

# Positive Rating Actions On Three Israeli Banks On The Supportive Operating Environment And Better Financial Performance

July 10, 2019

- We expect the Israeli economy to continue to support the banking sector's improving financial performance, characterized by strong asset quality and cost of risk at historical lows.
- Macroprudential measures and government-led supply-side initiatives have led to some stability of house prices over the past two years, reducing the risk of imbalances.
- Banks have gradually diversified their credit exposures and now have more balanced loan books, and single-name concentration has decreased, reducing risks in a downside scenario.
- At the same time, we see some risks stemming from the commercial real estate sector's increase in supply in recent years, as well as heightening competition from nonbank players in unsecured retail lending.
- Our view of a lower risk of economic imbalances leads us to reassess Israel's banking sector to group '3' of our Banking Industry Country Risk Assessment from group '4', and the anchor for Israeli banks, the starting point for our rating analysis, to 'bbb+' from 'bbb'.
- We are therefore raising our ratings on Bank Leumi, Bank Leumi USA, and Bank Hapoalim, and revising to positive from stable our outlook on Israel Discount Bank and IDB NY.

PARIS (S&P Global Ratings) July 10, 2019--S&P Global Ratings today took the following rating actions on Israeli banks:

- We raised the long- and short-term issuer credit ratings on Bank Leumi le-Israel B.M. to 'A/A-1' from 'A-/A-2'. In addition, we raised the long-term rating on Bank Leumi USA to 'A-' from 'BBB+'. The outlooks are stable.
- We raised the long- and short-term issuer credit ratings on Bank Hapoalim B.M. to 'A/A-1' from 'A-/A-2'. The outlook is stable.
- We revised the outlooks to positive from stable on Israel Discount Bank Ltd. (IDB) and its core subsidiary Israel Discount Bank of New York (IDB NY), and affirmed the 'BBB+/A-2' long- and short-term issuer credit ratings.

## RATIONALE

The Israeli economy's high income level, sustained growth, and moderate leverage have underpinned improvements in the banking sector, including business opportunities and growth, strengthening profitability, and stronger asset quality. Although banks have a large exposure to

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the real estate sector, we see risks as more limited following the stabilization of prices in the past two years and the regulator's macroprudential measures. We believe these improvements represent an overall strengthening of the Israeli banking sector, which we now assess in our Banking Industry Country Risk Assessment (BICRA) group '3', versus group '4' previously. Consequently, we have revised to 'bbb+' from 'bbb' the anchor that starts our rating analysis of banks with most of their operations and revenues in Israel.

The Israeli economy has not faced a recession in the past 15 years, and GDP in U.S. dollar terms has increased by over 55% since 2010 to above \$40,000, with the unemployment rate remaining at historical lows. External fundamentals remain strong, with a positive current account and an improving net creditor position. At the same time, as a small open economy in the Middle East, Israel remains exposed to geopolitical shocks and a rise in global protectionist sentiment.

Israeli banks have diversified their credit exposures and showed a limited appetite for growth over the past five years, resulting in sound asset quality. Systemwide, nonperforming loans reduced to 1.2% and the cost of risk to 0.2% in 2018.

Israeli banks' large exposure to real estate remains a potential risk. Lending to construction and commercial real estate accounted for about 16% of total bank loans as at end-2018, and it increased by 11% in 2018. The commercial real estate sector appears relatively healthy, supported by the rising demand for office space from services industry and the continual increase in private consumption. At the same time, low interest rates support real estate players' financial position. Rapid growth of office space construction in 2018, after a 16-year record high of completions, creates a risk of oversupply in the next few years, in our view. We consider that shopping malls may be under more pressure because the growing use of e-commerce is taking a toll on retailers, and some cities appear to have an oversupply of retail space. That said, we believe institutional investors, such as insurance companies and pension funds, are more exposed to this segment than banks.

We see exposure to residential mortgage lending as a relatively lower risk. The regulator has imposed higher capital requirements for mortgage loans, strict limits on the floating rate portion of new loans, and a cap on the loan-to-value ratio of 75%, among various other measures to curb risks. We do not envisage a sharp correction in house prices under our base case, but rather a more moderate growth pace than in the past decade, given the government's recent supply-boosting measures.

High single-name corporate borrower concentration has declined markedly over past years. Holding company structures have gradually been dismantled, and large corporates have deleveraged or increasingly tap nonbank funding sources. However, we still see some risks related to the concentration in the credit portfolios, partly due to the economy's small size and less diversified structure.

In our view, risk in the unsecured consumer lending portfolio is currently low, given the low household debt at 42% of GDP and moderate level of expense for credit losses at 0.8% in 2018. However, the financial strength of Israeli households, in aggregate, masks high disparities in wealth and income. Moreover, the rising number of nonbank players in this segment increases supply, which potentially leads to a greater debt burden for the lower-income decile households. This could increase the financial vulnerability of households and trigger higher credit losses in a downturn scenario.

The trend for industry risk in Israel is stable. We expect banks' profitability will remain sound on the back of solid growth and improving operating efficiency. Furthermore, we anticipate revenues will gradually improve over the next two years due to slightly higher interest rates, solid private-sector credit growth of about 5%, and slow margin improvement, supported by a better

lending mix. Banks are addressing historically moderate efficiency by embracing digitization, closing branches, and reducing headcount. The key challenge for Israeli banks remains coping with investment costs for IT, compliance, and regulation, and financial-technology (fintech) competition, potentially disrupting business models. There have been attempts to spur competition in retail and the small and midsize enterprise (SME) segment, where a handful of large banks have dominant positions.

The two largest banks recently had to divest their credit card operations, but it is still too early to predict how the competitive landscape will evolve. In our view, Israeli banks are currently relatively well placed to face changes in the competitive environment, but it will remain a threat for both bank and nonbank players in the foreseeable future.

Operational risks, such as information security and cyber threats, are gaining prominence on banks' and regulators' agendas. We think the Israeli banking system carefully addresses these issues, supported by extensive regulatory framework and skilled resources.

- Bank Leumi le-Israel B.M.: A/Stable/A-1

We have revised up our assessment of Bank Leumi's stand-alone credit profile (SACP) to 'a-' from 'bbb+', reflecting the higher anchor and lower economic risk score. As a result, our risk-adjusted capital (RAC) ratio before adjustments will remain comfortably above 10% in the coming future. Bank Leumi's capitalization is also likely to benefit from moderate asset growth, despite increasing dividends and share buyback plans. At the same time--and despite sound asset quality indicators--we consider the bank's risk position to be weaker than that of peers operating in countries with similar economic risk. Although the bank exhibits strong risk metrics, this distinction points to the rather concentrated nature of the Israeli economy. In our base case, we consider that the risks attached to the economic impact of geopolitical tensions in the region should remain contained and manageable.

We expect the bank to retain its strong market position and sound funding and liquidity, benefiting from the supportive economy. On June 30, 2019, CEO Ms. Rakefet Russak-Aminoach announced her upcoming resignation. We regard Leumi's senior management as experienced and professional and do not expect her departure to have a material impact on the bank.

## OUTLOOK

The stable outlooks on Bank Leumi and Bank Leumi USA indicate a limited likelihood of ratings upside or downside over the next 24 months. The ratings on the bank already take into account benefits from the benign and stable operating conditions we expect in Israel. Therefore, we expect the bank's overall business, financial, and risk profile to remain broadly stable in the foreseeable future.

### Downside scenario

Rating pressure could materialize if the Israeli economy, notably the real estate sector, deteriorated markedly. Such weakening might be triggered by global or local economic stress or by a pronounced escalation in local geopolitical turbulence. Furthermore, we could take a negative rating action if there are major asset quality or operational issues in its U.S. operations, or if regulatory or legislative decisions, such as the recent sale of the bank's credit card subsidiary, had a long-lasting adverse effect on the bank's business position.

### Upside scenario

Although remote, we could raise the ratings if the bank materially improved its capital policy or risk profile.

## Bank Leumi USA

The stable outlook on Bank Leumi USA reflects the outlook on its parent. Absent a change in our rating on the parent, we will only raise or lower our 'A-' rating on Bank Leumi USA if we alter our view of its strategic importance to its parent. We currently consider the bank to be highly strategic and therefore rate it one notch below the group credit profile.

- Bank Hapoalim B.M.: A/Stable/A-1

We have revised up our assessment of Bank Hapoalim's SACP to 'a-' from 'bbb+', reflecting the higher anchor and lower economic risk score. As a result, our RAC ratio before adjustments will remain comfortably above 10% in the coming years. At the same time, compared with larger and more diversified peers operating in countries with similar economic risk, we consider Bank Hapoalim's risk exposures to be more concentrated, reflecting its geographic focus on Israel and the relatively concentrated nature of the local economy. In our base-case scenario, we consider that the risks attached to the economic impact of geopolitical tensions in the region will remain contained.

We expect the bank to maintain its strong market position and sound funding and liquidity, supported by the economic environment. On April 15, 2019, the bank's CEO Arik Pinto announced his intention to retire at the end of the year. Given the stability of the top management, we don't expect this decision to materially affect the bank's strategy.

## OUTLOOK

The stable outlook on Bank Hapoalim indicates a limited likelihood of ratings upside or downside over the next 24 months. The ratings on the bank already capture benefits from the benign and stable operating conditions we expect in Israel, and we expect the bank's overall business, financial, and risk profile to remain broadly stable in the foreseeable future.

### Downside scenario

Rating pressure could emerge if the Israeli economy, particularly the real estate sector, deteriorated markedly. Such weakening might be triggered by global or local economic stress or by a pronounced escalation in geopolitical turbulence. Furthermore, a negative rating action could occur if there are major asset quality or operational issues in Bank Hapoalim's U.S. operations or if regulatory or legislative decisions, such as the recent forced sale of the bank's credit card subsidiary, materially weakened its business position.

### Upside scenario

Although a remote scenario, we could upgrade Bank Hapoalim if the bank materially improved its capital policy or risk profile. Final certainty with regard to the size of the expected settlement with the U.S. authorities of client tax-evasion charges would be a precondition for an upgrade.

- Israel Discount Bank Ltd.: BBB+/Positive/A-2

Our ratings on IDB and its U.S. subsidiary IDB NY reflect our more positive view of the banking sector and the bank's good progress in terms of efficiency and cost of risk, albeit still behind peers. In addition, we believe that the bank pursues faster lending growth than its peers. Still, the bank's capitalization will likely benefit from an expected moderation of its fast-paced loan growth and improved efficiency. We note, nevertheless, that our expectation remains sensitive to dividend payouts, which could be higher than the current policy of 15% per year, as earnings continue to improve and IDB tries to close the gap with peers.

According to our base case, the RAC ratio could improve more than 10% by the end of 2021. If

sustained, this would be positive for the ratings. The long-term rating on IDB is one notch above its SACP, reflecting our view of a moderately high likelihood that Israel would provide extraordinary support to IDB in the event of financial distress. We classify IDB as having high systemic importance.

## OUTLOOK

The positive outlook on IDB and IDB NY indicates the possibility of an upgrade over the next 12-24 months should capitalization continue to improve. This will hinge on the continuation of the positive momentum of previous years in terms of its operational efficiency, cost of risk, and profitability. If this materializes, and we conclude that our prediversification RAC ratio will remain sustainably above 10%, we could raise the ratings.

We could revise the outlook to stable if the current positive trend in the bank's capitalization stops or reverses, such that IDB's RAC ratio stays below 10%. This could stem from the pace of loan growth or cost of risk exceeding our projections, or the bank failing to deliver further on improving its efficiency. Similarly, a sharp increase in future dividend pay-outs at the expense of capital build-up could trigger an outlook revision to stable.

## BICRA Score Snapshot

### Israel

	To	From
BICRA Group	3	4
Economic risk	3	4
Economic resilience	Intermediate risk	Intermediate risk
Economic imbalances	Low risk	Intermediate risk
Credit risk in the economy	Intermediate risk	Intermediate risk
Economic risk trend	Stable	Positive
Industry risk	4	4
Institutional framework	Intermediate risk	Intermediate risk
Competitive dynamics	High risk	High risk
Systemwide funding	Low risk	Low risk
Industry risk trend	Stable	Stable

BICRA--Banking Industry Country Risk Assessment. BICRA economic risk and industry risk scores are on a scale from 1 (lowest risk) to 10 (highest risk). For more details on our BICRA scores on banking industries across the globe, please see "Banking Industry Country Risk Assessment Update," published monthly on RatingsDirect. Last publication was on June 27, 2019.

## Ratings Score Snapshots

	To	From
<b>Bank Hapoalim B.M.</b>		
Issuer Credit Rating	A/Stable/A-1	A-/Positive/A-2
SACP	a-	bbb+
Anchor	bbb+	bbb
Business Position	Strong (+1)	Strong (+1)
Capital and Earnings	Strong (+1)	Adequate (0)

## Ratings Score Snapshots (cont.)

	To	From
Risk Position	Moderate (-1)	Adequate (0)
Funding and Liquidity	Average and Adequate (0)	Average and Adequate (0)
Support	1	1
GRE Support	0	0
Group Support	0	0
ALAC Support	0	0
Sovereign Support	1	1
Additional Factors	0	0
<b>Bank Leumi le-Israel B.M.</b>		
Issuer Credit Rating	A/Stable/A-1	A-/Positive/A-2
SACP	a-	bbb+
Anchor	bbb+	bbb
Business Position	Strong (+1)	Strong (+1)
Capital and Earnings	Strong (+1)	Adequate (0)
Risk Position	Moderate (-1)	Adequate (0)
Funding and Liquidity	Average and Adequate (0)	Average and Adequate (0)
Support	1	1
GRE Support	0	0
Group Support	0	0
ALAC Support	0	0
Sovereign Support	1	1
Additional Factors	0	0
<b>Israel Discount Bank Ltd.</b>		
Issuer Credit Rating	BBB+/Positive/A-2	BBB+/Stable/A-2
SACP	bbb	bbb
Anchor	bbb+	bbb
Business Position	Adequate (0)	Adequate (0)
Capital and Earnings	Adequate (0)	Adequate (0)
Risk Position	Moderate (-1)	Adequate (0)
Funding and Liquidity	Average and Adequate (0)	Average and Adequate (0)
Support	1	1
GRE Support	0	0
Group Support	0	0
ALAC Support	0	0
Sovereign Support	1	1
Additional Factors	0	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
- 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
- General Criteria: Understanding S&P Global Ratings' Rating Definitions, June 3, 2009

## Related Research

- Banking Industry Country Risk Assessment Update: June, June 27, 2019
- Bulletin: Israel Economy Will Weather Upcoming Snap Election, May 31, 2019
- Israel Ratings Affirmed At 'AA-/A-1+'; Outlook Stable, Feb. 1, 2019

## Ratings List

Upgraded		
	To	From
<b>Bank Hapoalim B.M.</b>		
Issuer Credit Rating	A/Stable/A-1	A-/Positive/A-2
	To	From
<b>Bank Leumi le-Israel B.M.</b>		
Issuer Credit Rating	A/Stable/A-1	A-/Positive/A-2
<b>Bank Leumi USA</b>		
Issuer Credit Rating	A-/Stable/--	BBB+/Positive/--

## Ratings Affirmed; Outlook Action

	To	From
<b>Israel Discount Bank Ltd.</b>		
Issuer Credit Rating	BBB+/Positive/A-2	BBB+/Stable/A-2
<b>Israel Discount Bank of New York</b>		
Issuer Credit Rating	BBB+/Positive/--	BBB+/Stable/--

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. 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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