FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Leumi's and Hapoalim's Ratings; Stable Outlook

Thu 30 Apr, 2020 - 12:24 PM ET

Fitch Ratings - London - 30 Apr 2020: Fitch Ratings has affirmed Bank Hapoalim B.M.'s (Hapoalim) and Bank Leumi Le-Israel B.M.'s (Leumi) Long-Term Issuer Default Ratings (IDRs) at 'A' with a Stable Outlook. The banks' Viability Ratings (VRs) are affirmed at 'a-'. A full list of rating actions is detailed below.

The rating action reflects a recent similar rating action on the State of Israel (see Fitch Affirms Israel at 'A+'; Outlook Stable; 23 April 2020) and considers the economic and financial market implications of the coronavirus outbreak.

Fitch estimates that the lockdown measures in place in Israel will result in a GDP contraction of 5.6% in 2020, followed by a sharp recovery in 2021. Uncertainties surrounding these forecasts are high and risks are on the downside. Israel has gradually started to lift lockdown measures, but the final impact on its GDP will depend on how well the process is managed and possible subsequent outbreaks are contained.

Fitch has affirmed the Israeli banks' VRs, reflecting the banks' resilience to pressures from the current coronavirus fallout. Both banks entered this crisis with sound asset quality, reporting low levels of impaired loans. Their structural profitability has remained fairly stable due to efficiency measures over the past couple of years. Capital levels at both banks are sound. In March 2020 Hapoalim stated that it had extensively negotiated the terms of an agreement with the US Authorities on the final payment of an outstanding penalty, which removed significant uncertainty around its capital levels.

If the recovery of the economy is slower than expected and the impact on the banks deepens, negative rating actions on the VRs may follow. We have revised the trend on our assessment of the banks' operating environment, asset quality and earnings to negative from stable, to reflect downside risk.

KEY RATING DRIVERS

IDRS, SUPPORT RATINGS (SRs) AND SUPPORT RATING FLOORS (SRFs)

Leumi's and Hapoalim's IDRs, SRs and SRFs reflect Fitch's expectation of an extremely high probability of state support, if needed. Our expectation is underpinned by Israel's ability to support domestic banks, as reflected in the recently affirmed sovereign ratings, combined with our belief that the state has a strong willingness to do so. This view is reinforced by the large franchises of the banks, their importance to the Israeli economy, and the government's objective of preserving confidence in the banking sector, especially considering the absence of both a deposit guarantee scheme and effective recovery and resolution legislation. Leumi and Hapoalim, each accounts for about 30% of sector assets and are considered to be domestically systemically important.

The banks' 'F1+' Short-Term IDRs are the higher of the two possible Short-Term IDRs corresponding to an 'A' Long-Term IDR. This is because we view the sovereign's propensity to support as more certain in the near term. We also view the risk for simultaneous deterioration in the liquidity profile of both Israel and its large banks (wrong-way risk) as low and have not identified other potential impediments to the prompt flow of funds to the banks.

VRs

The VRs of both banks reflect their strong domestic franchises, modest risk appetite despite the presence of some industry concentrations, healthy asset quality entering this crisis, resilient earnings and sound capitalisation, particularly in view of the banks' high risk-weight density for their risk profiles.

The measures implemented by the government to deal with the coronavirus crisis have resulted in a large contraction of the economy and an increase in the number of unemployed and on unpaid leave to around a quarter of the workforce (as per Israel's National Employment Agency) in April 2020, compared with 3.4% at end-February. To deal with these pressures, the government in Israel and the Bank of Israel (BoI) introduced a series of measures that are intended to stimulate the economy and allow the banks to lend sufficiently and appropriately in order not to stifle economic growth further.

The BoI rolled out a ILS5 billion SME credit facility to provide banks with low interest-rate loans to extend to micro and small businesses. It also cut its base interest rate to 0.1% from 0.25% on 6 April and simultaneously extended its repo operations, which it began in mid-March, to include corporate bonds as collateral. BoI also pursues quantitative easing through a ILS50 billion government bond purchase programme. It further eased the guidelines on classifications and provisioning of impaired and restructured loans, if arrears have been caused by the coronavirus crisis, and are deemed to be temporary. US-dollar liquidity pressures in the system were eased by the provision of US-dollar swap facilities.

Despite these measures, we expect asset quality to be negatively affected at both Hapoalim and Leumi. Most at risk are exposures to commercial and SME clients active in vulnerable sectors, including aviation, tourism, hospitality and leisure and energy, although the impact on asset quality is likely to be broader. These will cause some longer-term impairment also in the mortgage and other personal lending sectors as Fitch expects unemployment to be close to 10% at end-2020. Non-performance in mortgage lending was virtually nil at end-2019, however.

The construction and real estate sectors should be somewhat protected by the decision of the government to allow home construction to continue as it has been deemed essential to the economy and for banks to increase their exposure to this sector up to a raised limit of 22% of exposure (as defined by the Bol) from 20% previously. However, we expect that this sector will also suffer some additional impairment, particularly if the completion and sale of homes is delayed by the current crisis.

The policy rate cut by the BoI is expected to put pressure on the banks' interest income, which accounts for almost two-thirds of total operating income. Both banks' balance sheets are structured to benefit from rising policy rates given the large amounts of current accounts on the balance sheets and liquidity buffers.

Further pressure on profitability is expected from higher loan impairment charges (LICs). Hapoalim published its 2019 annual results recording additional provisioning arising from the unfolding health crisis in the amount of about ILS680 million for 4Q19 based on the information available up to that point (compared with ILS400 million LICs in 9M19).

The outbreak presents a downside risk to the banks' capitalisation as increased drawdown of credit by SMEs and, if the crisis extends materially into 2020, by consumers, would result in higher risk-weighted assets (RWA). Credit demand is likely to remain elevated in the coming quarters. The government guarantees on loans to SMEs will provide some RWA relief.

To allow higher lending, BoI reduced the capital requirement for banks by 1pp for six months from 29 March 2020, which can be extended by a further six months if necessary. Thereafter the banks will be given 24 months to return to the pre-crisis capital levels and requirements. Leumi's and Hapoalim's regulatory common equity Tier 1 (CET1) requirements declined to 9.3%. We expect the banks to continue to operate with moderate capital management buffers over the reduced requirement, although a material reduction in capital buffers will put pressure on the banks' VRs.

Capital should be supported by the banks' decisions to put dividend distribution and share buy-back plans on hold. The agreement of terms reached by Hapoalim with the US Authorities in 1Q20 has reduced some of the uncertainty over capital pressure. At end-2019, Leumi reported a CET1 ratio of 11.9% and Hapoalim at 11.5%.

Liquidity in the system remains strong, particularly in shekel. Liquidity is supported by a stable funding base, mostly made up of customer deposits, with limited wholesale funding needs, as well as the recent measures taken by BoI. Customer deposits are granular and have been stable historically, including during periods of economic stress and political instability, despite the absence of a deposit guarantee scheme in Israel.

LEUMI'S SUBORDINATED DEBT

Fitch has affirmed the rating of Leumi's USD750 million Tier 2 subordinated notes at 'BBB'. The rating is notched twice from Leumi's VR, to reflect the heightened likelihood of poor recoveries in the event of default. We do not notch the notes for non-performance as in our opinion the principal loss absorption feature gives rise to low incremental non-performance risk relative to the bank's VR

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Hapoalim's and Leumi's Long- and Short-Term IDRs could be affected by a change in Fitch's assumptions about the Israeli authorities' propensity or ability to provide timely support to the banking sector. A downgrade of Israel's Long-Term IDR is likely to result in a similar downward revision and downgrade of the banks' SRFs and Long-Term IDRs, respectively. The introduction of a resolution law, which could indicate a reduced propensity to provide support, is in discussion but we do not expect this law to come into effect within the next 24 months.

A downgrade of the VRs would most likely be driven by a deeper and more prolonged crisis, with an economic recovery from the crisis being more remote than we currently expect. A delay to this recovery would likely result in more permanent damage to the bank's earnings and asset quality, which would be difficult to restore within a short period of time. Capital below the banks' reduced targets without a plan to rebuild it sufficiently and swiftly, could also lead to a VR downgrade.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

In the event Hapoalim and Leumi are able to withstand ratings pressure arising from the coronavirus outbreak, the upgrade of their VRs is unlikely given the already high rating in the context of their company profiles. However, improving profitability on the back of a more diversified business model while maintaining strong capital ratios and healthy asset quality could allow the banks' VRs to be upgraded.

An upgrade of Israel's Long-Term IDR is unlikely to result in an upgrade of the banks' Long-Term IDRs. This is because, in line with our criteria, 'A'/'A-' are typical SRFs for domestic systemically important banks in countries whose sovereigns are rated 'AA' or 'AA-' and where support propensity is high.

LEUMI'S SUBORDINATED DEBT

The notes' rating is primarily sensitive to a change in the bank's VR, from which it is notched. The notes' rating is also sensitive to a change in notching should Fitch reassess the notes' loss severity or relative non-performance risk.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Leumi's and Hapoalim's Long-Term IDRs, SRs and SRFs reflect Fitch's expectation of an extremely high probability of state support, if needed,

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING

ENTITY/DEBT	RATING		
Bank Leumi Le-Israel B.M.	LT IDR	A	Affirmed
	ST IDR	F1+	Affirmed
	Viability	a-	Affirmed
	Support	1	Affirmed
	Support Floor	A	Affirmed
• subordinated	LT	BBB	Affirmed

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Bank Hapoalim B.M.	EU Issued
Bank Leumi Le-Israel B.M.	EU Issued

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