitisation Fund "ICO-Mediación Ay T" for a total of EUR 14.099 million, of which ICO retained EUR 13.169 million rated Aaa. Direct lending increased by 27% and intermediation loans by 26% during the year. The institution also benefited from a EUR 965.5 million increase in its regulatory capital, of which EUR 303 million came from the Spanish government, allowing its capital ratios to experience some improvement.

For the first time, a new strategic plan (2006-2010) was passed by a vote in December 2006, which lays down the long-term objectives. Firstly, ICO aims to increase substantially its lending both in mediation (indirect lending, for example to small and medium-sized enterprises - SMEs) and in direct lending. Secondly, the institution intends to achieve better efficiency levels than the average of its European peers, and thirdly, ICO is pursuing a strategy of self-reliance for funding purposes.

## **DETAILED RATING CONSIDERATIONS**

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

Factor 1: Qualitative Rating Factors

Franchise Value

Trend: Neutral

ICO is the sole specialised lending institution and the Kingdom of Spain's financial agency and as such possesses a dominant franchise in Spain. ICO embodies various important functions for the Spanish economy and can act in turn as:

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

(ii) A development bank. As such, it supports and promotes economic activities in Spain and abroad, in particular those that "due to their social, cultural, innovating or environmental transcendence, merit their being fostered" according to its statutes. Sectors specified by the government as priority targets include small and medium-sized enterprises (SMEs), Spanish companies' investments abroad, regional development, renewable energy sources, research and development, telecommunications and other infrastructure, as well as social housing. A sizeable part of ICO's lending, particularly to SMEs, is carried out indirectly through the Spanish commercial and savings banks (see 'Asset Quality' below).

(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.

According to its strategic plan, ICO aims to increase lending both in mediation (indirect lending, for example to SMEs) and in direct lending, so as to generate sufficient internal capital to support expected growth.

The institution has no competitors in Spain and its activities outside Spain - supporting the development of Spanish companies - ensure a certain degree of geographical diversification.

## Factor 2: Risk Positioning

Trend: Neutral

In terms of risk management, ICO has structures and processes that are commensurate with the amount of risk taken. Credit risk is most notable in direct lending, while in the case of indirect lending, the borrower risk is transferred to the 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. The trading book solely comprises derivatives, which are in fact held for hedging purposes and ICO does not engage in any speculative trading activities, limiting thereby market risk. However, ICO incurs interest and foreign currency risk that arises from obtaining funding in international capital markets in currencies other than the euro but which is fully hedged. As at December 2007, the sensitivity to foreign exchange rate changes of +/- 10% was 0.75%. Similarly, ICO also monitors its interest rate risk. As at December 2007, the sensitivity of the net interest income to a 100 bp change was 12.1% in euros and 0.61% in US dollars.

As regards operational risk, ICO is in the process of developing its systems and procedures, strengthening the internal control of incidences and the development of contingency planning.

## Factor 3: Regulatory Environment

Please refer to Moody's Banking System Outlook for Spain published in April 2008.

## Factor 4: Operating Environment

Please refer to Moody's Banking System Outlook for Spain published in April 2008.

## Quantitative Rating Factors

### Factor 5: Profitability

Trend: Neutral

The Kingdom of Spain, as owner of ICO, only requires the non-profit organisation to cover its costs on an ongoing basis. Therefore, ICO's profitability measures have historically compared modestly with the average for Spanish commercial and savings banks. However, there has been an improvement over the last few years, largely due to the more favourable interest rate context. In 2007, ICO's net interest margin stood at 0.59% and its recurring earnings power at 1.04%, somewhat below 2006 levels of 0.68% and 1.19% respectively. Nevertheless, we note that the 2006 results included the recovery of impaired assets (EUR 91 million), without which risk-weighted recurring earning power stood at 0.6%. Around 61% of new lending in 2007 was mediation loans (which generally yield Euribor flat), with the remaining 39% being direct loans.

Due to its nature, ICO's profitability displays little diversification, with 90.5% of its total revenue stemming from net interest income in 2007.

### Factor 6: Liquidity

Trend: Neutral

ICO funds its activities almost exclusively through tapping international capital markets; its Aaa/P-1 ratings enable it to borrow at very favourable rates.

As at December 2007, bonds comprised 88.6% of total funding. This percentage has been increasing in recent years, as ICO has decreased its reliance on funding from the European Investment Bank (EIB) and interbank borrowing, which accounts for 3.2% of total funding. We note that the reliance on interbank borrowing is set to remain low, as ICO uses it essentially to adjust for temporary liquidity needs. The lending portfolio represents the bulk of ICO's balance sheet, with a ratio of gross loans to total assets of 70% (including mediation and interbank loans) at year-end 2007. Nevertheless, we view ICO's liquidity as ample, based on the expectation that its Aaa/P-1 ratings will provide it with continuous ready access to funds. This should be further supported by the increasing geographical diversification of the investor base that has taken place over the past few years. We also note that the reliance on short-term funding is limited and that ICO's balance sheet is fairly well matched with regard to maturities of the assets and liabilities.

In terms of liquidity management, we derive some comfort from ICO's system of limits to monitor liquidity as described above. In March 2007, the Securitisation Fund "ICO-Mediación Ay T was established for a total of EUR 14.099 million, of which ICO retained EUR 13.169 million rated Aaa. This fund, which comprises the securitisation of the credit rights stemming from ICO's mediation loans to credit institutions from 2001 to 2006, is kept on balance sheet and can be repo'ed, thereby making the balance sheet more liquid 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 fulfil the latter's regulatory capital requirements. Thanks to a EUR 965.5 million increase in its regulatory capital, ICO's total capital ratio rose to 11.23%, an increase of 2.75 percentage points (pp) when compared with the previous year's figure. This fact is particularly important taking into consideration the deterioration ICO's capital ratios had experienced in the previous years due to the institution's strong growth. Once under the Basel II regime, and as approved by Spanish law (Presupuestos Generales del Estado 2007), ICO's solvency ratio will not be able to fall below 9.5%. From 2012 onwards, the plan foresees that ICO will be self-funded.

#### Factor 8: Efficiency

Trend: Neutral

ICO's efficiency indicators have remained broadly stable in recent years, with an adjusted cost-to-income ratio of 37.3% in 2007, slightly above the average of the last three years. It is important to note, however, that the institution has no branch network and there is scope for improvement in this ratio, as identified by the strategic plan. As this may be offset by the continuing investments required for Basel II and modernisation of IT systems, we would expect the institution's efficiency ratios to remain broadly stable.

#### Factor 9: Asset Quality

Trend: Neutral

Due to the very nature of its activities, ICO's loan book is varied in terms of asset quality. Its problem loans improved in 2007, to 2.7% of gross loans at the end of the year, compared with 4.0% at end-2006. As expected for a public policy institution such as ICO, these ratios appear to be higher than those registered in the private financial sector in Spain. Given that some operations are mandated by the Spanish government, some loans become doubtful shortly after they are granted. Without these, the problem loans ratio would be 1.48% (1.43% in 2006). The Kingdom of Spain (Aaa/P-1) guarantees part of the loans granted by ICO.

The loan book comprises the following:

(i) Indirect lending mainly to SMEs, and also to other target sectors in Spain, comprising 61.5% of the loan book in 2007 (including bonds rated Aaa from the securitisation deal mentioned above), up from 57% in 2006. On these loans, most of the borrower risk is transferred to the commercial and savings banks (cajas) in Spain, which act as intermediaries for distribution. Therefore the credit exposure represents counterparty risk for ICO, which is relatively low given the overall high credit quality of the Spanish financial institutions.

(ii) Direct loans (domestic and international) comprise 38.2% of the loan book at end-2007, up from 32% the previous year. These are typically larger loans, associated with higher profitability for ICO, but also with higher credit risk as ICO is exposed to the end-borrower.

(iii) Loans to former state-owned banks, now merged into Banco Bilbao Vizcaya Argentaria (BBVA, Aa2/B+/P-1), comprise 0.3% of the loan book, down from 7% in 2006. Such loans are being gradually paid off - the bulk by 2009 - and will not be replaced.

We further note that the problem loans ratio above considers only direct loans as gross loans, while indirect loans, since they are typically granted to financial institutions, are reported as loans to banks. In contrast to the pattern shown in previous years, the ratio of loan loss reserves to problem loans decreased slightly to 89.7% in 2007 (98.6% in 2006).

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