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Research Update:

Banco Internacional de Costa Rica S.A. 'BB-/B' Issuer Credit Ratings Affirmed; Outlook Remains Negative

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Overview

- The bank has strengthened its corporate governance and liquidity policies after the 2016 conflicts between BICSA's shareholders.
- We continue to believe that BICSA's main advantage is its well-diversified loan portfolio by geography, which could offset revenue volatility given the bank's concentration in one business line (trade finance).
- The bank has a highly concentrated funding structure compared with the Panamanian banking system, given the importance of its wholesale funding sources.
- We're affirming our global scale issuer credit ratings on BICSA at 'BB-/B'.
- The negative outlook on BICSA for the next 12 months reflects that on Costa Rica.

Rating Action

On Aug. 16, 2018, S&P Global Ratings affirmed its 'BB-' long- and 'B' short-term issuer credit ratings (ICR) on Banco Internacional de Costa Rica S.A. (BICSA). The outlook remains negative.

Rationale

The ratings on BICSA reflect its well-diversified loan portfolio by geography, which could offset revenue volatility given the bank's concentration in one business line: trade finance. In addition, the short-term nature of BICSA's loan portfolio gives its business profile flexibility. The ratings also consider our projected risk-adjusted capital (RAC) ratio that should hover around 8% for the next 24 months. The bank's healthy asset quality metrics--in line with regional peers --are a result of its conservative underwriting standards. The ratings also incorporate BICSA's highly concentrated funding structure in relation to the Panamanian banking system, given the relevance of its wholesale funding sources. Therefore, the bank's stand-alone credit profile (SACP) remains at 'bb'.

The sovereign ratings on Costa Rica (BB-/Negative/B) constrain our ratings on

BICRA. Even though the bank's geographically diverse loan portfolio allows it to pass our sovereign stress-test of a hypothetical default of Costa Rica, as a government-related entity (GRE), the bank could still be susceptible to negative government influence during periods of stress in the Costa Rican economy that could affect its financial flexibility. After the 2016 conflicts between BICSA's shareholders about the bank's ownership and decision-making process that hurt its business and financial profile, the bank has strengthened its corporate governance and liquidity policies. However, if these measures consistently prove to be effective at avoiding potential government interference--through solid governance standards and financial resilience--we could consider rating BICSA above Costa Rica.

The 'bb+' anchor for BICSA considers our Banking Industry Country Risk Assessment (BICRA) methodology and our weighted average economic risk in the countries in which the bank has exposure through its loan portfolio. BICSA operates mainly in Costa Rica (41%) and Panama (26%), and also has exposure to the U.S. (around 5%). The rest of its operations are spread out in other Latin America countries such as Nicaragua, El Salvador, and Guatemala. As a result, the weighted economic risk for BICSA is '6.9', which we round to '7'. The anchor also considers the industry risk of Panama, where BICSA is legally domiciled and where it follows its regulatory requirements. (see "Banking Industry Country Risk Assessment: Costa Rica," published on April 2, 2018, and "Banking Industry Country Risk Assessment: Panama," published on Nov. 1, 2017).

Despite BICSA's small market share in the Panamanian banking system, its geographically diverse loan portfolio continues to support its business position assessment, which could offset revenue volatility from the bank's concentration in one business line. In addition, the short-term nature of BICSA's loan portfolio provides flexibility to its business profile. Following the 2016 conflicts between BICSA's shareholders that affected its business and financial profile,[the bank has strengthened its corporate governance and liquidity policies to avoid similar events in the future. We expect the bank's revenues to continue growing for the next two years, with the majority of its income coming from stable sources (mainly interest income from the loan portfolio). The management has kept a conservative strategy, but is willing to continue growing the business now that the board conflicts have passed, while continuing to strengthen corporate governance to help BICSA have a less volatile financial profile.

Our average forecast RAC ratio of 8.0% for the next 24 months supports our capital and earnings assessment for BICSA. We also take into account its quality of capital (fully composed of paid-in capital and retained earnings) and earnings. Finally, we expect that the bank will maintain modest credit growth aligned with the expected growth of the economies where it has loan portfolio exposures. Our forecast RAC ratio reflects the following base-case scenario assumptions:

- Loan portfolio growth of 7% in 2018 and 8% in 2019;
- Higher net interest margins hovering between 2.42% and 2.52% for the next

two years, reflecting the increasing participation of total loans within the bank's assets;

- S&P risk-weighted assets (RWA) before diversification increasing by an average of 7.7% for the next 12 to 24 months, driven by the bank's total credit risk exposure;
- Efficiency levels around 56%, on average, for the next two years--slightly better than previous years. Core earnings to adjusted assets should be 0.67% for the same period;
- We don't consider any dividend payouts;
- Non-performing assets (NPAs) will return to around 2% for the next two years; with credit losses below 1%. Loan loss reserves should still be low, around 53%, resulting from low income, new reserve generation, and higher charge-offs; and
- No capital injections or external growth.

BICSA's risk position assessment is supported by its conservative underwriting standards and still healthy asset quality metrics, which are similar to its Panamanian peers and other banks that operate in the same economic risk score. As of June 30, 2018, its NPAs ratio was 2.4% with a three-year average of 1.9%, while its net charge-offs (NCOs) were 1.5% of total loans. We expect BICSA's asset quality to improve because most of its NPAs are foreclosed assets. Once the bank sells those assets, its metrics should return to historical levels. Also as a result of the worse NPAS, reserve coverage continues to be around 55%. However, these low loss reserves aren't a major threat to the bank considering the amount of guarantees that it has for its loan portfolio, for which the bank has historically efficiently recovered. Furthermore, BICSA improved its top 20 clients concentration to 26.2% at the end of 2017 from 30.6% in 2016, and we expect it will continue to reduce this concentration. For the next few years, we expect asset quality to improve to around 2% with NCOs below 1%.

Our funding assessment reflects the significance of BICSA's wholesale funding sources. The bank's customer deposit concentration, relatively low stable funding ratio (SFR), and higher loan-to-deposits (LTD) indicator than other rated banks in the region limit our assessment. As of June 30, 2018, the bank's funding mix consisted of 56% customer deposits, 34% credit facilities, and the rest is made up of domestic market debt issuances. The bank's customer deposits are mainly composed of wholesale depositors, which tend to be less stable than retail ones. As of June 30, 2018, the bank's top 20 depositors represented 50.2% of its total deposits, which compares adversely to its Panamanian peers' average of 15%. Additionally, as of the same date, BICSA's SFR was 95.22%--below the 100% of other banks we rate in Panama--given the lower share of deposits in its funding base. As of the same date, the bank's LTD ratio was 171.25%, which also compares negatively to the 89.5% for the rest of the Panamanian banking system. BICSA has access to different credit facilities denominated in U.S. dollars that continue to provide access to long-term funding. Over the next year, we expect the bank to keep a similar funding structure because the management's strategy to diversify its funding mix will be gradual.

After the conflicts between BICSA's shareholders in 2016, the bank revamped its liquidity policies and is now more cautious about its metrics and gaps. Our liquidity assessment continues to be underpinned by our broad liquid assets to short-term wholesale ratio and the bank's large share of short-term loans that it could easily turn into cash to address stressful economic conditions. As of June 2018, this ratio improved to 0.83x from a three-year average of 0.59x. We don't expect any changes in the bank's liquidity profile and believe it will maintain a regulatory liquidity ratio of at least twice the minimum level of 30%. BICSA passes our liquidity sovereign stress-test of a hypothetical default of Costa Rica mainly because of its adequate geographic diversification in terms of liquidity sources.

Our rating also includes our view of BICSA as a GRE for Costa Rica, because the two largest public banks in the country are the bank's main shareholders. Nonetheless, we think that BICSA has limited importance and a limited link with the government. As a result, we base our rating on BICSA solely on its SACP rather than on expected extraordinary support from the government of Costa Rica. This assessment stems from:

- BICSA's limited important role to the government, since we believe it acts as a profit-seeking bank in a very competitive environment. In our opinion, a private entity could easily undertake its activities; and
- Its limited link with the government. We believe the government may not be willing to provide timely support if needed.

Outlook

The negative outlook on BICSA for the next 12 months reflects that on Costa Rica. Although the bank passes our sovereign stress test, the potential negative influence from the government would ultimately constrain its financial flexibility in a period of stress for the Costa Rican economy.

Downside scenario

Over the next 12 months, if we were to lower our foreign currency ratings on Costa Rica, a similar action would follow on BICSA.

Upside scenario

We could revise the bank's outlook to stable in the next 12 months if we take a similar action on Costa Rica. We could also raise the ratings if we believe that BICSA could consistently prove its autonomy and financial resiliency to Costa Rica's negative influence, therefore removing our sovereign ratings cap.

Ratings Score Snapshot

Issuer Credit Rating	BB-/Negative/B
SACP	bb
Anchor	bb+
Business position	Adequate (0)
Capital and earnings	Adequate (0)
Risk position	Adequate (0)
Funding and liquidity	Below Average and Adequate (-1)
Support	0
GRE support	0
Group support	0
Government support	0
Additional factors	-1

Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- 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: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Banco Internacional de Costa Rica S.A.	
Issuer Credit Rating	BB-/Negative/B

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.