

CREDIT OPINION

2 July 2020

Update

✓ Rate this Research

RATINGS

Israel Discount Bank

Domicile	Tel Aviv, 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	Positive

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

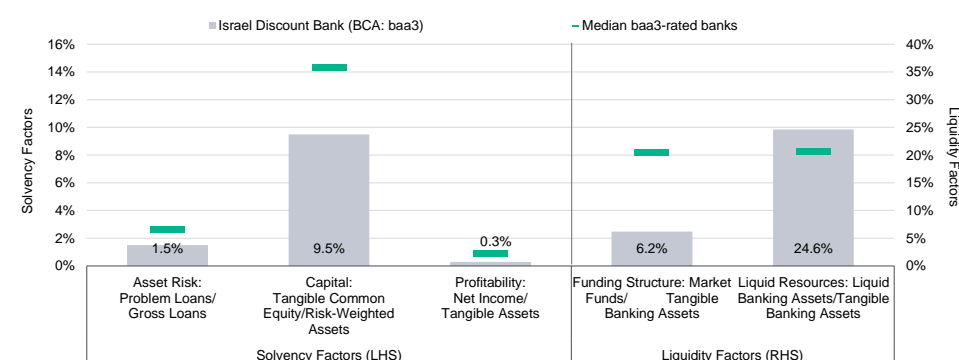
[Israel Discount Bank](#) (IDB)'s A3 long-term deposit ratings reflect (1) the bank's baa3 Baseline Credit Assessment (BCA); and (2) three notches of rating uplift based on our assessment of a very high probability of support from the [Government of Israel](#) (A1 stable), in case of need.

IDB's baa3 BCA reflects (1) its favourable deposit-based funding structure along with comfortable liquidity; and (2) adequate capital buffers, with a reported Common Equity Tier 1 (CET1) ratio of 10.0% as of March 2020, which is below similarly-rated international peers mainly reflecting Bank of Israel's (BoI) more conservative risk-weighting, and a 6.5% leverage ratio.

At the same time, IDB's BCA reflects downside risks from potential geopolitical tensions and a sharp correction in property prices. The bank's recent asset quality has been strong, but the coronavirus-induced economic slowdown will lead to some deterioration, while the bank's relatively unseasoned loan book will be tested under the weakening credit conditions. Problem loans (defined as impaired loans and loans that are more than 90 days overdue) rose to 1.5% of gross loans in March 2020 from 1.2% at end-2019, and we expect the impact will be more pronounced the longer the disruption lasts. The bank's profitability will also be under pressure, but the bank's continued focus on reducing its cost base, which is higher than peers, has the potential to mitigate partly these negative pressures.

Exhibit 1

Rating Scorecard - Key financial ratios



These are our [Banks Methodology](#) scorecard ratios. Asset risk and profitability reflect the weaker of either the latest figure and the three-year and latest figure average. Capital is the latest reported figure. Funding structure and liquid resources reflect the latest fiscal year-end figures.

Source: Moody's Investors Service

Credit strengths

- » Stable deposit-based funding structure and comfortable liquidity
- » Recent asset quality has been strong, supported by improved underwriting standards
- » Very high likelihood of government support, in case of need, underpins the deposit ratings

Credit challenges

- » Profitability will come under pressure, but continued focus on reducing high cost base may provide some support
- » Problem loans and credit costs will rise; geopolitical tensions and high property prices remain a downside risk
- » Modest risk-weighted capitalisation, but moderate leverage

Outlook

The positive outlook on IDB's long-term deposit ratings reflects our expectation that the recent improvement in the bank's solvency, mainly its asset quality and profitability, will resume following a temporary impact from the economic fallout of the coronavirus pandemic.

Factors that could lead to an upgrade

- » IDB's ratings could be upgraded if the bank's solvency profile demonstrates resilience against the currently stressed operating conditions. For instance, if despite the economic fallout from the coronavirus outbreak, the bank's profitability remains broadly stable due to sustained efficiency improvements and contained credit costs over the entire fiscal period. Generally, a stronger credit loss performance during the current downturn compared to past performance, while the bank's loan book becomes more seasoned, may also lead to positive rating pressure.
- » The bank's ratings could also be upgraded because of materially strengthened capital buffers.

Factors that could lead to a downgrade

- » The outlook on IDB's ratings could be revised to stable if there is a sustained reversal from recent improvements in the bank's solvency ratios, and more specifically if the deterioration in operating conditions becomes more severe and leads to a weakening of the bank's asset quality and profitability. The outlook could also be revised to stable in case the bank's credit loss performance is materially worse than peers.
- » Downward pressure could be exerted on IDB's ratings if the bank's capitalisation declines from current levels.
- » There could also be negative rating pressure if we consider that the government's willingness or capacity to provide support has materially declined.

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.moody's.com for the most updated credit rating action information and rating history.

Key indicators

Exhibit 2

Israel Discount Bank (Consolidated Financials) [1]

	03-20 ²	12-19 ²	12-18 ²	12-17 ²	12-16 ²	CAGR/Avg. ³
Total Assets (ILS Million)	276,404.0	259,823.0	239,176.0	221,221.0	219,577.0	7.3 ⁴
Total Assets (USD Million)	78,136.5	75,223.8	64,006.4	63,722.1	57,053.0	10.2 ⁴
Tangible Common Equity (ILS Million)	18,697.0	18,127.0	17,142.0	15,114.0	14,025.3	9.2 ⁴
Tangible Common Equity (USD Million)	5,285.4	5,248.1	4,587.4	4,353.6	3,644.2	12.1 ⁴
Problem Loans / Gross Loans (%)	1.5	1.2	1.2	1.7	2.4	1.6 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	9.5	9.6	9.8	9.2	8.9	9.4 ⁶
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	12.8	11.1	10.7	14.7	20.9	14.0 ⁵
Net Interest Margin (%)	2.2	2.4	2.4	2.3	2.2	2.3 ⁵
PPI / Average RWA (%)	2.3	1.9	1.8	1.7	1.4	1.8 ⁶
Net Income / Tangible Assets (%)	0.3	0.7	0.7	0.6	0.4	0.5 ⁵
Cost / Income Ratio (%)	57.3	63.4	66.2	66.6	71.8	65.0 ⁵
Market Funds / Tangible Banking Assets (%)	7.5	6.2	5.4	4.6	5.7	5.9 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	26.1	24.6	24.7	27.1	30.1	26.5 ⁵
Gross Loans / Due to Customers (%)	89.1	92.5	90.1	86.8	83.2	88.4 ⁵

[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 because of the scale of reported amounts. [4]Compound annual growth rate (%) based on the periods for the latest accounting regime. [5]Simple average of periods for the latest accounting regime.

[6]Simple average of Basel III periods.

Sources: Moody's Investors Service and company filings

Profile

IDB was the fourth-largest bank in Israel with a 15% market share in deposits and 17% in loans as of the end of 2019. The bank was incorporated in 1935.

IDB provides a full range of banking services out of its 178 branches in Israel, as of March 2020. IDB has the largest international operations among Israeli banks, carried out through Israel Discount Bank of New York (IDB New York), its US subsidiary, which mainly focuses on mid-sized companies and private banking. IDB New York operates branches in New York, Florida and California and has representative offices in Latin America and in Israel.

In December 2019, IDB acquired 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. Given the small size of Municipal Bank (accounting for roughly 3% of IDB's assets), the merger did not have a material impact on IDB's fundamentals.

Recent developments

We [expect](#) advanced economies collectively to contract in 2020. We expect a gradual recovery beginning in the second half of the year, but that outcome will depend on whether governments can reopen their economies while also safeguarding public health. A rebound in demand will determine the ability of businesses and labour markets to recover from the shock. Even with a gradual recovery, we expect 2021 real GDP in most advanced economies to be below pre-coronavirus levels.

Nevertheless, we have [maintained](#) our stable outlook on Israel's banking system, for now. We expect Israel's economy to contract in 2020, which will lead to an increase in problem loans and weigh on the banks' profitability. However, the deterioration in asset quality will be from strong levels, and will be mitigated by the relatively low private-sector debt and the comprehensive [policy response](#) from the authorities aiming to limit long-term damage to the economy. The economy's underlying strengths position it to recover strongly from the crisis, and we expect Israel's medium term growth potential will remain robust.

Detailed credit considerations

Asset quality will deteriorate but from recently strong levels; geopolitical tensions and high property prices remain a downside risk

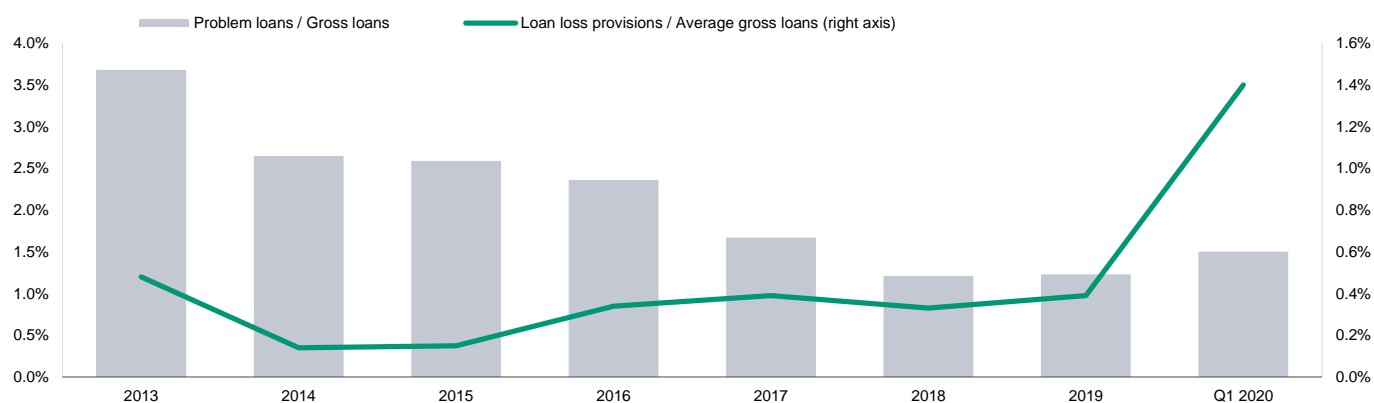
We expect that the coronavirus-induced economic disruption will drive an increase in IDB's problem loans and credit costs in the coming quarters, but the deterioration will be from recently strong levels. The stressed operating conditions will also test the bank's

relatively unseasoned loan book following significant growth in recent years. The bank's loan book grew by compound annual rate of 9.5% over the period 2016-2019, which significantly outpaced the market. The full extent of the asset quality deterioration will, however, depend on how severe the economic fallout will be, and whether higher unemployment persists into 2021. Although the bank's past through-the-cycle loan performance had been relatively weaker than peers, the bank tightened its underwriting standards, diversified its loan book and reduced single-borrower concentrations that could help improve future resilience. We continue to see elevated asset risks from potential geopolitical tensions and exposure to Israel's real estate market along with high property prices.

IDB's asset quality improved in recent years, helped by Israel's supportive operating environment. The ratio of problem to gross loans was a low 1.2% as of the end of 2019 and the coverage ratio was 110%. Cost of risk had declined, with average credit costs of 0.3% of gross loans for the period 2014-2019, benefiting from recoveries on previously provisioned amounts, compared to 0.6% for the period 2006-2013. However, the bank's average credit costs of 0.5% over the period 2006-2019 that includes an entire economic cycle exceeded that of its main peers.

However, the weakening credit conditions and increase in unemployment from historically low levels will lead to a deterioration in the bank's asset quality. Problem loans to gross loans increased to 1.5% in March 2020 and annualised credit costs were 1.4% in the first quarter of 2020 (see Exhibit 3), higher than peers. The bank booked NIS545 million in collective provisions for the expected increase in credit risk following an update in its model assumptions and NIS111 million in specific provisions for individual borrowers. The bank's exposures to vulnerable sectors in Israel, such as, hotels and transportation was 3% of total credit risk¹ as of March 2020, while its exposure to the wider commerce sector, part of which will also be negatively affected by the supply and demand shock, was 9% of the total. The bank's US operations, where lending accounts for 14% of total net credit to the public, will likely not provide significant diversification benefits, given the global economic downturn. Finally, the bank's exposure to small businesses in Israel at around 20% of total net credit as of March 2020, which would likely be hardest hit by the economic disruption, also poses increased asset risks.

Exhibit 3

IDB's asset quality will deteriorate but from strong levels

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

The immediate impact on asset quality will be mitigated by government support measures and [payment holidays](#). Also, in recent years, the bank tightened its credit standards both in retail and business lending and eliminated exposures to holding companies, which had caused an increase in problem loans in the past, with no exposures to a borrower group exceeding 15% of the bank's capital as of March 2020. Diversification in IDB's loan book improved following the bank's growth strategy which targeted expansion primarily in mortgages, lending to small business and consumer lending.

Similarly to other Israeli banks, credit risks also remain elevated owing to persistent geopolitical tensions that could compromise business confidence and economic activity. In addition, the sharp rise in property prices over the last decade renders Israeli banks vulnerable to a potential correction. IDB's exposure to housing mortgages and loans to the construction and real estate sectors accounted for around 24% and 16% respectively of its domestic loan book as of March 2020. High house prices combined with reduced consumer affordability expose banks to a potential house price correction, along with unexpectedly higher interest rates and a rise in unemployment. Risks are nonetheless mitigated by a number of macroprudential measures and higher capital buffers against

mortgages.² Although we expect the current crisis to cool the housing market, a structurally limited supply of new housing units can provide some price support. We see the higher risk in the office space market and commercial real estate, such as shopping malls and retail space, from the fallout of coronavirus pandemic.

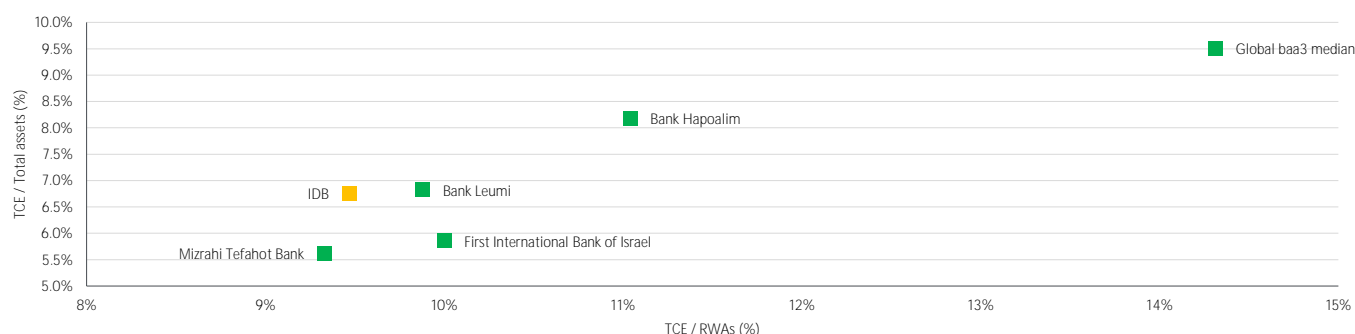
Modest risk-weighted capitalisation and moderate leverage

We view IDB's risk-weighted capitalisation as modest. However, IDB's loss-absorption buffers are supported by relatively conservative regulatory risk-weights, especially on mortgage lending, which drives relatively moderate leverage. We expect the bank's capital buffers to remain broadly stable despite the negative impact of the pandemic on the bank's profitability, supported by the temporary suspension of dividend payments and a more moderate lending growth.

IDB reported a CET1 ratio of 10.0% as of March 2020, exceeding the 8.2% minimum regulatory requirement, which applied at that time. The bank's Basel III leverage ratio was 6.5%, above the 5% minimum regulatory requirement, around the same level as its tangible common equity (TCE)-to-total assets ratio of 6.8%. Our own TCE/risk-weighted assets (RWAs) ratio was 9.5% as of March 2020, below that of similarly-rated international peers (see Exhibit 4). However, the Bank of Israel (BoI) maintains a more conservative regulatory framework, which results in higher RWAs. For example, the average risk weighting on mortgage lending is over 50% in Israel, against much lower risk weights applied by banks using the internal ratings-based approach and even the 35% used in the standardised approach.

Exhibit 4

IDB's capitalisation against domestic and global peers



Note: IDB as of March 2020; all other Israeli banks as of the end of 2019

Source: Moody's Investors Service

Against the prospect of a significant weakening in economic activity, the BoI decided to lower banks' capital requirements by 1 percentage point for a period of six months (with the possibility of an extension by six months) in order to support the provision of credit to the real economy. This reduced IDB's minimum CET1 ratio requirement to 8.2% in March from 9.2% at the end of 2019. Following this period, banks will be required to replenish capital, in case it is reduced, over a period of two years. At the same time, in line with the BoI's recommendation, in April IDB announced that it will discontinue the distribution of dividends. As a result, combined with more moderate loan growth, we expect the bank's capital levels to remain broadly stable.

Profitability will come under pressure, but continued focus on reducing high cost base may provide some support

After a gradual improvement in recent years, IDB's profitability will be under pressure because of a rise in credit costs and lower business volumes. The extent on which the bank delivers on its efficiency measures has the potential to partly mitigate the negative pressures on profitability from the coronavirus-induced economic disruption. IDB's cost base remains relatively high and its efficiency is still weaker than its domestic peers, despite significant improvement since 2015.

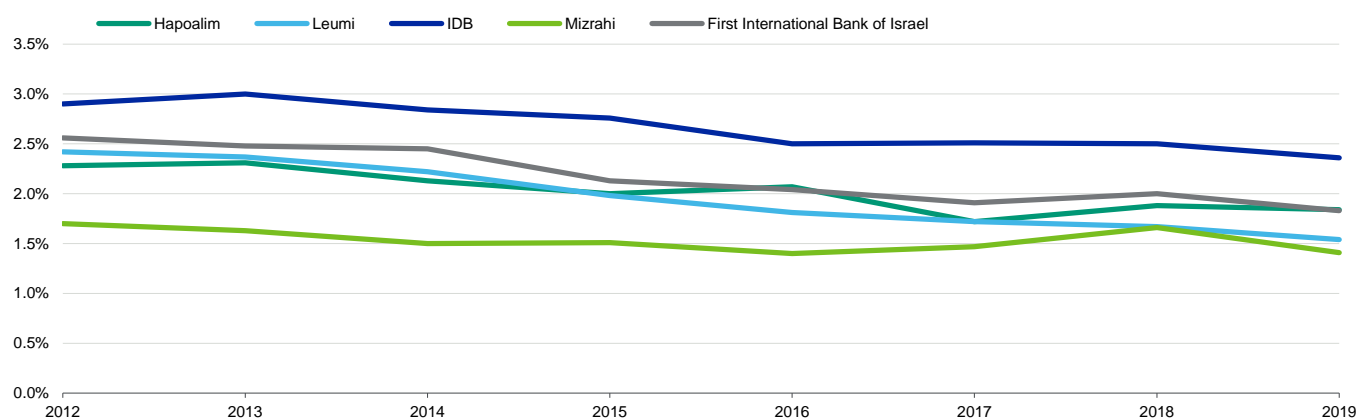
IDB's net income declined to 0.3%³ of tangible assets in the first three months of 2020 as the bank booked the aforementioned substantial provisions, down from 0.7% in 2019 and 2018. In addition to higher credit costs, the sustained low interest rate environment, with the policy rate recently reduced to 0.1%, coupled with lower loan growth and low CPI will also pressure the bank's margins. Fee income growth will be challenged by lower lending activity and credit card transactions. However, the bank's continued focus on reducing costs has the potential to partly offset the negative effects on profitability.

We expect the bank to maintain its cost focus. Efficiency initiatives already taken by the bank, such as reduction in headcount by 20% since 2013 through successive early retirement plans and a reduction in the number of branches and real estate space, has already improved its efficiency, with the cost-to-income improving to 63.4% in 2019 from 76.5% in 2015. However, the bank's cost base is still high with reported operating expenses at 2.2% of total assets in Q1 2020 (2019: 2.4%) and continues to compare unfavorably with its domestic peers.

Exhibit 5

IDB's cost base has declined substantially in recent years, but remain higher than its domestic peers

Operating expenses / Total assets



Based on Moody's adjusted figures

Source: Moody's Investors Service

The bank is currently revisiting its 2021 financial targets of a 10% return on equity and 60% cost-to-income ratio in light of the increased uncertainty. Over the medium term, we expect the key pillars of IDB's strategic plan to remain, mainly the bank's growth strategy, particularly in mortgages where its market share is lower than its natural market share, and its focus on digital offerings, with the coronavirus crisis accelerating the transition to alternative channels. Following the divestment of the two largest banks' credit card companies, we note that IDB has been allowed for the time being to retain its majority owned credit card subsidiary, enhancing the bank's profitability prospects.

Stable deposit-based funding structure and comfortable liquidity

IDB benefits from a large and stable deposit-based funding structure, with low reliance on potentially more confidence-sensitive market funding. Deposits accounted for 83% of non-equity funding as of March 2020, and we expect the bank to remain primarily deposit funded, benefitting from the strong savings culture in Israel. Further, 55% of the deposit base in Israel was from granular retail deposits. Our assessment also considers that foreign deposits, which could be more vulnerable to an institution-specific loss in depositor confidence, made up 13% of total as of March 2020. Deposits from institutional and capital markets investors were 8.5% of total deposits in Israel, relatively lower than peers. Nonetheless, both domestic and foreign deposits had proven to be stable during past systemic shocks in Israel.

The bank also maintains comfortable liquidity buffers at 26% of tangible banking asset as of March 2020. Cash and interbank balances accounted for 11% of total assets, with securities accounting for an additional 15%. The securities portfolio primarily comprises of A1-rated Israeli government securities at 67% of total, while 19% is invested in mortgage-backed and asset-backed securities of US government agencies and the remaining is in highly rated fixed-income securities of US and European financial institutions. IDB also reported a Liquidity Coverage Ratio at 129% as of March 2020, above the 100% minimum requirement.

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.

ESG considerations

In line with our general view for the banking sector, IDB has a low exposure to Environmental risks, see our [Environmental](#) risks heat map for further information. Although Israel is exposed to environmental risk through rising temperatures, drought episodes and water scarcity given its geographical location in a semiarid climate zone, the authorities have taken a number of steps to address these risks, including through seawater desalination and wastewater recycling.

Overall, we believe banks, including IDB, face moderate social risks, see our [Social](#) risk heatmaps. 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. We also regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety.

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.

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% deposits market share as of the end of 2019, 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

Counterparty Risk Ratings (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 agreements.

IDB's CRR is 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.

Methodology and scorecard

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 6

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	1.5%	a1	↓↓	baa3	Sector concentration	Unseasoned risk
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel III - transitional phase-in)	9.5%	ba1	↔	ba1	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	0.3%	ba3	↑	ba1	Expected trend	
Combined Solvency Score		baa2		ba1		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	6.2%	a1	↔	a2	Deposit quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	24.6%	baa2	↔	baa2	Stock of liquid assets	
Combined Liquidity Score		a3		a3		
Financial Profile				baa3		
Qualitative Adjustments				Adjustment		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint				A1		
BCA Scorecard-indicated Outcome - 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 7

Category	Moody's Rating
ISRAEL DISCOUNT BANK	
Outlook	Positive
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

Endnotes

- [1](#) Credit risk in Israel including on- and off-balance sheet exposures and excluding government and banks
- [2](#) The measures include loan-to-value limits, a monthly repayment cap at 40% of a borrower's month salary and limit on the variable-rate of interest part of the mortgage.
- [3](#) Moody's adjusted figure which is affected by the defined-benefit plan adjustment, a Moody's standard adjustment which takes into account the return on plan assets. Given the significant volatility in the financial markets, return on plan assets was negative in Q1 2020.,

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