

Research Update:

# Israeli Bank Leumi 'A/A-1' Ratings Affirmed On Likely Containment Of COVID-19 Impact

July 20, 2020

## Overview

- While we anticipate that Israeli GDP will contract by 5.5% in 2020 due to the impact of COVID-19, we believe that the domestic economy will rebound fast and recover fully in 2021.
- We believe that Bank Leumi le-Israel B.M. (Leumi) entered the crisis with strong financials and that it will be able to preserve its profitability to a level that is sufficient to absorb the impact of the pandemic.
- We acknowledge that Leumi's capitalization is sensitive to market volatility and anticipate that it will confirm the decline in its large pension liability in the second quarter of 2020, contributing to a gradual recovery of its capitalization by 2022.
- We are therefore affirming our 'A/A-1' ratings on the bank.
- The stable outlook reflects our view that Leumi will gradually improve its capitalization over the next two years.

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## Rating Action

On July 20, 2020, S&P Global Ratings affirmed its 'A/A-1' long- and short-term issuer credit ratings on Bank Leumi le-Israel B.M. (Leumi) and its 'A-' long-term issuer credit rating on its subsidiary, Bank Leumi U.S.A. The outlook remains stable.

## Rationale

The affirmation reflects our expectation that Leumi, in line with the Israeli banking sector, should be able to weather the economic shock from COVID-19 with a contained impact on its profitability in the medium term, buoyed by its strong financials before the crisis.

After more than a decade of sustained economic growth of about 3%, the spread of COVID-19 and the lockdown measures imposed to contain the virus pushed the Israeli economy into recession, with real GDP expected to fall by 5.5% in 2020. While we acknowledge a high degree of uncertainty around the evolution of the pandemic, in our central scenario, we expect the Israeli economy to

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weather this shock and rebound by over 6% in 2021. We base our view on the expected global recovery in second-half 2020 and the strong fundamentals of the Israeli economy, combined with the sizable support package to avoid permanent damage to the country's highly productive capacity.

In this context, we expect Leumi to report some asset quality and profitability deterioration in 2020 and 2021, before gradually returning to pre-COVID levels of net income in 2022.

Specifically, we expect lower interest margins and depressed economic activity to constrain revenues, with fees hit in the second and third quarters of 2020 in particular. We acknowledge that Leumi already increased its loan loss provisions in the first quarter of 2020, and we expect its credit losses to amount to about 70-80 basis points (bps) in 2020 on the back of asset quality deterioration. We anticipate that nonperforming loans (NPLs) will increase in 2020 before gradually reducing afterwards.

We anticipate only moderate lending growth in the next couple of years amid the uncertain economic conditions. In addition, we expect the bank will not distribute dividends in 2020, to support its capitalization under the current uncertain market conditions.

We also acknowledge that Leumi's risk-adjusted capital (RAC) ratio is sensitive to market volatility owing to market risk charges and large pension obligations. We deduct the latter entirely from Leumi's total adjusted capital (TAC), our measure of capital. The deduction of pension obligations increased to about Israeli shekel (ILS) 3.9 billion as of December 2019 amid market movements and some one-offs. We factor into our forecast our view that the negative contribution of pension obligations will sustainably decline amid higher credit spreads, thus supporting capitalization. Our forecasts are supported by first-quarter 2020 data that show a deduction of pension obligations amounting to about ILS2 billion.

As such, we forecast that the bank's RAC ratio will gradually increase to about 10% in 2022 from 9.3% as of December 2019.

Our ratings continue to factor in Leumi's high exposure to the real estate and mortgages (47% of its net loans). Though we expect a stagnation in the housing market in 2020, we anticipate that the risk associated with mortgage exposures will be contained, helped by macroprudential measures that the Bank of Israel introduced in the past. We expect a recovery in the labor market in 2021-2022, supporting mortgage borrowers' creditworthiness. A deviation from this expectation might have negative implications for the bank's asset quality.

We consider that the bank's exposure to income-producing real estate is more vulnerable in the current environment than other sectors in its real estate lending portfolio. For example, shopping malls were already under pressure from growing e-commerce activity and office segments already faced the risk of oversupply. The current situation heightens the sensitivity of these sectors to the economic downturn, where, in the case of a prolonged recession, we could see lower demand, rising vacancies, and reducing profitability and valuation of real estate players. At about 9% of the lending book, we consider the bank's exposure to this portfolio to be manageable as it benefits from the high level of collateralization with contained loan-to-value levels.

## Outlook

The stable outlook on Leumi reflects our expectation that the bank will be able to contain asset quality deterioration while gradually building up capital amid the current difficult economic conditions in Israel. Specifically, we expect the bank's RAC ratio to increase above 10% over the next two years, with asset quality metrics remaining broadly in line with domestic peers.

## Downside scenario

We could lower the ratings if Leumi fails to strengthen its capitalization. This could happen if the bank's credit losses rise much more than we expect and end up eroding its RAC or if the bank's pension liabilities do not decline.

Furthermore, we could take a negative action if the Israeli economy deteriorated markedly, with a notable impact on the real estate sector. This might result from higher-than-expected economic stress amid the COVID-19 pandemic or a pronounced escalation in local geopolitical turbulence. Finally, although less likely, a negative rating action could occur if there are major asset quality or operational issues in Leumi's U.S. operations, or if regulatory or legislative decisions have a prolonged, adverse effect on the bank's business profile.

## Upside scenario

Although unlikely during our two-year outlook period, an upgrade could happen if Leumi materially improved its capital and risk profile.

## Ratings Score Snapshot

<b>Issuer Credit Rating</b>	A/Stable/A-1
<b>SACP</b>	a-
Anchor	bbb+
Business Position	Strong (+1)
Capital and Earnings	Strong (+1)
Risk Position	Moderate (-1)
Funding and Liquidity	Average and Adequate (0)
<b>Support</b>	1
GRE Support	0
Group Support	0
ALAC Support	0
Sovereign Support	1
<b>Additional Factors</b>	0

## Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- 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

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- General Criteria: Methodology: Timeliness Of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings, Oct. 24, 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

## Related Research

## Ratings List

### Ratings Affirmed

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#### Bank Leumi le-Israel B.M.

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Issuer Credit Rating A/Stable/A-1

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Junior Subordinated BBB

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#### Bank Leumi USA

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Issuer Credit Rating A-/Stable/--

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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](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceId/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352) Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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