

CREDIT OPINION

17 December 2019

Update

 Rate this Research

RATINGS

Bank Leumi

Domicile	Israel
Long Term CRR	A1
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Debt	Not Assigned
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

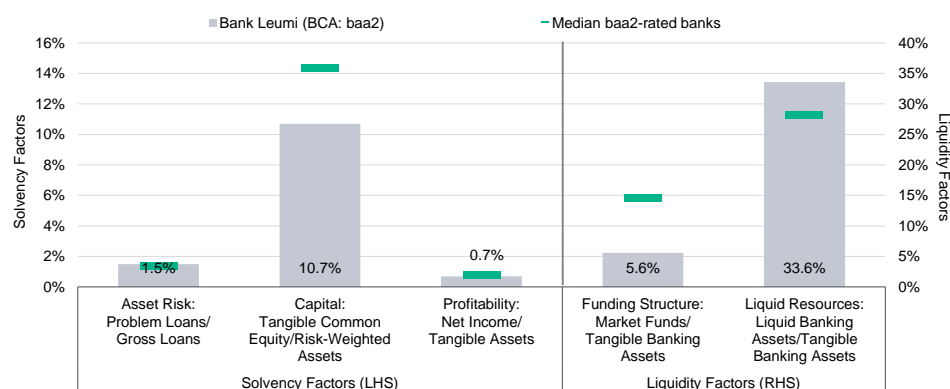
We assign A2/Prime-1 deposit ratings to Bank Leumi. These incorporate a three-notch uplift from the bank's baa2 baseline credit assessment (BCA), based on our assessment of a very high likelihood of government support ([Israel](#), A1 positive) in case of need.

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 1.2% of gross loans as of September 2019, a strong retail deposit base and comfortable liquidity, with liquid assets (cash, interbank and securities) at 31.6% of tangible banking assets, and the net loans-to-deposits ratio at 78%. The bank maintains an equity-to-assets ratio of 7.7% as of September 2019, in line with similarly-rated international peers, but its reported Tier 1 ratio of 11.7% 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 1.7%¹ of assets for the first 9 months of 2019. However, initiatives are under way to address this issue, with the bank's efficiency on an improving trend.

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 the implementation of a multi-year streamlining program is improving the bank's efficiency
- » 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 the bank's high cost base.

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]

	09-19 ²	12-18 ²	12-17 ²	12-16 ²	12-15 ²	CAGR/Avg. ³
Total Assets (ILS Million)	454,508.0	460,657.0	450,838.0	438,603.0	416,499.0	2.4 ⁴
Total Assets (USD Million)	130,763.6	123,277.4	129,862.7	113,962.8	107,040.3	5.5 ⁴
Tangible Common Equity (ILS Million)	34,601.0	34,108.8	30,671.4	29,368.2	26,741.8	7.1 ⁴
Tangible Common Equity (USD Million)	9,954.8	9,127.9	8,834.8	7,630.8	6,872.6	10.4 ⁴
Problem Loans / Gross Loans (%)	1.2	1.4	1.6	1.7	1.8	1.6 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	10.7	10.5	9.9	9.8	8.7	9.9 ⁶
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	9.0	10.2	12.8	14.2	16.0	12.4 ⁵
Net Interest Margin (%)	2.0	2.0	1.9	1.8	1.8	1.9 ⁵
PPI / Average RWA (%)	2.1	1.8	1.8	1.5	1.5	1.8 ⁶
Net Income / Tangible Assets (%)	0.9	0.7	0.8	0.6	0.7	0.7 ⁵
Cost / Income Ratio (%)	51.7	56.8	57.8	63.4	64.0	58.7 ⁵
Market Funds / Tangible Banking Assets (%)	6.1	5.6	4.9	4.8	4.6	5.2 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	31.6	33.6	35.6	35.0	31.7	33.5 ⁵
Gross Loans / Due to Customers (%)	78.9	75.4	74.9	76.5	80.6	77.3 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 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

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.

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 in various fields. As of September 2019, Bank Leumi reported total consolidated assets of NIS454.5 billion (USD130.8 billion) with a market share (by assets) of around 29%². For more information on the bank, please see [Issuer Profile - Bank Leumi](#).

Leumi has intensified its digital banking activities and in mid-June 2017 launched Pepper, the first mobile-only digital banking application in Israel. Pepper provides a tailor-made banking experience based on artificial intelligence and allowing customers to chat with a banker 24 hours six days a week (except Shabbat). The bank's digital initiatives also include the launch of various products such as 'Digital Mortgage' and 'VIDEA', an advanced digital platform for investment management, and the establishment of a 'Data Division'.

Recent developments

Leumi sold its entire interests in Leumi Card to Warburg Pincus Financial Holdings, a corporation under the control of investment fund Warburg Pincus. The transaction was completed in February 2019 and incorporated in the bank's 9M 2019 financials.

In July 2019, Leumi completed the sale of its entire holding in its subsidiary, Bank Leumi Romania, to First Bank, Romania. The transaction did not have a material impact on the bank's financial results.

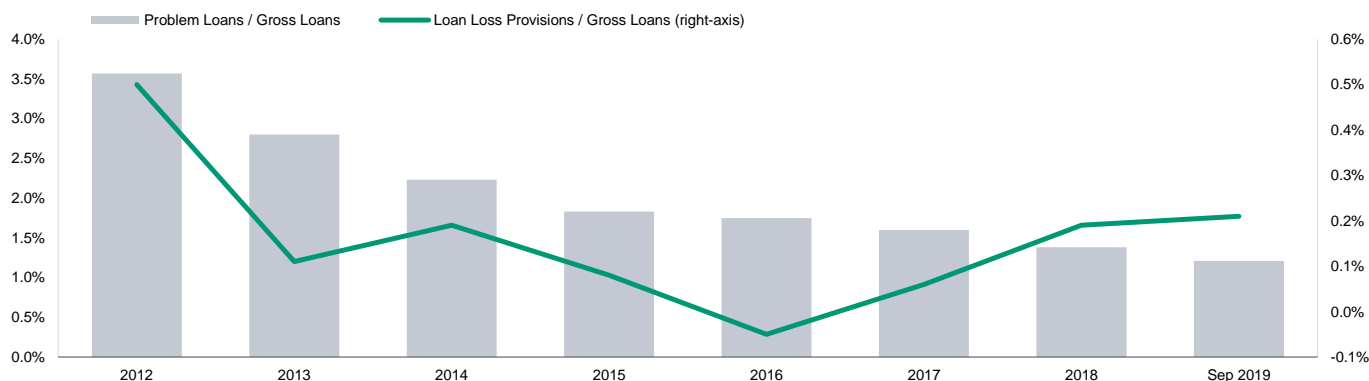
Detailed credit considerations

Bank Leumi displays good asset quality

As of September 2019, the bank reported NPLs of around 1.2% of gross loans. Provisioning reserves as a percentage of gross loans stood at 1.2%, implying a coverage ratio of around 96%. Provisioning requirements remain low, equivalent to 0.21% of average gross loans in 9M 2019, and we expect these to remain at around these levels (20-25 basis points) in 2020. Over the next three years, we expect these to rise to around 40-50 basis points, as recoveries of previously provisioned amounts begin to fade.

Exhibit 3

Bank Leumi's asset quality metrics have been improving



Source: Bank's financial statements

The improvement in the bank's asset quality in recent years partly reflects 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 reflects the country's competitive economy and the banks' uninterrupted access to domestic funding. The economy has shown resilience despite extensive geopolitical challenges. For 2019F and 2020F, we project the economy to grow by 3.1% and 3.2% respectively, with inflation remaining low at around 0.7% in 2019F and 1.3% in 2020F. 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 domestic construction and real estate sectors accounting for around 18% 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. 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 15% of the bank's capital.

Modest capital buffers but these have improved and the bank maintains a stronger leverage ratio

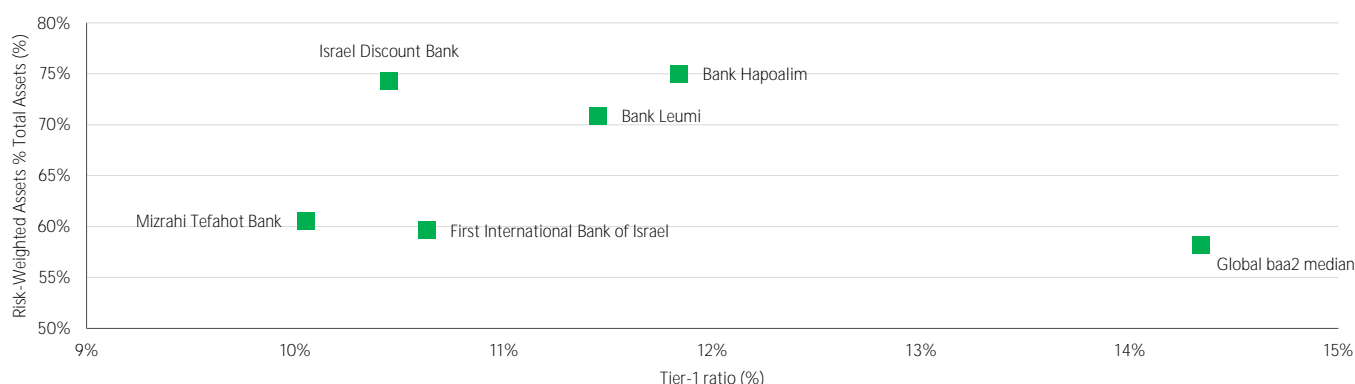
The bank has been building up its capital in recent quarters, and posted a Basel III-compliant Tier 1 ratio of 11.7% at end-September 2019 (Dec 2018: 11.1%), boosted by the completion of the sale of Leumi card. This is comfortably above the minimum regulatory requirement of 10.3%, but below similarly-rated 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 71% and its equity-to-assets ratio which stood at 7.7%, in line with similarly rated peers, with a (Basel III) leverage ratio of 7.4%.

The bank's capitalisation is sensitive to changes in interest rates that affect the future liabilities of its defined benefits pension scheme. According to the bank, this exposure is partly hedged and will gradually reduce in the next 10 to 15 years. 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.

Going forward, we expect Leumi's capital metrics to remain broadly stable. Accelerated credit growth as well as lower earnings retention will offset capital generation. Leumi increased its dividend payout ratio to around 40% (with a maximum payout of 50%) and recently completed a second NIS700 million share buy-back plan (equivalent to around 20% of the bank's 2018 earnings), bringing the effective earnings distribution to around 60% for 2019.

Exhibit 4

Bank Leumi's capitalisation against domestic and global peers



Note: Israeli banks as at end-September 2019

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

During 2019, the bank issued additional NIS1.4 billion of Tier 2 CoCos. The instruments have equity conversion features, a duration of 11 years (non-call six) 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%. The bank also exchanged legacy subordinated instruments with Basel III eligible instruments (for an amount of NIS1.2 billion) and further redeemed an additional NIS1.2 billion of non-eligible subordinated instruments.

Relatively high cost base translates to moderate profitability metrics; but a multi-year streamlining program is leading to an improvement in the bank's efficiency

Bank Leumi exhibits moderate profitability, weighed down by the low interest rate environment, the high tax rate and the bank's high cost base as explained below. For the first nine months of 2019, the bank reported bottom line profits of NIS2.81 billion, translating to a return on tangible assets of around 0.8%, boosted by the completion of the sale of Leumi card (which resulted in NIS314 million gains before tax).

Going forward, we expect the favourable operating environment in Israel (A1 positive) to support the bank's lending opportunities and revenues. However, profitability will be constrained by the sustained low interest rate environment (current interest rates at 0.25%), low inflation (which impacts the bank's CPI-linked assets) and increased provisioning charges as recoveries converge to more normalised levels. Pressure on fees will also continue due to various regulatory measures. While the forced disposal of Leumi card will weigh on the bank's fee income generation, we expect Leumi will remain active in the credit card segment, for example through operating agreements with other credit card companies, partially mitigating against the lost revenues.

Leumi reported operating expenses as a percentage of assets at 1.7% during 9M 2019, partly reflecting the banking sector's high unionisation and resultant high personnel costs, which are also negatively 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, leading to a gradual improvement of its efficiency metrics. Employee numbers have already reduced by around 300 during 2018 and 2,200 over the past four years, while under the bank's new early retirement plan, an additional 400 employees will retire by the end of 2019. Also, the bank recently announced the relocation of its headquarters away from the centre. As a result of the bank's streamlining efforts, cost-to-income ratio improved to 56.9% in 9M 2019 (excluding the gains related to the Leumi card sale) from 59.6% during the corresponding period a year earlier.

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-September 2019, the bank posted a loans-to-deposits ratio of 78%.

Liquid assets (cash, interbank assets and securities) accounted for approximately 32% of total assets. Bonds and subordinated notes stood at NIS20 billion (4.4% 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 broadly at the current levels. The strength of the bank's funding and liquidity position is also evident from its 121% Liquidity Coverage Ratio as of end-September 2019.

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, hence vulnerable to a loss in depositor confidence. Deposits of more than NIS100 million, which are generally non-retail, make up 28% of the total.

Environment, social and governance considerations

In line with our general view for the banking sector, Leumi has a low exposure to Environmental risks, see our [Environmental risks heatmap](#) for further information. Although Israel is exposed to environmental risk related to climate change, through rising temperatures, drought episodes and water scarcity, the authorities have taken a number of steps in order to assess the risks stemming from climate change, e.g. through its National Program for Adaptation to Climate Change adopted in July 2018.

Overall, we believe banks, including Leumi, face moderate social risks³. 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.

Governance is highly relevant for Leumi, 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. We do not currently have material concerns around Leumi's own governance, although we note the past investigation by the US authorities regarding allegations of assisting US customers to evade taxes, which was settled in 2014. Corporate governance remains a key credit consideration and requires ongoing monitoring.

Our approach to ESG is explained in more detail in our report on [The impact of environmental, social and governance risks on bank ratings](#) and our cross-sector methodology [General Principles for Assessing Environmental Social and Governance Risks](#).

Source of facts and figures cited in this report

Unless noted otherwise, we have sourced data relating to systemwide 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 9 August 2018.

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						
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	←→	baa2	Sector concentration	
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel III - transitional phase-in)	10.7%	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	5.6%	a1	←→	a2	Deposit quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	33.6%	a3	←→	a3	Stock of liquid assets	
Combined Liquidity Score		a2		a2		
Financial Profile				baa2		
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				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

[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
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

Endnotes

- [1](#) on annualized basis
- [2](#) As of June 2019
- [3](#) See our [Social risk heatmaps](#).

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