

Credit Opinion: Israel Discount Bank

Global Credit Research - 21 Dec 2015

Tel Aviv, Israel

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Baa1/P-2
Baseline Credit Assessment	ba1
Adjusted Baseline Credit Assessment	ba1
Counterparty Risk Assessment	A3(cr)/P-2(cr)

Contacts

Analyst	Phone
Melina Skouridou, CFA/Limassol	357.25.586.586
Constantinos Kypreos/Limassol	
Sean Marion/London	44.20.7772.5454
Corina Moustra/Limassol	357.25.586.586

Key Indicators

ISRAEL DISCOUNT BANK (Consolidated Financials)[1]

	[2]9-15	[2]12-14	[3]12-13	[3]12-12	[3]12-11	Avg.
Total Assets (ILS million)	206,914.0	206,946.0	200,507.0	201,012.0	202,472.0	[4]0.5
Total Assets (USD million)	52,718.3	53,179.7	57,766.3	53,874.7	52,951.2	[4]-0.1
Tangible Common Equity (ILS million)	12,953.0	12,684.3	11,506.6	11,038.9	10,154.5	[4]6.3
Tangible Common Equity (USD million)	3,300.2	3,259.5	3,315.1	2,958.6	2,655.6	[4]5.6
Problem Loans / Gross Loans (%)	2.7	2.7	3.7	5.1	5.2	[5]3.9
Tangible Common Equity / Risk Weighted Assets (%)	8.8	8.7	8.4	7.9	7.3	[6]8.7
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	22.9	22.3	32.3	47.2	51.4	[5]35.2
Net Interest Margin (%)	2.2	2.2	2.2	2.3	2.5	[5]2.3
PPI / Average RWA (%)	1.2	0.8	1.3	1.4	1.2	[6]1.0
Net Income / Tangible Assets (%)	0.5	0.3	0.5	0.4	0.5	[5]0.4
Cost / Income Ratio (%)	76.5	83.9	77.4	75.2	77.4	[5]78.1
Market Funds / Tangible Banking Assets (%)	6.2	6.8	6.4	6.9	7.6	[5]6.8
Liquid Banking Assets / Tangible Banking Assets (%)	30.9	31.9	31.6	33.2	34.7	[5]32.5
Gross loans / Due to customers (%)	82.2	80.4	79.9	79.4	77.8	[5]79.9

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; LOCAL GAAP [3] Basel II; LOCAL GAAP [4] Compound Annual Growth Rate based on LOCAL GAAP reporting periods [5] LOCAL GAAP reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & LOCAL GAAP reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

We assign Baa1/Prime-2 deposit ratings to Israel Discount Bank (IDB), Israel's third-largest bank with a 15% market share of total assets. The deposit ratings incorporate a three-notch uplift from the bank's ba1 baseline credit assessment (BCA), based on our assessment of a very high probability of government support in the event of need. We also assign a Counterparty Risk Assessment (CR Assessment) of A3(cr) / Prime-2(cr).

The ratings, and specifically the bank's BCA, are driven by (1) IDB's favourable deposit-based funding structure, with customer deposits accounting for 79% of non-equity funding; (2) its large liquidity buffers with a liquidity coverage ratio of 131.5% as of September 2015; and (3) its moderate capital buffers, on a global basis although higher than most domestic peers, with a Common Equity Tier 1 ratio of 9.5% as of September 2015.

IDB's ba1 BCA also captures its weaker-than-domestic-peers asset quality metrics, with the ratio of non-performing loans (NPLs, defined as impaired loans plus other loans over 90 days overdue) to gross loans of 2.7% as of September 2015, as well as its weak profitability and efficiency metrics with a cost-to-income ratio of 77% for the nine months to September 2015.

Rating Drivers

- Good asset quality on a global basis although weaker than domestic peers
- Moderate, although better than domestic peers, capital buffers
- Weak profitability and efficiency metrics
- Strong retail deposit base and good liquidity
- Israel's Strong Macro Profile
- Very high likelihood of government support, in case of need, underpins the deposit ratings

Rating Outlook

All ratings carry a stable outlook.

What Could Change the Rating - Up

Upward pressure could originate from improvements in the bank's BCA following evidence of materially improved profitability and efficiency metrics, combined with asset quality improvements.

What Could Change the Rating - Down

Negative pressure could be exerted on the ratings if a deterioration in operating conditions leads to a weakening of asset quality, profitability and capital metrics.

DETAILED RATING CONSIDERATIONS

GOOD ASSET QUALITY METRICS ON A GLOBAL BASIS ALTHOUGH WEAKER THAN DOMESTIC PEERS

IDB maintains good asset quality metrics relative to similarly rated banks globally, as it benefits from strong underwriting standards as well as a strict regulatory and legal framework that allows the banks full recourse to the borrowers. Nevertheless with a ratio of NPLs to gross loans of 2.7% as of September 2015 and credit costs standing at 0.27% for Q3 2015, IDB's asset quality metrics are the weakest amongst its rated domestic peers. Further, we expect IDB's credit costs, which were supported in recent quarters at low levels due to cash recoveries, to rise reaching the historical average level of 0.5%-0.6%.

Credit risks remain elevated in IDB's loan book driven by (1) the still high, albeit declining, concentration levels in the bank's loan book, which makes its asset quality vulnerable to a potential deterioration in the financial position of one of its large borrowers; and (2) the increasing credit risk in the mortgage market in Israel, mainly as a result of the sharp property price increases of around 100% in the last 7 years that have outpaced household income growth. These developments render the asset quality of the system's banks vulnerable to interest rate rises or to a potential weakening in economic activity, which could lead to higher unemployment and a correction in real-estate prices. However, while we have recently revised downwards our forecast for Israel's real GDP growth on account of weaker demand for Israel's exports, we continue to expect meaningful economic expansion of 3.0% for 2016. As of September 2015 mortgages accounted for 17% of IDB's loan book.

MODERATE, ALTHOUGH BETTER THAN DOMESTIC PEERS, CAPITAL BUFFERS

IDB already meets its 9.0% (plus 1% capital add-on against its mortgage portfolio resulting in 9.14% minimum CET 1) regulatory minimum Common Equity Tier 1 (CET 1) capital ratio, which will become effective 1 January 2017: with a CET 1 ratio of 9.5% as of September 2015, the bank's capital buffers are above those of most of its domestic peers. Our scenario analysis shows that the bank can absorb the added credit costs we expect under our central scenario.

However, IDB's capital buffers compare unfavourably with similarly rated banks globally, although we recognise that IDB uses the more conservative "standardised approach" in calculating risk-weighted assets (RWAs). Its RWAs-to-total-assets ratio stands at 71% as of September 2015, higher than the 69% average of similarly rated banks globally and significantly higher than banks and systems using the internal ratings-based (IRB) approach. The average RWAs-to-total assets ratio for euro-area banks, most of which use the IRB for the RWA calculation, was 41% as of June 2015.

WEAK PROFITABILITY AND EFFICIENCY METRICS

For the nine months to September 2015 IDB reported a 38% year-on-year increase in net income to NIS738 million (USD190 million). The improvement mainly stems from a reduction in expenses, primarily staff costs, reflecting IDB's efforts to control its cost base through the introduction of an early retirement scheme in 2014.

Nevertheless, with an annualised return on RWA of 0.67% and cost to income ratio of 77%, IDB's profitability and efficiency metrics are below its local peers and those of similarly rated banks globally. The pressure on the bank's profitability stems from (1) its high cost base, with operating costs at 2.8% of total assets and its cost-to-income ratio at 77%, which excludes one-off costs; (2) the low interest rate environment, which adversely affects net interest margins; and (3) Israel's high tax rate, with the statutory tax rate at 37.7%.

We acknowledge the management's efforts to address some of these issues via its 2015-19 strategic plan. Specifically, following reductions in the head count and the disposal of non-core assets, management aims to maintain its current cost base and improve the cost-to-income ratio and align IDB's efficiency metrics with its domestic peers as the top line grows.

STRONG RETAIL DEPOSIT BASE AND GOOD LIQUIDITY

The bank maintains a stable deposit-based funding structure. Deposits accounted for 79% of non-equity funding as of September 2015, and primarily comprise of granular retail deposits. We expect the bank to continue to be primarily deposit funded, benefitting from the strong savings culture in Israel. Although the bulk of deposits are of a short-term nature (with this being the main reason for the funding structure adjustments in our scorecard), both domestic and foreign deposits have proven to be stable during past shocks in Israel.

IDB also maintains good liquidity buffers. As of September 2015, cash and interbank balances accounted for 13% of total assets, with securities accounting for an additional 19%. The securities portfolio primarily comprises of A1-rated Israeli government securities (57% of the total), while an additional 21% is invested in mortgage-backed and asset-backed securities of US government agencies. The balance is invested in highly rated fixed-income securities of US and European financial institutions. With the liquidity coverage ratio at 131.5% as of September 2015, IDB already exceeds the 100% minimum requirement effective as of January 2017.

ISRAEL'S STRONG MACRO PROFILE

Discount Bank's Macro Profile is underpinned by the country's competitive and diversified economy, supported by high income levels, gradually improving debt metrics and ample funding. The economy has shown resilience despite extensive geopolitical challenges. The banking sector benefits from the country's strong savings culture, which provides sufficient customer deposits for the banks to avoid reliance on more volatile market funding. Our views of the Israeli operating environment also incorporate our assessment of risks surrounding rising real-estate prices and elevated lending by non-banks such as insurance companies and pension funds, which are weakening banks' credit conditions.

SOURCE OF FACTS AND FIGURES CITED IN THIS REPORT

Unless noted otherwise, data related to system-wide trends is sourced from the central bank. Bank-specific figures originate from the bank's reports and Moody's Banking Financial Metrics. All figures are based on our own chart of account and may be adjusted for analytical purposes. Please refer to the document: "Financial Statement Adjustments in the Analysis of Financial Institutions" <https://www.moody.com/research/Financial-Statement-Adjustments-in-the-Analysis-of-Financial-Institutions>

[Adjustments-in-the-Analysis-of-Financial-Institutions--PBC_182293](#)) published on 15 June 2015. The numbers in the key indicators table at the top of the page do not reflect restatements carried out by the bank to prior years financials.

Notching Considerations

GOVERNMENT SUPPORT

We assume a very high likelihood of government support for Discount Bank's rated deposits. This assumption reflects the Israeli government's longstanding practice of injecting capital into systemically important banks in case of need, rather than using resolution tools or allowing the institution to enter bankruptcy. This assumption is particularly applicable to Discount Bank given its 15% share of the domestic market, and hence the material systemic consequences of an unsupported failure. We therefore incorporate three notches of government support into the bank's deposit ratings (Baa1).

CR ASSESSMENT

The CR Assessment is positioned at A3(cr)/Prime-2(cr). The CR Assessment, prior to government support, is positioned one notch above the Adjusted BCA of ba1, reflecting our view that its probability of default is lower than that of deposits. We believe senior obligations represented by the CR Assessment will be more likely preserved in order to limit contagion, minimise losses and avoid disruption of critical functions.

The CR Assessment also benefits from three notch of systemic support, in line with our support assumptions on deposits. This reflects our view that any support provided by governmental authorities to a bank which benefits deposits is very likely to benefit operating activities and obligations reflected by the CR Assessment as well, consistent with our belief that governments are likely to maintain such operations as a going-concern in order to reduce contagion and preserve a bank's critical functions.

About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our rating committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment 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 Factors

Israel Discount Bank

Macro Factors	
Weighted Macro Profile	Strong

Financial Profile						
Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
<i>Problem Loans / Gross Loans</i>	3.5%	baa1	← →	baa3	Sector concentration	Single name concentration
Capital						
<i>TCE / RWA</i>	8.8%	ba3	← →	ba3	Risk-weighted capitalisation	Stress capital resilience
Profitability						
<i>Net Income / Tangible Assets</i>	0.4%	ba1	← →	ba2	Earnings quality	

Combined Solvency Score		ba1		ba2		
Liquidity Funding Structure						
<i>Market Funds / Tangible Banking Assets</i>	6.8%	a1	← →	baa1	Deposit quality	
Liquid Resources						
<i>Liquid Banking Assets / Tangible Banking Assets</i>	31.9%	a3	← →	a3	Stock of liquid assets	
Combined Liquidity Score		a2		baa1		

Financial Profile

ba1

Qualitative Adjustments

Adjustment

Business Diversification
Opacity and Complexity
Corporate Behavior

0
0
0

Total Qualitative Adjustments

0

Sovereign or Affiliate constraint

A1

Scorecard Calculated BCA range

baa3 - ba2

Assigned BCA

ba1

Affiliate Support notching

0

Adjusted BCA

ba1

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Deposits	0	0	ba1	3	Baa1	Baa1

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on <http://www.moody's.com> for the most updated credit rating action information and rating history.

Moody's
INVESTORS SERVICE

© 2015 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND ITS RATINGS AFFILIATES ("MIS") ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS,

OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS FOR RETAIL INVESTORS TO CONSIDER MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS IN MAKING ANY INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's Publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of

any rating, agreed to pay to Moody's Investors Service, Inc. for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moody's.com under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

For Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657 AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail clients. It would be dangerous for "retail clients" to make any investment decision based on MOODY'S credit rating. If in doubt you should contact your financial or other professional adviser.

For Japan only: MOODY'S Japan K.K. ("MJKK") is a wholly-owned credit rating agency subsidiary of MOODY'S Group Japan G.K., which is wholly-owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO. Moody's SF Japan K.K. ("MSFJ") is a wholly-owned credit rating agency subsidiary of MJKK. MSFJ is not a Nationally Recognized Statistical Rating Organization ("NRSRO"). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJKK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJKK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJKK or MSFJ (as applicable) have, prior to assignment of any rating, agreed to pay to MJKK or MSFJ (as applicable) for appraisal and rating services rendered by it fees ranging from JPY200,000 to approximately JPY350,000,000. MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.