

## CREDIT OPINION

4 July 2018

### Update

 Rate this Research

### RATINGS

Domicile	Israel
Long Term CRR	A1
Type	LT Counterparty Risk Rating - Fgn Curr
Long Term Deposit	A2
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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## Bank Leumi

### Update to credit analysis

#### Summary

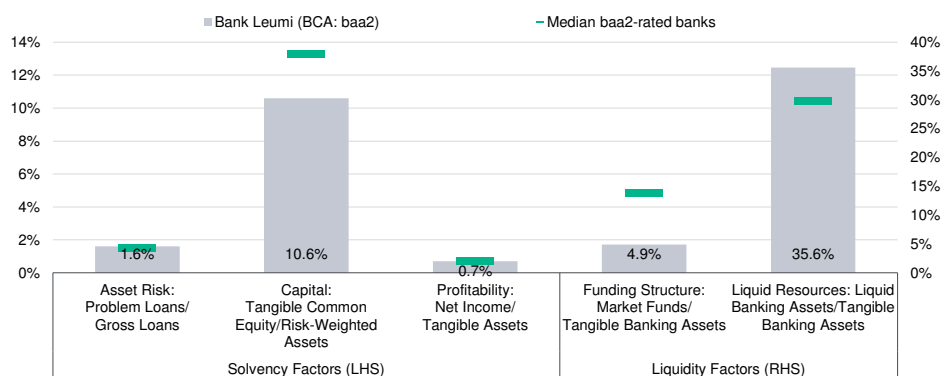
We assign A2/Prime-1 deposit ratings to Bank Leumi, a leading Israeli bank with approximately 29% market share of total assets. The deposit ratings incorporate a three-notch uplift from the bank's baa2 baseline credit assessment (BCA), based on our assessment of a very high likelihood of government support in case of need.

The ratings – and specifically the bank's BCA – are supported by Bank Leumi's resilient asset quality, with problem loans (NPLs, defined as "impaired" loans plus other loans over 90 days overdue) at 1.4% of gross loans as of March 2018, a strong retail deposit base and comfortable liquidity, with liquid assets (cash, interbank and securities) at 34% and the net loans-to-deposits ratio at 73%. The bank maintains an equity-to-assets ratio of 7.5% as of March 2018, in line with similarly-rated international peers, but its reported Tier 1 ratio of 11.1% remains below international peers, although this primarily results from Bank of Israel's (BoI) stricter risk weight classifications.

Over the medium term, asset quality remains vulnerable to persistent geopolitical risks and high systemic risks relating to the Israeli property market. Compared to international peers, the bank has a high cost base, with operating costs of 2.6% of average risk-weighted assets for Q1 2018, although initiatives are under way to address this issue.

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

- » Low level of NPLs and significantly reduced single-name concentrations
- » Strong retail deposit base and good liquidity
- » Very high likelihood of government support, in case of need, underpins the deposit ratings

## Credit challenges

- » High cost base that translates to moderate profitability; but a multi-year streamlining program is being implemented
- » Regional / geopolitical situation and high property prices present tail risks

## Rating outlook

The ratings have a stable outlook, with the bank's strong funding/liquidity and low level of NPLs balancing vulnerabilities relating to the property market, and moderate profitability metrics.

## Factors that could lead to an upgrade

- » Upward pressure could originate from improvements in the bank's standalone credit assessment following evidence of improved efficiency and profitability and stronger capital adequacy.

## Factors that could lead to a downgrade

- » Negative pressure could be exerted on the ratings if a deterioration in the operating conditions lead to a weakening of asset quality and profitability, or if Moody's considers that the government's ability and/or capacity to provide support has materially changed.

## Key indicators

Exhibit 2

### Bank Leumi (Consolidated Financials) [1]

	3-18 <sup>2</sup>	12-17 <sup>2</sup>	12-16 <sup>2</sup>	12-15 <sup>2</sup>	12-14 <sup>2</sup>	CAGR/Avg. <sup>3</sup>
Total Assets (ILS million)	450,567	450,838	438,603	416,499	396,984	4.0 <sup>4</sup>
Total Assets (USD million)	128,336	129,863	113,963	107,040	102,014	7.3 <sup>4</sup>
Tangible Common Equity (ILS million)	33,593	30,642	29,368	26,742	23,070	12.3 <sup>4</sup>
Tangible Common Equity (USD million)	9,568	8,826	7,631	6,873	5,928	15.9 <sup>4</sup>
Problem Loans / Gross Loans (%)	1.4	1.4	1.7	1.8	2.2	1.7 <sup>5</sup>
Tangible Common Equity / Risk Weighted Assets (%)	10.6	9.9	9.8	8.7	7.5	9.3 <sup>6</sup>
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	10.2	11.3	14.2	16.0	21.2	14.6 <sup>5</sup>
Net Interest Margin (%)	1.8	1.9	1.8	1.8	2.0	1.9 <sup>5</sup>
PPI / Average RWA (%)	1.6	1.8	1.5	1.5	1.2	1.5 <sup>6</sup>
Net Income / Tangible Assets (%)	0.7	0.8	0.6	0.7	0.4	0.6 <sup>5</sup>
Cost / Income Ratio (%)	58.5	58.1	63.4	64.0	70.5	62.9 <sup>5</sup>
Market Funds / Tangible Banking Assets (%)	3.3	4.9	4.8	4.6	5.6	4.6 <sup>5</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	34.1	35.6	35.0	31.7	28.9	33.1 <sup>5</sup>
Gross Loans / Due to Customers (%)	73.6	74.9	76.5	80.6	84.6	78.1 <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 Financial Metrics

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](http://www.moody's.com) for the most updated credit rating action information and rating history.

## Profile

Bank Leumi Le-Israel B.M. (Bank Leumi) provides banking, financial and nonbanking services to large corporations, middle-market companies, small businesses, households and wealthy customers. It also holds investments in nonbanking corporations, including those operating mainly in the fields of insurance, energy, chemicals and infrastructure. As of March 2018, Bank Leumi was the largest bank in Israel with reported total consolidated assets of NIS450.6 billion (USD128.3 billion). For more information on the bank, please see [Issuer Profile - Bank Leumi](#).

Leumi has intensified its digital banking activities and recently launched Pepper, the first mobile-only digital banking application in Israel. Pepper provides a tailor-made banking experience based on artificial intelligence, while allowing customers to chat with a banker 24 hours six days a week (except Shabbat), while the procedure for opening a Pepper account takes only eight minutes. Leumi also reached an agreement to sell a 15% stake in its US subsidiary, Bank Leumi USA, in an effort to expand its customer base, gain greater access to US capital markets and leverage the new shareholders' experience in the US financial markets.

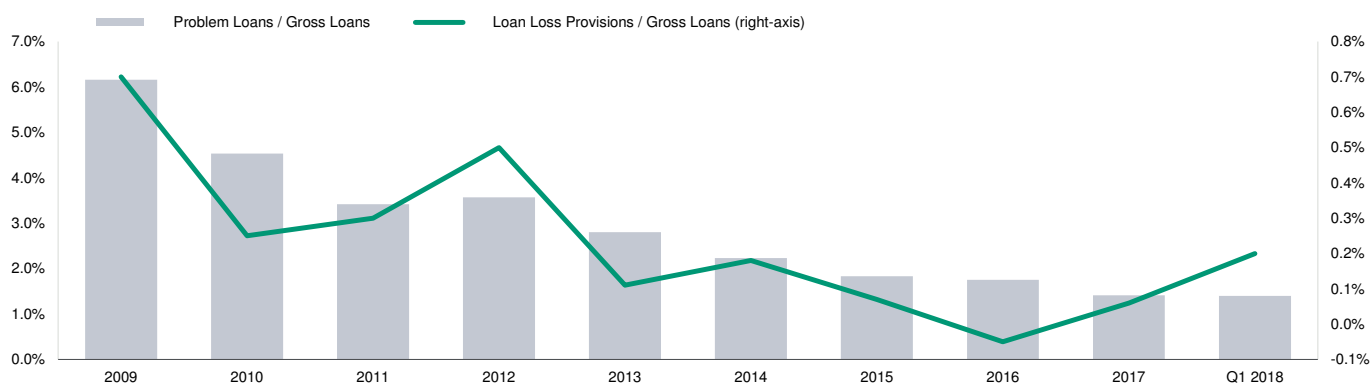
## Detailed credit considerations

### Bank displays good asset quality

As of March 2018, the bank reported NPLs of around 1.4% of gross loans. Provisioning reserves as a percentage of gross loans stood at 1.2%, implying a coverage ratio of around 87%. Provisioning requirements remain low, at 0.2% of gross loans, however, we expect provisioning expenses to normalize to more sustainable levels; we expect these to rise to around 40-50 basis points over the next three years.

Exhibit 3

#### Bank Leumi's asset quality metrics on an improving trend



Source: Bank's financial statements

The improvement in the bank's asset quality in recent years partly reflect Israel's solid economic growth, robust wage growth, low unemployment and strong business confidence. The strong operating environment – as documented by our "Strong" macro profile score – also reflect the country's competitive economy and the banks' uninterrupted access to domestic funding. The economy has shown resilience despite extensive geopolitical challenges. For 2018, we project the economy to grow by 3.2%, with inflation remaining low at around 1.5%. The banking sector benefits from the country's strong savings culture, which provides sufficient customer deposits for the banks to avoid more volatile market funding. Our views of the Israeli operating environment also incorporate our assessment of risks surrounding rising real-estate prices and authorities' plans to intervene and further increase competition in the banking sector.

Leumi's asset quality remains vulnerable to persistent geopolitical tensions that could still compromise business confidence and economic activity; similarly, increased house prices combined with reduced consumer affordability expose banks to an increase in interest rates, rising unemployment and to a potential house price correction. Leumi maintains high sectoral concentrations, with loans granted to the construction and real estate sectors accounting for around 20% of total loans, and housing loans accounting for an additional 29%.

However, risks are mitigated by (1) the low level of household debt; (2) stricter regulation which enforces tighter underwriting standards and higher capital buffers against mortgages; (3) our projections of sustained low unemployment and interest rates; and (4)

continued government efforts to increase the supply of homes and initial indications that house prices are stabilising. We also note that Leumi has been reducing its single name and group concentrations and that it maintains lower credit concentrations relative to local peers, with no credit exposure to large borrowers, groups of borrowers and banking group of borrowers whose debt exceeds 10% of the bank's capital.

Litigation risks have receded following the payment of a \$400 million fine to US authorities in 2016 regarding allegations that some of the Group's customers (who are US taxpayers) may have breached US law by preparing and presenting false tax returns to the Internal Revenue Service (IRS). The bank has also disposed of its related Swiss and Luxemburg operations, while it subsequently recouped a (net) \$66 million as part of an insurance settlement.

### Modest Tier 1 capital buffers, but with a stronger leverage ratio

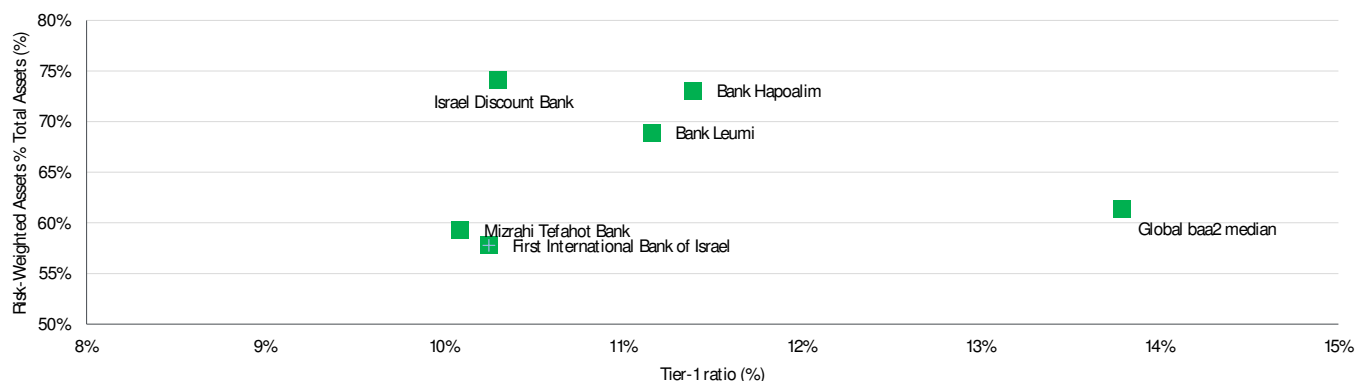
The bank has been building up its capital in recent quarters, and posted a Basel III-compliant Tier 1 ratio of 11.1% at end-March 2018, comfortably above the minimum regulatory requirement of 10.3%, but below similarly-rated international peers. We do, however, recognise that BoI maintains a strict regulatory framework, which results in much higher risk weighted assets. For example, the average risk weighting on mortgage lending is over 50% in Israel, against a much lower risk weightings applied by banks using the internal ratings-based approach. This is also evident by Leumi's high RWAs-to-total assets ratio of 69% and its equity-to-assets ratio which stood at 7.5%, in line with similarly rated peers, with a (Basel III) leverage ratio of 6.9%.

Management also maintains a contingency plan in case it needs to further increase its capital metrics, including the purchase of insurance to reduce capital requirements relating to the issuance of guarantees, and/or the potential sale of part of its loan portfolio. The bank's capitalisation would also benefit from an increase in interest rates, as this would reduce the future liabilities of its defined benefits pension scheme, further boosting its capital levels.

Going forward, we expect Leumi's capital metrics to remain broadly stable, as the bank has increased its dividend payout ratio to around 40% and introduced a NIS700 million share buy-back plan; at the same time, capital metrics will receive a significant boost once the Leumi Cards transaction/disposal is completed.

Exhibit 4

#### Bank Leumi's capitalisation against domestic and global peers



Note: Israeli banks are as of December 2017

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

In 2016, the bank has issued NIS926 million of Tier 2 CoCos. The instruments have equity conversion features, a duration of 10 years (non-call five) and may be converted to equity at either the point of non-viability (as defined by Bank of Israel) or if Tier 1 drops below 5%.

### Relatively high cost base translates to moderate profitability metrics; but a multi-year streamlining program is being implemented

Going forward, we expect profitability to remain pressured by the low interest rate environment which keeps margins down, increased provisioning charges as recoveries converge to more normalised levels, the high tax rate and Leumi's high cost base as explained below.

For the first three months of 2018, the bank reported bottom line profits of NIS730 million, translating to return on risk-weighted assets of around 1.0%.

Leumi reported operating expenses as a percentage of average RWA at 2.6% during Q1 2018, partly reflecting the banking sector's high unionisation and resultant high personnel costs, which are also affected by a special tax imposed on salaries paid. Leumi's efficiency indicators – in line with those of most other Israeli banks – are inferior to similarly rated international peers. However, the Bank is implementing a multi-year streamlining program, which we expect will lead to a gradual improvement of its efficiency metrics; employee numbers have already reduced by 435 during 2017 and 2,900 over the past six years.

### **Strong retail deposit base and good liquidity**

Bank Leumi exhibits a sound liquidity profile, which is supportive of the bank's standalone financial strength. The liquidity profile is underscored by a large and granular deposit base with a high proportion of retail deposits, a large stock of liquid assets and a good level of equity and long-term sources of funds. At end-March 2018, the bank posted a loans-to-deposits ratio of 73%.

Liquid assets (cash, interbank assets and securities) accounted for approximately 34% of total assets and 42% of deposits. Bonds and subordinated notes stood at NIS15.6 billion (3.5% of total assets), providing term funding while supporting better maturity matching of assets and liabilities. As we expect modest balance sheet growth over the coming quarters, Bank Leumi's funding and liquidity metrics will likely remain at broadly the current levels. The strength of the bank's funding and liquidity position is also evident from its 122% Liquidity Coverage Ratio as of March 2018.

Both domestic and foreign deposits have proven to be stable during past shocks in Israel, while the bank remains a large net interbank placer. Leumi adopts comprehensive liquidity management practices that incorporate liquidity scenarios and conservative limits. The bank seeks to maintain a surplus of liquid assets as a proportion of short-term market funding in local and foreign currency for various time periods of up to one month, under normal and stressed conditions. The effectiveness of the bank's internal liquidity management models is tested through daily liquidity forecasting and measurement.

Despite the above strengths, we note that the bulk of deposits are either of short-term maturity or sourced from institutional investors (with deposits of more than NIS100 million making up 30% of the total), hence vulnerable to a loss in depositor confidence.

### **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 banks' 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](#)" published on 13 June 2017.

## **Support and structural considerations**

### **Government support considerations**

We believe there is a very high likelihood of government support for Bank Leumi's rated deposits. This reflects the Israeli government's past practice of injecting capital into systemically important banks in case of need. This is particularly the case for Bank Leumi given its 29% share of the domestic market and hence material systemic consequences of an unsupported failure. We thus incorporate three notches of government support into our deposit ratings, rating them at A2.

While a new resolution framework is also under way in Israel, we expect it will exclude bail-in features for banks' depositors and other senior creditors. Instead, the new framework will likely focus on early intervention adding to the tools the Bank of Israel has available to restore ailing banks.

### **Counterparty Risk Ratings (CRRs)**

Moody's Counterparty Risk Ratings (CRRs) are opinions of the ability of entities to honour the uncollateralized portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event such liabilities are not honoured. CRR liabilities typically relate to transactions with unrelated parties. Examples of CRR liabilities include the uncollateralized portion of payables arising from derivatives transactions and the uncollateralized portion of liabilities under sale and repurchase agreements.

We believe that CRR liabilities have a lower probability of default than the bank's deposit and senior unsecured debt as they will more likely be preserved in order to minimise banking system contagion, minimise losses and avoid disruption of critical functions. For this reason, we assign CRR, prior to government support, one notch above the adjusted BCA.

### **Leumi's CRR is placed at A1/Prime-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 baa2), to which we then typically add the same (three) notches of government support uplift as applied to deposit ratings. As such, Leumi's CRR is set at A1/Prime-1.

Leumi's Counterparty Risk (CR) Assessment is also positioned at A1(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

### Bank Leumi

#### Macro Factors

<b>Weighted Macro Profile</b>	<b>Strong</b>	<b>100%</b>
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Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	1.6%	a2	← →	baa2	Sector concentration	
Capital						
TCE / RWA	10.6%	baa3	← →	baa3	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	0.7%	baa3	← →	baa3	Return on assets	Earnings quality
Combined Solvency Score		baa1		baa3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	4.9%	aa3	← →	a2	Deposit quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	35.6%	a2	← →	a3	Stock of liquid assets	
Combined Liquidity Score		a1		a2		
Financial Profile				baa2		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint:				A1		
Scorecard Calculated BCA range				baa1-baa3		
Assigned BCA				baa2		
Affiliate Support notching				0		
Adjusted BCA				baa2		

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	baa1	3	A1	A1
Counterparty Risk Assessment	1	0	baa1 (cr)	3	A1 (cr)	--
Deposits	0	0	baa2	3	A2	A2

Source: Moody's Financial Metrics

## Ratings

Exhibit 6

### Category Moody's Rating

#### BANK LEUMI

Outlook	Stable
Counterparty Risk Rating	A1/P-1
Bank Deposits	A2/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2
Counterparty Risk Assessment	A1(cr)/P-1(cr)

Source: Moody's Investors Service



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