MOODY'S INVESTORS SERVICE

CREDIT OPINION
17 May 2018

Update

Rate this Research

RATINGS

**Banco Cooperativo Espanol, S.A.**

| | |
|---|---|
| Domicile | Spain |
| Long Term Debt | Withdrawn |
| Type | Senior Unsecured MTN - Dom Curr |
| Outlook | Not Assigned |
| Long Term Deposit | Baa3 |
| Type | LT Bank Deposits - Fgn Curr |
| Outlook | Stable |

*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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# Banco Cooperativo Espanol, S.A.

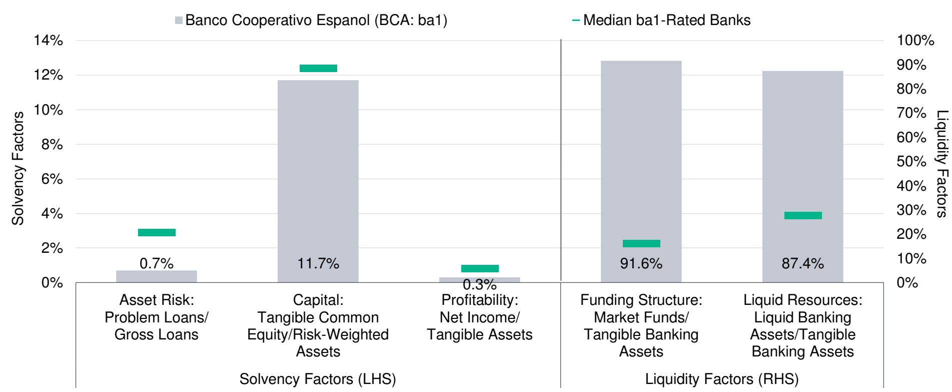
Update to credit analysis

## Summary


Banco Cooperativo Espanol, S.A.'s (BCE) Baa3/Prime-3 deposit ratings reflect (1) the bank's ba1 Baseline Credit Assessment (BCA); (2) a one-notch uplift from our assumption of a high probability of support from the rural cooperatives associated under the Asociación Española de Cajas Rurales (AECR); and (3) a moderate level of loss given failure on these instruments. BCE's Counterparty Risk (CR) Assessment has been assigned at Baa1(cr)/Prime-2(cr).

BCE's BCA of ba1 reflects the bank's moderate risk profile and its adequate liquidity position. Factors constraining the BCA are: (1) the high capital ratios do not capture the risks inherent in BCE's activities; and (2) its modest but stable profitability levels.


Exhibit 1
**Key financial ratios**




*Source: Moody's Financial Metrics*

## Credit strengths

» Moderate risk profile

» BCE's role as service provider for the rural cooperatives associated under the AECR

» Adequate liquidity profile, despite sizeable repo activity

## Credit challenges

» The bank's high capital ratios do not capture the risks inherent in BCE's activities

» Historically modest but stable profitability indicators

## Outlook

The stable outlook on BCE's deposit ratings reflects our expectation that the improving operating environment will support the stabilisation of the bank's financial fundamentals, as well as the gradual improvement in those of the rural cooperative sector.

## Factors that could lead to an upgrade

Upward pressure could be exerted on BCE's BCA if the bank reduces its leverage on a sustainable manner and/or improves its profitability levels. The bank's adjusted BCA could be upgraded if the performance of the Spanish rural cooperatives amalgamated under the AECR improves significantly.

Any change to the adjusted BCA would likely also affect the deposit rating because it is linked to the standalone BCA.

BCE's deposit rating could also change because of changes in the loss given failure faced by the bank's deposits.

## Factors that could lead to a downgrade

Downward pressure on BCE's adjusted BCA could be driven by (1) a significant deterioration in the credit profile of the rural cooperatives; (2) the bank's inability to maintain its role as a primary service provider for the rural cooperatives; and (3) a higher risk profile, which could stem from aggressive new lending activities or from other market or credit activities outside of BCE's intermediary role for the rural cooperatives.

## Key indicators

Exhibit 2

**Banco Cooperativo Espanol, S.A. (Consolidated Financials) [1]**

| | 12-16[2] | 12-15[2] | 12-14[2] | 12-13[3] | 12-12[3] | CAGR/Avg.[4] |
|---|---|---|---|---|---|---|
| Total Assets (EUR million) | 14,080 | 17,443 | 20,036 | 24,263 | 21,467 | -10.0[5] |
| Total Assets (USD million) | 14,851 | 18,948 | 24,245 | 33,433 | 28,302 | -14.9[5] |
| Tangible Common Equity (EUR million) | 460 | 416 | 378 | 344 | 307 | 10.6[5] |
| Tangible Common Equity (USD million) | 485 | 452 | 458 | 474 | 405 | 4.6[5] |
| Problem Loans / Gross Loans (%) | 0.5 | 0.9 | 0.9 | 1.6 | 0.2 | 0.8[6] |
| Tangible Common Equity / Risk Weighted Assets (%) | 11.7 | 11.1 | 9.4 | 10.6 | 9.6 | 10.7[7] |
| Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%) | 1.1 | 2.0 | 2.2 | 2.4 | 0.8 | 1.7[6] |
| Net Interest Margin (%) | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3[6] |
| PPI / Average RWA (%) | 1.5 | 1.5 | 1.9 | 2.5 | 1.3 | 1.6[7] |
| Net Income / Tangible Assets (%) | 0.3 | 0.2 | 0.2 | 0.2 | 0.1 | 0.2[6] |
| Cost / Income Ratio (%) | 30.2 | 28.7 | 24.2 | 22.8 | 38.9 | 29.0[6] |
| Market Funds / Tangible Banking Assets (%) | 91.6 | 93.3 | 94.8 | 96.2 | 96.0 | 94.4[6] |
| Liquid Banking Assets / Tangible Banking Assets (%) | 87.4 | 90.7 | 91.5 | 94.6 | 90.8 | 91.0[6] |
| Gross Loans / Due to Customers (%) | 179.5 | 154.5 | 199.0 | 109.5 | 245.8 | 177.7[6] |

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] May include rounding differences due to scale of reported amounts [5] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime [6] Simple average of periods presented for the latest accounting regime. [7] Simple average of Basel III periods presented

*Source: Moody's Financial Metrics*

## Profile

With €7.3 billion total assets as of the end of December 2017, BCE is a financial group whose aim is to provide the 38 rural cooperatives amalgamated under the AECR, which account for around 1.6% of Spain's financial system, with a cost-effective comprehensive range of financial services. The bank is owned by these rural cooperatives and by Germany-based DZ Bank AG (deposits Aa1 stable/senior unsecured Aa3 negative, BCA baa2/Adjusted BCA a2).

## Detailed credit considerations

### Moderate risk profile

We assign an Asset Risk score of baa1 to BCE to reflect the bank's low level of non-performing loans (NPLs) and the market risk associated with the bank's high exposure to Spanish sovereign debt.

At end-December 2017, BCE significantly reduced the size of its balance sheet, mainly reducing its repo activity and selling a large part of its securities portfolio. The bank's securities portfolio amounted to €2.5 billion as of the end of December 2017, compared to €6.7 billion a year earlier. It comprises (1) a €2.2 billion public-sector portfolio, mostly composed of Spanish sovereign debt; and (2) a €320 million private-sector portfolio. This securities portfolio is highly liquid, and it has an average duration of 3.7 years.

Out of the total securities portfolio, €2.4 billion (or 95%) was invested on behalf of the rural cooperatives (using the excess liquidity these entities had previously deposited with BCE), and the credit risk arising from these investments is jointly and severally guaranteed by these rural cooperatives. The entity has also entered into a number of interest-rate swaps, which cover the interest rate risk of €2.4 billion, or 95% of the portfolio. Despite this, we note that BCE's exposure to Spanish sovereign debt, which comprises the bulk of the securities portfolio, still creates some market risk for the bank.

BCE's NPL ratio has historically been negligible, standing at 0.5% as of the end of December 2017, unchanged versus a year earlier and equivalent to a score of aa3. BCE's loan book now accounts for 17% of its total assets, up from 8% a year earlier, as a result of the substantial decline of the bank´s total assets at the end of 2017.

### The bank's high capital ratios do not capture the risks inherent in BCE's activities

We assign a Capital score of ba2 to BCE, to reflect the volatility of the bank's leverage ratio inherent to its activity as treasury provider and other risks not fully captured in risk-weightings.

As of the end of December 2017, BCE's tangible common equity (TCE)/risk-weighted assets (RWA) stood at around 17%, up from 12% a year earlier. Such increase has been mainly driven by the substantial reduction of the bank´s RWAs and sovereign debt portfolio as of December 2017. However, we believe the bank's capital ratios do not adequately capture the risks — such as operational, reputational and performance risks — inherent in BCE's activities. At the end of 2017, the bank's leverage ratio (defined as TCE as a percentage of total assets) stood at 6.8%, up from 3.3% a year earlier.

In terms of regulatory ratios, BCE reported a phased-in Common Equity Tier 1 capital ratio of 25.2% as of the end of December 2017, up from 21.3% a year earlier. Our more conservative capital assessment, relative to regulators' capital ratios, is primarily explained by the more conservative risk weighting that we apply to the sovereign exposures compared with regulators' risk weighting of 0%[1].

### Historically modest but stable profitability indicators

BCE's Profitability score of b2 reflects our expectations that the bank will return to its normalised profitability levels of around 0.1% of net income/tangible banking assets.

BCE's earnings are relatively stable and its margins are very narrow, given that the bank's objective is to act as an all-round service provider to the rural cooperatives rather than to maximise profits. However, BCE's profitability indicators have improved since 2012 on the back of increased returns from the bank's securities portfolio.

As of the end of December 2017, the bank reported a net profit of €37 million, down from €45 million a year earlier, which represented 0.5% of the bank's tangible banking assets (0.3% as of the end of December 2016). However, we note that the increase in our profitability ratio is driven by the reduction in the bank´s balance sheet at end-2017, and that BCE's earnings are currently boosted by non-recurring gains arising from the securities carry trade.

### Adequate liquidity profile, although repo activity is sizeable

We have assigned a score of b2 to funding structure, four notches above the Macro-Adjusted score of caa3, reflecting our assessment that BCE is not dependent on this market funding to perform its activity.

Given the nature of BCE's assets and liabilities, its balance sheet is highly liquid. The bank has traditionally taken sight deposits of member banks and invested them in short-term assets. In recent years, BCE has also issued government-guaranteed debt and accessed ECB funding on behalf of its member banks. Nonetheless, the credit risk associated with these activities is assumed by member banks.

If we exclude this activity performed on behalf of the member banks (which is the bulk of BCE's activity), market funding would represent 57% of BCE's tangible banking assets as of the end of December 2017. BCE's market funding is primarily composed of ECB funding and other repos that the entity uses for its carry trade activity to boost profitability.

We assign a Liquid Resources score of a2 to BCE to reflect the encumbrance of some of the bank's liquid assets. BCE's liquid banking assets accounted for 75% of its tangible banking assets as of the end of December 2017, equivalent to a Liquid Resources Macro-Adjusted score of aa3.

## Support and structural considerations

### Affiliate support

We believe there is a high probability of support from the rural cooperatives associated under the AECR, given BCE's role as a central treasury provider for this group of entities. As a result of our affiliate support assessment, BCE's Adjusted BCA is baa3, one notch above the bank's BCA.

### Loss Given Failure (LGF) analysis

BCE is subject to the EU Bank Recovery and Resolution Directive (BRRD), which we consider to be an operational resolution regime. Accordingly, we apply our Advanced LGF approach and most of our standard assumptions, a residual TCE of 3%, losses post-failure of 8% of tangible banking assets, a 25% run-off in junior wholesale deposits and a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt. Because we consider BCE's deposit base to be essentially wholesale in nature, we assume that 80% of the deposit base is junior, compared with our estimated EU-wide average of 26%.

For BCE's deposits, our LGF analysis considers the likely impact on loss given failure of the combination of its own volume and subordination. Our LGF analysis indicates a moderate loss given failure for deposits and leads us to position our Preliminary Rating for BCE's deposits at the same level as the Adjusted BCA. Please refer to the Instrument Class table at the bottom of the scorecard.

### Counterparty Risk (CR) Assessment

The CR Assessment is an opinion of how counterparty obligations are likely to be treated if a bank fails and is distinct from debt and deposit ratings in that it (1) considers only the risk of default rather than both the likelihood of default and the expected financial loss suffered in the event of default, and (2) applies to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (for example, swaps), letters of credit, guarantees and liquidity facilities.

**BCE's CR Assessment is positioned at Baa1(cr)/Prime-2(cr)**.

The CR Assessment is positioned two notches above the Adjusted BCA of baa3, based on the buffer against default provided to the senior obligations represented by the CR Assessment by subordinated instruments amounting to 9.8% of tangible banking assets. The main difference with our Advanced LGF approach used to determine instrument ratings is that the CR Assessment captures the probability of default on certain senior obligations, rather than expected loss; therefore, we focus purely on subordination and take no account of the volume of the instrument class.

## Methodology and scorecard

### About Moody's Bank Scorecard

Our scorecard is designed to capture, express and explain in summary form our Rating Committee's judgement. When read in conjunction with our research, a fulsome presentation of our judgement is expressed. As a result, the output of our scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

## Rating methodology and scorecard factors

Exhibit 3

**Banco Cooperativo Espanol, S.A.**

| **Macro Factors** | | |
|---|---|---|
| **Weighted Macro Profile** | **Strong -** | **100%** |

| **Factor** | **Historic Ratio** | **Macro Adjusted Score** | **Credit Trend** | **Assigned Score** | **Key driver #1** | **Key driver #2** |
|---|---|---|---|---|---|---|
| Solvency | | | | | | |
| Asset Risk | | | | | | |
| Problem Loans / Gross Loans | 0.7% | aa3 | ←→ | baa1 | Sector concentration | |
| Capital | | | | | | |
| TCE / RWA | 11.7% | baa3 | ←→ | ba2 | Expected trend | Nominal leverage |
| Profitability | | | | | | |
| Net Income / Tangible Assets | 0.3% | ba3 | ←→ | b2 | Return on assets | |
| Combined Solvency Score | | baa1 | | ba1 | | |
| Liquidity | | | | | | |
| Funding Structure | | | | | | |
| Market Funds / Tangible Banking Assets | 91.6% | caa3 | ←→ | b2 | Market funding quality | |
| Liquid Resources | | | | | | |
| Liquid Banking Assets / Tangible Banking Assets | 87.4% | aa3 | ←→ | a2 | Asset encumbrance | |
| Combined Liquidity Score | | ba3 | | ba1 | | |
| Financial Profile | | | | ba1 | | |
| Business Diversification | | | | 0 | | |
| Opacity and Complexity | | | | 0 | | |
| Corporate Behavior | | | | 0 | | |
| Total Qualitative Adjustments | | | | 0 | | |
| Sovereign or Affiliate constraint: | | | | Baa2 | | |
| Scorecard Calculated BCA range | | | | baa3-ba2 | | |
| Assigned BCA | | | | ba1 | | |
| Affiliate Support notching | | | | -- | | |
| Adjusted BCA | | | | baa3 | | |

| **Balance Sheet** | **in-scope (EUR million)** | **% in-scope** | **at-failure (EUR million)** | **% at-failure** |
|---|---|---|---|---|
| Other liabilities | 12,051 | 85.6% | 12,051 | 85.6% |
| Deposits | 1,605 | 11.4% | 1,605 | 11.4% |
| Preferred deposits | 321 | 2.3% | 305 | 2.2% |
| Junior Deposits | 1,284 | 9.1% | 963 | 6.8% |
| Equity | 422 | 3.0% | 422 | 3.0% |
| Total Tangible Banking Assets | 14,078 | 100% | 14,078 | 100% |

| Debt class | De Jure waterfall | | De Facto waterfall | | Notching | | LGF Notching Guidance vs. Adjusted BCA | Assigned LGF notching | Additional notching | Preliminary Rating Assessment |
|---|---|---|---|---|---|---|---|---|---|---|
| | Instrument volume + subordination | Sub-ordination | Instrument volume + subordination | Sub-ordination | De Jure | De Facto | | | | |
| Counterparty Risk Assessment | 9.8% | 9.8% | 9.8% | 9.8% | 2 | 2 | 2 | 2 | 0 | baa1 (cr) |
| Deposits | 9.8% | 3.0% | 9.8% | 3.0% | 0 | 0 | 0 | 0 | 0 | baa3 |

| Instrument class | Loss Given Failure notching | Additional Notching | Preliminary Rating Assessment | Government Support notching | Local Currency Rating | Foreign Currency Rating |
|---|---|---|---|---|---|---|
| Counterparty Risk Assessment | 2 | 0 | baa1 (cr) | 0 | Baa1 (cr) | -- |
| Deposits | 0 | 0 | baa3 | 0 | Baa3 | Baa3 |

*Source: Moody's Financial Metrics*

## Ratings

Exhibit 4

| Category | Moody's Rating |
|---|---|
| **BANCO COOPERATIVO ESPANOL, S.A.** | |
| Outlook | Stable |
| Bank Deposits | Baa3/P-3 |
| Baseline Credit Assessment | ba1 |
| Adjusted Baseline Credit Assessment | baa3 |
| Counterparty Risk Assessment | Baa1(cr)/P-2(cr) |

*Source: Moody's Investors Service*

## Endnotes

1 See Moody's Adjustment to Increase the Risk Weightings of Sovereign Debt Securities in the Analysis of Banks: Frequently Asked Questions.

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