

## CREDIT OPINION

26 September 2019

Update

✓ Rate this Research

### RATINGS

#### Israel Discount Bank

Domicile	Israel
Long Term CRR	A2
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Debt	Not Assigned
Long Term Deposit	A3
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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## Israel Discount Bank

### Update to credit analysis

#### Summary

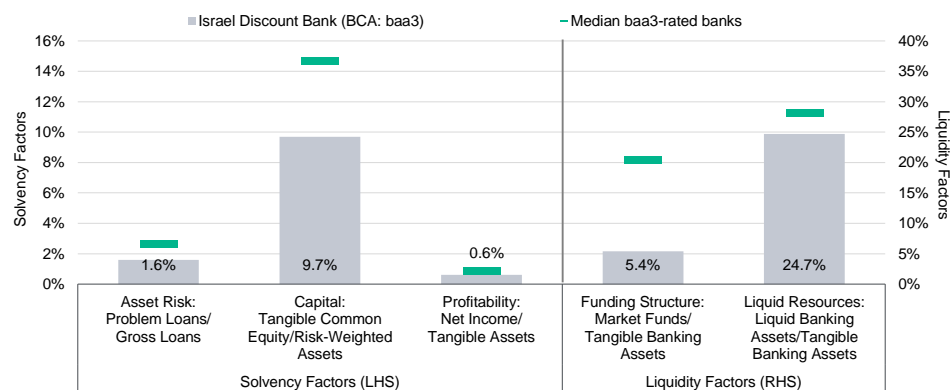
[Israel Discount Bank's](#) (IDB), A3/Prime-2 deposit ratings incorporate three-notches of uplift from the bank's baa3 baseline credit assessment (BCA), resulting from our assessment of a very high probability of support from the government of Israel (A1 positive) in case of need. Our support assumption reflects IDB's systemic importance, being Israel's fourth-largest bank with around 15% market share of total assets.

IDB's baa3 BCA reflects its: (1) favourable deposit-based funding structure, with customer deposits accounting for 86% of non-equity funding; (2) large liquidity buffers with a liquidity coverage ratio (LCR) of 133%; and (3) improving capital buffers, with a reported Common Equity Tier 1 (CET 1) ratio of 10.4% as at end-June 2019.

Though the ratio of non-performing loans (NPLs, defined as impaired loans plus other loans over 90 days overdue) to gross loans improved to 1.2% as at end-June 2019, IDB's ratings also reflect elevated credit risks which stem from the sharp increase in property prices over the last decade and rapid loan growth. IDB's baa3 BCA also captures its improving profitability and efficiency, with a H1 2019 cost-to-income ratio of 63.7%.

Exhibit 1

#### Rating scorecard - key financial ratios



Note: Asset risk and profitability ratios reflect the weaker of either the latest reported or 3-year average ratios. Capital ratio is the latest reported figure. Funding structure and liquid resources ratios reflect the latest year-end figures.

Source: Moody's Financial Metrics

## Credit strengths

- » Strong retail deposit base and good liquidity
- » Better asset quality than similarly rated banks globally
- » Improved capital buffers
- » Very high likelihood of government support, in case of need, underpins the deposit ratings

## Credit challenges

- » Credit risks remain elevated, despite improving asset quality, owing to the sharp increase in property prices in Israel over the last decade and high loan growth
- » Despite improvement, efficiency remains weak

## Outlook

The stable outlook on IDB's long-term deposit ratings balances our expectation that the bank's financial fundamentals, mainly profitability and efficiency, will continue to improve in the coming quarters against high loan growth which may increase problem loans and credit costs as these loans season.

## Factors that could lead to an upgrade

- » The bank's ratings could be upgraded following further improvement in asset quality, profitability, efficiency and capital.

## Factors that could lead to a downgrade

- » A deterioration in operating conditions leading to a weakening of asset quality, profitability and the bank's capital metrics or a reduced willingness and/or capacity by the government to support IDB in case of need would lead to a downgrade of the deposit ratings.

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 [www.moodys.com](http://www.moodys.com) for the most updated credit rating action information and rating history.

## Key indicators

Exhibit 2

### Israel Discount Bank (Consolidated Financials) [1]

	06-19 <sup>2</sup>	12-18 <sup>2</sup>	12-17 <sup>2</sup>	12-16 <sup>2</sup>	12-15 <sup>2</sup>	CAGR/Avg. <sup>3</sup>
Total Assets (ILS Million)	244,313.0	239,176.0	221,221.0	219,577.0	205,260.0	5.1 <sup>4</sup>
Total Assets (USD Million)	68,501.2	64,006.4	63,722.1	57,053.0	52,751.8	7.8 <sup>4</sup>
Tangible Common Equity (ILS Million)	17,668.0	17,142.0	15,114.0	14,025.3	12,607.6	10.1 <sup>4</sup>
Tangible Common Equity (USD Million)	4,953.8	4,587.4	4,353.6	3,644.2	3,240.2	12.9 <sup>4</sup>
Problem Loans / Gross Loans (%)	1.2	1.2	1.7	2.4	2.6	1.8 <sup>5</sup>
Tangible Common Equity / Risk Weighted Assets (%)	9.7	9.8	9.2	8.9	8.6	9.2 <sup>6</sup>
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	10.8	10.7	14.7	20.9	22.9	16.0 <sup>5</sup>
Net Interest Margin (%)	2.6	2.4	2.3	2.2	2.1	2.3 <sup>5</sup>
PPI / Average RWA (%)	2.0	1.8	1.7	1.4	1.2	1.6 <sup>6</sup>
Net Income / Tangible Assets (%)	0.8	0.7	0.6	0.4	0.4	0.6 <sup>5</sup>
Cost / Income Ratio (%)	62.5	65.9	66.6	71.8	76.5	68.7 <sup>5</sup>
Market Funds / Tangible Banking Assets (%)	5.4	5.4	4.6	5.7	5.5	5.3 <sup>5</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	23.3	24.7	27.1	30.1	31.6	27.3 <sup>5</sup>
Gross Loans / Due to Customers (%)	92.3	90.1	86.8	83.2	82.0	86.9 <sup>5</sup>

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

Source: Moody's Investors Service; Company Filings

## Profile

Israel Discount Bank was incorporated in 1935. IDB is the fourth largest bank in Israel with roughly 15% market share in deposits and 16% in loans. The bank offers comprehensive banking services in all areas of financial activity, through its 182 branches in Israel, including the 76 branches of Mercantile Discount Bank Ltd, IDB's subsidiary bank in Israel. IDB has the largest international operations amongst Israeli banks, carried out through IDB New York, its subsidiary in the United States of America which mainly focuses on mid-sized companies and private banking. IDB NY operates branches in the New York, Florida and California and has representative offices in Latin America and in Israel.

## Detailed credit considerations

### Recent Developments

On 12 September 2018, IDB announced that it has made an offer for the acquisition of Municipal Bank (formerly Dexia Israel Bank Ltd.), a small bank with a market share of less than 0.5% specialising in lending to local municipalities. The proposed acquisition is part of IDB's growth initiatives. On November 13, 2018, a merger agreement was signed between IDB's subsidiary, Mercantile Bank, and Municipal Bank, under which Municipal Bank would merge with Mercantile Bank for a consideration of NIS758.59 per share, equivalent to a total amount of approximately NIS670 million.

The completion of the transaction is subject to various conditions and regulatory approvals, which include approvals by the Bank of Israel, the Competition Commissioner and the shareholders of Municipal Bank. On 23 May 2019, IDB received the merger confirmation from the Competition Commissioner, subject to certain terms, which have not yet been fulfilled.

Given the small size of Dexia (accounting for roughly 3% of IDB's assets), we do not expect the merger to have a material impact on IDB's fundamentals.

### Credit risks remain elevated, despite improving asset quality, in view of the sharp increase in real estate prices in Israel over the last decade and high loan growth

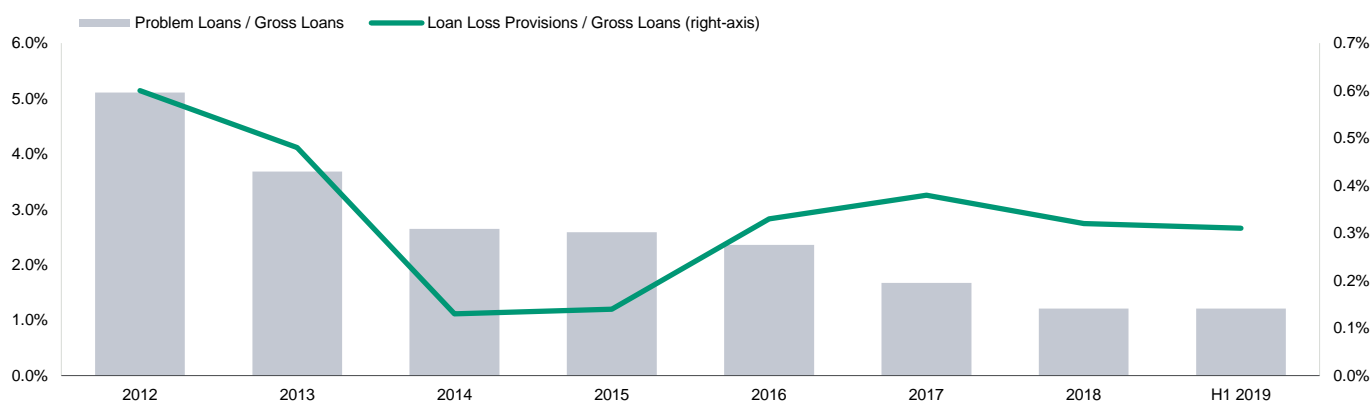
We expect IDB's asset quality to remain broadly stable, benefitting from the strong macroeconomic environment, the bank's strong underwriting standards as well as a strict regulatory and legal framework that allows the banks full recourse to the borrowers. The improvement in the bank's asset quality in recent years partly reflects the strong operating environment driven by the country's competitive economy. The economy has shown resilience despite extensive geopolitical challenges and reduced demand for Israeli

exports, which account for approximately 30% of GDP. We project the economy to grow by 3.1% in 2019 and 3.3% in 2020. Solid economic growth, alongside high employment, rising wages, high household wealth and continued low interest rates, will underpin borrowers' repayment capacity.

IDB's asset quality has improved over recent years comparing favorably with similarly rated banks globally. The bank tightened its credit standards both in retail and business lending and eliminated exposures to holding companies which caused an increase in problem loans in the past. The ratio of nonperforming loans (NPL's) to gross loans declined to 1.2% as at end-June 2019 from 2.6% as at year-end 2015 while the coverage ratio has improved to 108% from 61% as at year-end 2015. The bank's cost of risk declined slightly, with loan-loss provisions accounting for 0.31% of gross loans in the first half of 2019 (2018: 0.32%), while credit costs for the period 2014-2018 remained below the historical average of 0.5%. Although in previous years Israeli banks reported low credit costs, benefitting from extraordinarily high cash recoveries on previously provisioned amounts, such recoveries are beginning to fade. As such, we expect credit costs to rise to more sustainable levels, close to the historical average. High loan growth may also increase problem loans and credit costs as these loans season, particularly if interest rates continue to rise.

Exhibit 3

### IDB's asset quality metrics have been improving



Source: Bank's financial statements; Moody's Investors Service

Diversification in IDB's loan book improved as a result of the bank's growth strategy which targeted expansion primarily in mortgages, SMEs and consumer lending. However, despite significant improvement in recent years, the bank's concentration in single borrowers and borrower groups increased in 2017-2018. During 2019, the bank took measures to reduce its concentration levels, which resulted in the bank not having any exposure to a borrower group with total (net debt) exceeding 15% of the bank's regulatory capital as at June 2019.

IDB's loan growth was below the market average between 2013-2015, owing to low capital and weaker asset quality and profitability. However with the successful implementation of its five year strategic plan for 2013-2018 which has been updated in 2016, the bank has been able to accelerate its loan growth rate in 2016-2018, particularly in 2018 when gross loans grew by 12%. We expect the bank's loan growth, which outpaced the market significantly in 2018, to moderate but still remain strong, in line with the 4.5% growth achieved in the first half of 2019. The bank revised its targeted growth areas, with credit growth to the consumer sector slowing down in view of higher risk, and mortgage and corporate lending driving the bank's loan growth.

Credit risks also remain elevated owing to the sharp rise in property prices over the last decade, by more than 100% since end-2007, leaving the banks vulnerable to a potential sharp correction. Further, banks' asset quality is vulnerable to significant, more than 5%, interest rate rises or to a potential weakening in economic activity, which could lead to higher unemployment. IDB's exposure to mortgages and loans to the construction and real estate sectors accounted for around 40% of its domestic loan book as at end-June 2019. As a result of tighter underwriting standards and high capital buffers against mortgages, we expect IDB to be resilient to a moderate decline in property prices. We also do not expect a scenario of a sharp reduction in property prices to materialize over the medium term given that demand continues to exceed supply.

### Improved capital buffers

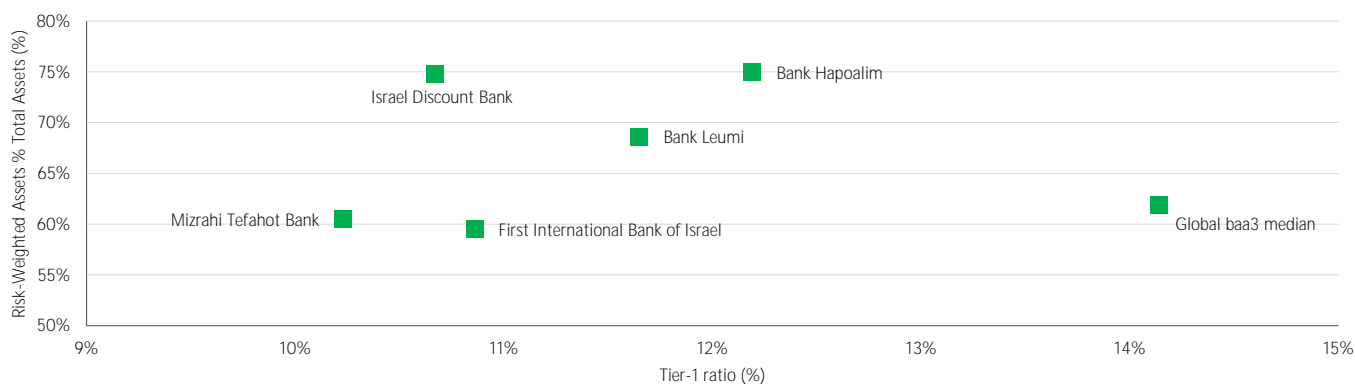
IDB reported a CET 1 ratio of 10.37% as of end-June 2019, providing a buffer above its 9.20% (9% plus 1% capital add-on against its mortgage portfolio) minimum regulatory requirement. Following the bank's improved capital buffers, the regulator approved a modest dividend payout ratio of 15%.

Going forward, we expect the bank's capital buffers to remain broadly stable and above the bank's internal target of 9.9%, for 2019, reflecting continued, albeit more moderate growth in risk-weighted assets and a modest dividend payout ratio. The bank announced a 15% dividend payout beginning with the fourth quarter 2018 earnings. If the acquisition of Municipal Bank is completed, the impact on IDB's CET 1 ratio would be a decrease of approximately 0.18%, according to the bank's estimate and based on year-end 2018 data.

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). The domestic regulator does not allow the application of the more advanced internal ratings-based (IRB) approach which would result in a higher Tier 1 ratio according to the bank's calculations. Its RWAs-to-total-assets ratio stands at 75% as of end-June 2019, significantly higher than banks using the internal ratings-based (IRB) approach. The average RWAs-to-total assets ratio for euro-area banks was around 39% as at end-2018.

Exhibit 4

#### IDB's capitalisation against domestic and global peers



Note: Israeli banks as at June 2019

Source: Moody's Investors Service

### Despite improvement efficiency remains weak

IDB's profitability has been improving and closing the gap with its domestic peers. In 2018 the bank reported its highest ever net income of NIS1.5 billion (around USD410 million), translating into a return on average assets of 0.67% (2015: 0.37%). Net income in H1 2019 reached NIS976 million, growing by 28% year-on-year, supported by strong business growth. We expect the favourable operating environment in Israel (A1 positive) to support the bank's lending opportunities and revenues. With current interest rates at just 0.25%, the bank's profitability also stands to benefit when interest rates start to rise, although we do not expect any increase in the near future.

In addition, we believe that efficiency initiatives taken by the bank have the potential to further boost profitability and improve its cost-to-income ratio, with the bank aiming to achieve 60% by 2021 under its strategic plan. These measures include a reduction in headcount via successive early retirement plans and a reduction in the number of branches and real estate space. According to the bank, headcount at Discount Bank, part of the Group, has reduced by 20% since 2013 and will further reduce by another 6% by 2021 due to natural retirement. Discount Bank also reduced its number of branches by 32 since 2014 to 106 as well as the real estate space used by its branches. Key pillars under IDB's strategic plan remain (1) the bank's growth strategy, and (2) a focus on digital offerings, including through a number of collaborations with fintech companies. Although IDB's efficiency has improved, with the bank's reported cost-to-income ratio falling to 63.7% in the first half of 2019 from 78.7% in 2015, it remains weaker than its domestic and similarly rated global peers.

### Strong retail deposit base and good liquidity

The bank maintains a stable deposit-based funding structure. Deposits accounted for 86% of non-equity funding as of end-June 2019, and primarily comprise 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 short-term (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 end-June 2019, cash and interbank balances accounted for 9% of total assets, with securities accounting for an additional 15%. The securities portfolio primarily comprises of A1-rated Israeli government securities (59% 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 133.3% as of end-June 2019, IDB exceeds the 100% minimum requirement.

### Environmental, social and governance considerations

In line with our general view for the banking sector, IDB has a low exposure to Environmental risks, see our [Environmental risk heatmaps](#) for further information.

The most relevant social risks for banks arise from the way they interact with their customers. Social risks are particularly high in the area of data security and customer privacy which is partly mitigated by sizeable technology investments and banks' long track record of handling sensitive client data. Fines and reputational damage due to product misselling or other types of misconduct is a further social risk. Societal trends are also relevant in a number of areas, such as shifting customer preferences towards digital banking services increasing information technology cost, aging population concerns in several countries impacting demand for financial services or socially driven policy agendas that may translate into regulation that affects banks' revenue base. In Israel, authorities are taking measures to promote competition in the banking system, which will weigh on the banks' profitability, together with high and rising wages. Overall, we consider banks, including IDB, to face moderate social risks.

Governance is highly relevant for IDB, as it is to all players in the banking industry. Corporate governance weaknesses can lead to a deterioration in a company's credit quality, while governance strengths can benefit its credit profile. Governance risks are largely internal rather than externally driven, and for IDB we do not have any particular governance concern. Nonetheless corporate governance remains a key credit consideration and requires ongoing monitoring.

### Source of facts and figures cited in this report

Unless noted otherwise, we have sourced data relating to system-wide trends and market shares from the central bank. Bank-specific figures originate from the banks' reports and Moody's Banking Financial Metrics. All figures are based on our own chart of accounts and may be adjusted for analytical purposes. Please refer to the document [Financial Statement Adjustments in the Analysis of Financial Institutions](#) published on 09 August 2018.

### Support and structural considerations

#### Government support

We assume a very high likelihood of government support for IDB's rated deposits. This assumption reflects the Israeli government's long standing practice of injecting capital into systemically important banks in case of need. This assumption is particularly applicable to IDB given its 15% share of the domestic market, and hence material systemic consequences of an unsupported failure. We therefore incorporate three notches of government support into the bank's deposit ratings, rating them at A3.

#### Counterparty Risk Ratings (CRRs)

CRRs are opinions of the ability of entities to honour the uncollateralised portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event such liabilities are not honoured. CRRs are distinct from ratings assigned to senior unsecured debt instruments and from issuer ratings because they reflect that, in a resolution, CRR liabilities might benefit from preferential treatment compared with senior unsecured debt. Examples of CRR liabilities include the uncollateralised portion of payables arising from derivatives transactions and the uncollateralised portion of liabilities under sale and repurchase agreement.

**Israel Discount Bank CRRs are positioned at A2/P-1**

We consider Israel a jurisdiction with a non-operational resolution (non-ORR) regime. For non-ORR countries, the starting point for the CRR is one notch above the bank's Adjusted BCA (of baa3), to which we then typically add the same (three) notches of government support uplift as applied to deposit ratings. As such, IDB's CRR is set at A2/Prime-1.

IDB's Counterparty Risk (CR) Assessment is also positioned at A2(cr)/Prime-1(cr), as the approach to reaching this assessment is identical to that for the CRR.

**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 methodology and scorecard factors

Exhibit 5

### Israel Discount Bank

#### Macro Factors

Weighted Macro Profile	Strong	100%					
Factor	Historic Ratio	Initial Score	Expected Trend	Assigned Score	Key driver #1	Key driver #2	
Solvency							
Asset Risk							
Problem Loans / Gross Loans	1.6%	a2	↔	baa3	Sector concentration	Loan growth	
Capital							
Tangible Common Equity / Risk Weighted Assets (Basel III - transitional phase-in)	9.7%	ba1	↔	ba1	Risk-weighted capitalisation	Stress capital resilience	
Profitability							
Net Income / Tangible Assets	0.6%	baa3	↔	ba1	Return on assets		
Combined Solvency Score		baa2		ba1			
Liquidity							
Funding Structure							
Market Funds / Tangible Banking Assets	5.4%	a1	↔	a2	Term structure		
Liquid Resources							
Liquid Banking Assets / Tangible Banking Assets	24.7%	baa2	↔	baa2	Stock of liquid assets		
Combined Liquidity Score		a3		a3			
Financial Profile							
Qualitative Adjustments				Adjustment			
Business Diversification				0			
Opacity and Complexity				0			
Corporate Behavior				0			
Total Qualitative Adjustments				0			
Sovereign or Affiliate constraint				A1			
Scorecard Calculated BCA range				baa2 - ba1			
Assigned BCA				baa3			
Affiliate Support notching				0			
Adjusted BCA				baa3			

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency Rating	Foreign Currency Rating
Counterparty Risk Rating	1	0	baa2	3	A2	A2
Counterparty Risk Assessment	1	0	baa2 (cr)	3	A2(cr)	
Deposits	0	0	baa3	3	A3	A3

[1]Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

Source: Moody's Investors Service

## Ratings

Exhibit 6

Category	Moody's Rating
<b>ISRAEL DISCOUNT BANK</b>	
Outlook	Stable
Counterparty Risk Rating	A2/P-1
Bank Deposits	A3/P-2
Baseline Credit Assessment	baa3
Adjusted Baseline Credit Assessment	baa3
Counterparty Risk Assessment	A2(cr)/P-1(cr)

Source: Moody's Investors Service

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