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Research Update:

Israel Discount Bank, IDB NY Outlooks Revised To Positive On Resilient Risk Profile, Capital Buffers; Ratings Affirmed

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Overview

- Israel Discount Bank Ltd. (IDB) has maintained sound asset quality and strong capital and loss provision buffers in the past two years amid the COVID-19 pandemic.
- The bank's profitability and solvency are improving thanks to a diversified revenue base supported by improving efficiency and a strengthening business franchise.
- We therefore revised our outlooks on IDB and its core subsidiary Israel Discount Bank of New York to positive from stable and affirmed our 'BBB+/A-2' ratings.
- The positive outlooks indicate the possibility we could raise our ratings over the next two years if IDB can post higher operating profitability and earnings generation than reported in the pre-pandemic period, which should help sustain its risk adjusted-capital ratio above 10%.

Rating Action

On Jan. 20, 2022, S&P Global Ratings revised its outlooks on Israel-based Israel Discount Bank Ltd. (IDB) and its core U.S. subsidiary Israel Discount Bank of New York (IDB NY) to positive from stable.

At the same time, we affirmed our 'BBB+/A-2' long- and short-term issuer credit ratings on IDB, and our 'BBB+' long-term ratings on IDB NY.

The rating actions also follow a revision to our methodologies for rating banks and nonbank financial institutions and for determining a Banking Industry Country Risk Assessment (BICRA; see "Financial Institutions Rating Methodology," published Dec. 9, 2021 and "Banking Industry Country Risk Assessment Methodology And Assumptions," published Dec. 9, 2021, on RatingsDirect). However, the changes in criteria in and of themselves did not affect the rating action.

Rationale

IDB is weathering the pandemic with a limited impact on its financial profile. IDB's profitability and asset quality metrics remained sound despite pandemic-related economic stress and the relatively rapid credit growth it achieved in the past few years. After dropping to a decade low of 5.15% in 2020 due to additional provisions for the pandemic, return on equity (ROE) surged to 14.8% in third-quarter 2021 after these provisions were gradually released over 2021. Owing to the normalization of its cost of risk and pronounced lending growth, notably in mortgages, we forecast an ROE of about 9% in 2022 and 2023. We expect IDB's nonperforming loan (NPL) ratio to decrease during this period to about 1.15% versus a peak of 1.38% on March 31, 2021.

This resilient performance should help IDB to further strengthen its sound capital and provisioning buffers despite the intended rapid growth in lending. We understand that IDB's internal capital targets are based on its plan, under which capital should support an annual risk-weighted asset (RWA) growth rate of 5%-6% and a dividend policy of up to 20% of net income. On Nov. 22, 2021, IDB's board of directors decided to re-establish the target common equity Tier 1 (CET1) ratio at 9.75% versus 8.16% required by the regulator (including an addition of 0.16% with respect to housing loans). IDB's Tier 1 capital base mostly comprises common equity. Even after the release of Israeli new shekel (ILS) 683 million of provisions during 2021, we expect loan loss reserves to cover more than 100% of its NPLs until year-end 2023. This provides additional protection to its sufficient capital buffers and mitigates the risks stemming from its fast loan growth and the high single-party and industry concentrations--notably to the construction segment--in its lending book. Positively, the bank brought its cost-to-income ratio to 63% during 2021 from 72% in 2016. Although there is still a gap between IDB and its domestic and foreign peers, this improvement helped the bank to visibly improve its return metrics. We also note IDB's high quality of earnings, which are well diversified by product. At about 31% of its revenue on average between 2016-2021, IDB has one of the highest fee and commission income contributions among the peer group.

As a result, we forecast IDB's risk-adjusted capital (RAC) ratio will improve to about 10% by year-end 2023. IDB's RAC ratio recovered to 9.7% on Sept. 30, 2021, from a pandemic-related dip of 9.2% at year end-2019. This is mostly thanks to the release of additional provisions linked to the pandemic, and a prudent dividend policy since 2019. We note that IDB's RAC ratio was already on a positive trend prior to the pandemic, owing to the bank's efforts to improve its operational efficiency. During 2021, the bank reduced its headcount by 8% and closed four branches. We understand that IDB will not pay any dividends from its earnings in 2020 and the first two quarters of 2021. During 2022 and 2023, we assume a payout ratio of 20%-30%, which should be supportive of its anticipated 5%-9% lending growth.

Our assessments of economic risk and industry risk in Israel are also unchanged at '3' and '4', respectively, after the revisions to our criteria. These scores determine the BICRA and the anchor, or starting point, for our ratings on financial institutions that operate primarily in that country. The trends we see for economic risk and industry risk remain stable. In addition, the stand-alone credit profile of IDB, and our assessment of the likelihood of extraordinary external support, are unchanged under our revised criteria. Therefore, our ratings on IDB also factor one notch of uplift given our view that Israel (AA-/Stable/A-1+) would provide extraordinary support to the bank in the event of financial distress.

Outlook

The positive outlooks over the next two years on IDB and its core banking subsidiaries, including IDB NY, reflect the possibility we could raise our ratings if the bank can continue enhancing its capitalization and preserve its improved profitability and earnings generation amid high business growth and strong market competition. Specifically, we anticipate IDB will report average net earnings of about ILS2.0 billion-ILS2.2 billion per year over 2022-2023, and maintain a prudent dividend payout sufficient to fund business growth and continue accumulating capital. We will monitor the evolution of asset quality, efficiency, and profitability metrics in comparison with those of higher-rated peers.

Upside scenario

An upgrade will hinge on continued positive momentum in terms of operational efficiency, cost of risk, and profitability. Specifically, it would be possible if we conclude that IDB can sustainably increase our pre-diversification RAC ratio above 10%, supported by the better quality of its earnings.

Downside scenario

We could revise the outlook to stable if the current positive trend in the bank's capitalization stops or reverses such that the RAC ratio remains visibly below 10% or the quality of its earnings and capital deteriorates, leading to a weaker earnings buffer and capital sustainability. This could stem from the pace of loan growth, dividend payouts to the detriment of internal capital generation, or cost of risk, exceeding our projections.

Ratings Score Snapshot

Issuer Credit Ratings	BBB+/Positive/A-2
SACP	bbb
Anchor	bbb+
Business position	Adequate (0)
Capital and earnings	Adequate (0)
Risk position	Moderate (-1)
Funding and	Average and (0)
Liquidity	Adequate
Support	+1
ALAC support	0
GRE support	0
Group support	0
Sovereign support	+1
Additional factors	0

Related Criteria

- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Banking Industry Country Risk Assessment Update: December 2021, Dec. 17, 2021
- Israel Ratings Affirmed At 'AA-/A-1+'; Outlook Stable, May 14, 2021
- Tech Disruption In Retail Banking: The Regulator Is Moving Israeli Banks Into A Digital Future, Feb. 5, 2020

Ratings List

**************** Israel Discount Bank Ltd. ****************

Ratings Affirmed; Outlook Action		
	To	**From**
Israel Discount Bank Ltd.		
Issuer Credit Rating	BBB+/Positive/A-2	BBB+/Stable/A-2
Israel Discount Bank of New York		
Issuer Credit Rating	BBB+/Positive/--	BBB+/Stable/--

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